

## The Economy

The current recession, dating back to December 2007, continues to roll on. This April will mark month 17 of the official recession, making it the longest post-World War II downturn. There has been much talk comparing the current economy to the Great Depression. However, there are major differences. Unemployment reached 25% then, but it is now 8.5%. There were 25 bank failures in 2008 versus hundreds in the early 1930s. There was no bank deposit insurance in the 1930s. We have increased deposit insurance coverage from \$100,000 to \$250,000. The response of the U.S. government has also been completely different. It has injected massive amounts of liquidity into the market, as opposed to decreasing the money supply as it did at the onset of the Depression. Worldwide trade collapsed in the 1930s as countries engaged in tariff wars (remember Smoot-Hawley?). Today, there is much greater international cooperation.

Comparing the current economy to the early 1980s may also help put things in perspective. Some readers will remember the Misery Index that was popularized during that recession. This number represented the sum of the unemployment and inflation rates. The index reached 22% in June 1980. It was 8.3% in February. Yes, unemployment may go up from its current level, possibly into the 10-11% range, but we tend to forget that unemployment reached 10.8% in late 1982.

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Many of the economic indicators we follow, while still in deep recessionary mode, appear to have troughed and have begun to edge upward. Examples include the consumer confidence surveys, housing starts, and retail sales. Durable goods orders actually increased 3.4% in February. And, very importantly, inflation currently remains very tame.

## Fixed-Income Markets

The credit markets remain in a very unsettled state. While much improved from the near-panic levels seen in September and October of 2008, conditions have still not stabilized in various sectors of the market. U.S. Treasury and agency obligations yield very little as the “flight to quality” remains in effect. Corporate bond pricing reflects a significant distinction being made between financial debt and non-financial debt. Yield spreads have narrowed substantially for good quality non-financials. The bond market obviously predicts further issues for financials, as spreads remain very wide for the sector. Adding to the problem is the fact that financial company bonds constitute more than 40% of the entire corporate bond market.

The municipal bond market held up relatively well in 2008 and has continued to do reasonably well in 2009. That said, munis are quite attractive compared to treasury and agency bonds of similar maturity. Another factor favoring municipal bonds is the fact that tax rates will be going up for the typical muni investor.

Our strategy remains very defensive. It is not time to be buying poorer credits or to be extending maturities. We need more healing in the credit markets.

## Equity Markets

The numbers in the table below tell the story. After a horrendous 2008, stocks delivered more pain in the first quarter. Once again, there was no place to hide as foreign markets also retreated. From its high of 1,565.15 (on October 9, 2007) to the low of 676.53 (on March 9, 2009), the S&P 500 lost 56.7% of its value. Volatility remains very high as we have witnessed some sharp rallies within the ongoing bear market. From an interim low on November 20 there was a 24% jump into early January. The low reached on March 9 was followed by a 23% spike in just 13 trading days.

History tells us a couple of very important things about bear markets. First, bear markets end and new bull markets begin well before the economy emerges from recession. Second, the recovery from the market lows is not only substantial, but it is rapid. In the aftermath of the 12 worst bear markets since the 1920s, stocks returned an average of 46% in the ensuing 12 months. Now the tough question: Have we seen the trough yet? Do not be surprised to see a retest or two of the March 9 low.

A brief review of sector performance shows that financials continued to underperform the market. After being down 57% last year, they lost another 29.5% in the first quarter. Industrials were the next worst sector, down 21.8%. The only positive sector was technology which posted a positive 4% return.

Index	2008	1st Quarter 2009
S&P 500	-40.0%	-11.7%
DJIA	-38.0%	-13.3%
Nasdaq	-45.0%	-3.1%
Russell 2000	-39.0%	-15.4%

\*Reflects price changes only

## Outlook

When the first quarter 2009 GDP number is finalized, we look for it to be only slightly better than the fourth quarter's -6.3%. We anticipate something in the neighborhood of a negative 5-6%. With consumers pulling back, it is difficult for the economy to advance since consumer spending accounts for 65-70% of GDP. Increased personal savings is good in the long run, but in the short run it hurts the economy.

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As the year advances, trends may improve marginally. We need real estate prices to stabilize and then increase to see any real recovery. Falling real estate prices signaled the beginning of the downturn and rising prices are needed to pull us out of the recession. Much of the massive government stimulus is directed at fixing the real estate mess. The question is: When will it begin to help? At the earliest, we do not expect a positive GDP number until the fourth quarter of this year.

