

INSIGHTS ON FRONT STREET



BY JOHN W. GUDRITZ, CFA
FRONT STREET INVESTMENT MANAGEMENT LLC

SEARCHING FOR SIGNS OF A MARKET BOTTOM

MARCH 2009

With the S&P 500 Index down 11% in February, off a little over 20% year-to-date in 2009 and over 50% lower than its 2007 peak, investors are wondering if we are near the bottom of this horrendous bear market. Based on historical valuation lows of prior secular bear markets we could see another 20% to 30% decline from current levels. But it is also possible that the market is now in the bottoming process and will be higher by the end of the year. Having protected our clients' portfolios through most of the devastation over the past year, we know our next big decision is when to get our clients back into the market. We are keeping a close eye on the economy and the market in search of signs of a market bottom.

The recent economic news is getting scary and the stock market is reflecting it as it falls to new lows. We just found out that the economy fell at an annual rate of 6.2% in the fourth quarter of 2008, which was the worst decline since the first quarter of 1982.

Consumer spending, which makes up 70% of our economy, plunged over 9% at an annualized rate during the quarter and it is probably not going to improve anytime soon. Companies are laying-off workers in record numbers and consumer confidence is at all time lows.

We are getting to the end of the fourth quarter earnings announcements for corporate America and they weren't pretty. Earnings for companies in the S&P 500 Index were down 70% from the prior year. Earnings estimates for 2009 are being slashed and as earnings fall, so do dividends.

A total of 288 companies in the U.S. cut or suspended their dividend payouts in the fourth

quarter. That was a record amount in the last 54 years, when Standard & Poor's started keeping records. So far in 2009 27 companies in the S&P 500 Index have decreased or eliminated their dividends. S&P data shows that dividends paid to U.S. investors could be down a total of 23% this year, the largest decline since 1938.

The bad news is not just in the United States. Many European countries are in worse shape. Some countries in Eastern Europe are going to have to be bailed out like Iceland was and for similar reasons. Even China and India are seeing their growth rates quickly deteriorate.

All in all, this recession is expected to be the worst since the one in 1973 to 1975 and the recovery is expected to be slow. The word "depression" is actually being used. Life as we have known it over the past 20 years has changed as we have discussed in prior newsletters. Households and companies will be more focused on repairing their respective

balance sheets and feeling more financially secure about their future. Spending money on more stuff won't provide the same emotional kick that it used to.

The good news about all of this bad news is that the bad news is already known and is being discounted in the stock market. We have been concerned that investors did not understand the serious ramifications of the banking crises, falling asset prices, and the deleveraging process. We think the market gets it now and prices are *beginning* to finally reflect it.

As I said at the start, we still see a possible 20% to 30% downside risk to the market so we are maintaining a defensive or protective mode. However, we understand that the massive \$787 billion economic stimulus program and deficit spending in the trillions of dollars will have a positive effect on the economy and the stock market will anticipate that recovery. It is smart to be looking for signs for a stock market bottom.

The stock market normally recovers about six months before the economy does. Therefore, it is likely we will be increasing our clients' exposure to the stock market when the economy still looks and feels bad. The market will rally on news that is "less bad" than what we had seen before or had expected.

Some of the economic indicators and data that we are keeping a close eye on include the Institute of Supply Management (ISM) Manufacturing Index, the Conference Board's Leading Economic Indicators (LEI) and the LEI diffusion index, and housing prices. We are also watching the financial markets particularly the yield spreads on corporate bonds over U.S. Treasury bonds and the internal indicators of the stock market like the number of advancing stocks in relation to the number declining along with the volume of each.

It is interesting to note that the ISM Manufacturing Index has actually been *less bad* over the last three months. It shows that the economy is contracting at a slightly slower pace.

The LEI was also less bad for the second consecutive month in January. While the expanding money supply has been the major factor for the improvement there have also been an increasing number of the 10 economic inputs that are contributing to the indicator's upturn.

Housing prices are still falling but the inventory of homes on the market is declining. Consumer spending was up in January for the first time in seven months. Credit spreads on corporate bonds are still wide but not quite as wide as they were last November. Lastly, the number of stocks hitting 12 month lows is much less than the number we saw at the market low last November.

Despite the fact that short-term interest rates are near zero with the money supply expanding and that trillions of dollars in government spending will be unleashed into the economy, we still see a very fragile economy that will need years to recover once the recession is over. For that reason, we continue to be very cautious. We want to see some additional verification that these "less bad" economic numbers are actually pointing to the end of this recession before we venture back into the market in a significant way.



FRONT STREET
INVESTMENT MANAGEMENT