# SARGENT BICKHAM LAGUDIS

*May 1, 2009*

# Market Commentary and Review

*"Nobody has been right three times."*

**SUMMARY:**

A year ago we thought we were 70% through the Bear market. We were wrong, but we should be a lot closer today.

There are many risks, but we are probably through the worst of the recession.

Fears of inflation are over blown.

Equities are likely to outperform government bonds and cash. Corporate and municipal bonds are favored over Treasuries.

How long will it take to reach the market highs of 2007?

## In This Letter



Dear Clients and Friends,

Last summer we began writing about the beginning of the end of the Bear Market. That was in July, and based on the average recessions and Bear Markets of the 20th Century there was reason to believe we were about 70% through. We were wrong. Like most economists and analysts, we did not foresee the credit meltdown triggered by the collapse of Lehman Brothers. There is no point in re-hashing the events, but now that almost a year has passed are we at the end? We believe the answer is yes and no. Yes, we are closer to the end of this bear market and recession, but we are not there yet.

As usual we start by summarizing returns for recent periods:

| | YTD thru 4/30/09 | Last 5 Yrs. Annualized Thru 4/30/09 |
|---|---|---|
| Large Cap (S&P 500) | -2.4% | -2.7% |
| Large Cap (Dow Jones Industrials) | -5.7% | -2.1% |
| Mid Cap (S&P 400) | +5.1% | +0.3% |
| Small Cap (S&P 600) | -1.9% | -0.2% |
| Nasdaq 100 | +15.5% | +0.2% |
| Foreign Stocks (EAFE) | -6.6% | +0.5% |
| Bonds (Barclays Aggregate) | -1.5% | +4.7% |
| Emerging Markets | +14.8% | +12.0% |
| REITs | -9.4% | -2.1% |
| High Yield Bonds | +6.6% | +1.5% |
| Commodities (AIG Index) | -5.3% | -2.8% |
| Alternative Assets Group (AAG) (11 Fund Avg.) | +2.5% | +8.3% |
| 65% Equity/ 35% Fixed-Benchmark | -1.4% | +0.2% |
| 50% Equity/ 50% Fixed-Benchmark | -1.0% | +1.3% |
| 35% Equity/ 65% Fixed-Benchmark | -0.5% | +2.4% |

** *Note: ETF returns are used for the indexes.*

The most intense phase of the economic and stock market downturns are likely behind us, and the odds are good that the recession will end this year. However, there are still many risks and uncertainties, and several factors suggesting the recovery will be muted.

While the government has been highly stimulative in their policies, and many people are talking about the inevitable rise in inflation due to the "government printing all that money", we do not believe inflation is a problem worth worrying about for the foreseeable future. Deflation is a more likely threat.

Banks still have problems. They have a trillion dollars or more of bad loans to write off, and nowhere near enough capital to cover them. The government will not have enough political will to inject the capital required. Toxic assets will have to be removed from balance sheets, and progress has been slow. There will be some banks that will need to be more or less nationalized, although they will make it sound like something else.

Equity markets have probably seen their lows, but future returns will likely resemble the economic recovery – modest. On the other hand, equity returns will probably exceed those from government bonds and cash.

The outlook for Treasury bonds is unattractive given the huge fiscal deficits and the eventual risk of inflation; but some corporate and municipal bonds are attractive.

In the near term, the dollar is still likely to benefit from worldwide risk aversion, but longer term the dollar is likely to fall. Gold and Treasury Inflation Protected Securities (TIPS) are good hedges against a falling dollar and rising inflation.

When global economic activity stabilizes, we think commodities and related businesses will do well. This may not be until 2010 or later, but investors are already looking forward to a recovery anticipating winners.

China will continue to be an important theme in investing. Their stimulus program has been more directly beneficial than ours according to some analysts.

The potential for health care reform has put a pall over the entire health care industry. It is too early to know what the changes will look like, but that has not stopped the market from speculating on the winners (few) and losers (many). In addition to pressures from government, the recession has also affected the sales of companies whose products are discretionary. We are told that orthopedic surgeries are down 20% or more locally, for example.

Real estate may not be declining at the same rate, but it is a long way from turning higher. Statistics are very untrustworthy right now. Inventory, sales, and values are skewed because there are many sellers who have taken their homes off of the market. They know they cannot sell. We are told that in the city and county of Boulder there are three to four hundred homes of $1 million or more on the market, and there have been maybe 15 sales in the city, and less than half a dozen in the county. Commercial real estate is only beginning to enter the credit crisis. Banks like JP Morgan are not making any new loans, and smaller banks cannot handle the re-financings needed. More bankruptcies and defaults are likely.

Consumer spending reached 70% of economic growth in 2007 and is likely to decline to 65% or less going forward. The personal savings rate fell to zero. Historically, it has averaged 6% to 10% and it is likely to increase back into that range. Due to the drop in wealth from real estate and the stock market, and the increase in unemployment, savings and investment will rise and spending will decrease. This is another reason to expect a slower economic recovery.

Finally, after a few missteps the new administration appears to have gained the confidence of the majority of the country. This is an important step in renewing optimism and economic recovery.

**Strategic Allocation Decisions**

We have been at our minimum equity weightings since the middle of 2008. We *have* been investing new money in stocks and equity mutual funds over the last several months, but with the market declines that did not result in increased allocations. We expect that as we go through 2009 and the early part of 2010 we will be increasing equity allocations back toward normal levels. It is too early to know when we would reach normal targets, and it is not our philosophy to be too aggressive, but we believe the direction has changed. While we expect periodic corrections, we are now as worried about missing a big move up as about moves down.

**U.S. Stocks**

Our model continues to show the market to be undervalued, although not as much as earlier this year. Earnings estimates for the S&P 500 range from $40 to $60 for 2009 due to bank write-offs (lower end after write-offs, higher end before them). We think the market is beginning to look through the write-downs, so we are using a middle of the road number of $50. At the current price of 873, the market P/E is 17.5 on 2009 earnings expectations of $50 and 14.5 on 2010 expectations of $60. You can see how this compares to history in the table below.

| Inflation | Average P/E |
|---|---|
| <2% | 23.5 |
| 2-3% | 19.7 |
| 3-4% | 17.6 |
| 4-5% | 14.8 |
| 5-6% | 13.1 |
| 6-7% | 9.5 |
| >7% | 8.5 |

Core inflation and the GDP price deflator are currently below 2%.

Everyone wants to know when the market will recover to its old highs. One answer would be to predict when earnings will reach their old highs. In 2007, annual S&P 500 earnings peaked at $95 – about double where they were at the market top of 2000. We now know some of those profits were false – built on too much leverage. But, at the 2007 market top the market was trading at only 16x earnings, whereas at the 2000 peak the market traded at 30x earnings. If earnings grow at their historical rate of 6%, it would take about 7 years to grow from $60 back to $90.

**Investment Grade Bonds**

Last year was a deceiving year in investment grade bonds. We use the Barclay's (formerly Lehman Brothers) Aggregate Bond Index as our proxy for this category. The problem last year was that there was a wide disparity between the Barclay's Agg. and almost all fixed income managers. This was due to the widely different returns between corporate bonds, municipal bonds, and government bonds. The Barclay's Agg. was up 5% last year, but the average bond fund / manager was down 7%.

This year the bond index has had a return of near zero, but the relative performance of last year has been reversed. More risky bonds have outperformed government bonds. We continue to see more opportunity in corporates and municipals than in government agencies or Treasuries.

**Alternative Assets Group**

This strategy has worked well this year. Like every investment strategy, it underperformed during last year's 4th quarter, but many of the positions have snapped back sharply. For example, the Goldman Sachs Emerging Markets Debt fund is up 12% this year. Corporate and high yield bonds have also been good performers. The Loomis Sayles Bond fund is up over 6% and high yield bonds are up even more. Commodities, including gold, have not shown strength this year. Gold is flat and the commodity index is down 5%.

**Model Equity**: *Every time we write a newsletter we get questions about why a client's portfolio differs from comments made here. The Model Equity Portfolio is a real account that we use to test our skills against the market and report our strategies and performance. However, because all our accounts are customized there will be stocks mentioned that will differ from individual portfolios.*

The model equity account is outperforming the market so far this year, ahead by about 2%. Success is coming more from stock selection rather than themes or sector differences. In fact, in the best performing sector for both us and the market, technology, we are suffering from being underweighted relative to the index. We also have been underweighted in financials, which hurt relative performance when the banks recovered from their lows in early March. Nevertheless, we have a number of stocks that are up over 20% this year such as Goldman Sachs, National Oilwell Varco, Schlumberger, Visa, and Apple.

Surprisingly, the worst performing sector has been consumer staples. We are somewhat at a loss to explain this, which is why we are not only holding our positions but consider this one of the most attractive areas for new investments. Great U.S. companies like Procter & Gamble, McDonalds, and Colgate-Palmolive are down over 10% this year. With attractive valuations, good dividends, and steady revenues we see these as attractive during this slow economy.

The other sector that has been weak is healthcare. This is one of the only sectors expected to have positive earnings growth this year. We can, however, understand the market's concerns for this sector; and it is due to the fear of healthcare reform. We are taking a look at our holdings one by one in an attempt to anticipate how they might be affected. New investments have been concentrated in areas we do not expect to be affected. For example, syringes, catheters, and blood pumps are necessities for hospitals.

**Foreign Equities and Fixed Income**

Europe is having the same problems as the U.S. with their financial system, and has the added burden of no central government. Some would say the Euro has survived a major test thus far. There were many who thought the Euro would collapse as one country after another dropped it as their currency so they could pursue more expansive monetary policies.

We think the U.S. is likely to be the first country to begin recovering from the recession because it has been more aggressive in government stimulus. As one example, U.S. GDP is expected to fall 2% - 3% this year. Germany, the world's leading export country, is expected to fall 4% - 6%. Likewise, Japan is expected to contract by 6% this year.

Asia, and China in particular, is likely to continue growing faster than the rest of the world. There are reports that their stimulus plan is working faster and better than ours. Emerging markets investments have been the best performers this year, and while there will be volatility in these investments it is too important to this sector. We expect to continue increasing allocations to emerging markets through both equity and fixed income investments.

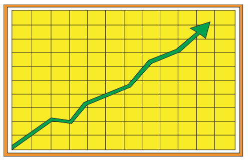
**Company News**

With all the volatility in the markets over the last year, we are very happy to have had stability in-house. We have had no changes to our team over the past two years, which we are quite proud of. We have received no TARP, TALF, PPIP, or any other government assistance; and we have no write downs due to bad loans. We are not merging with another bank, brokerage firm, etc., etc. In other words, this financial crisis has proven the success of our business model. In every downturn we have had more clients at the end of a bear market than at the beginning, and this will be no exception.

We are happy to announce a new custodial relationship with Fidelity. We now have custodial relationships with Schwab, Fidelity, and TD Ameritrade. Some clients have 401k's or other accounts at Fidelity and we can now connect these to our portfolio accounting system providing consolidated reports and seamless management. If you have Fidelity accounts and want to learn more give us a call.

We are now in our third decade of providing financial services to clients in Boulder and beyond. We thank those of you who provided names of people for us to contact and remind the rest of you we have received all our clients through referrals, and would be proud to help your friends, family, or associates. Like all businesses it is important for us to continue to grow so we can keep adding the resources to provide you the best possible service and performance. If you know of anyone who might be interested in our services, or simply receive our newsletter, please have them give us a call or check us out at: **www.sargentbickham.com**

*Many happy returns,*



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