Lassus Wherley ...a view from the top

Building Better Futures

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Not Again!

Is There Really Still Hope???

There are many words to describe what we all felt Monday as the financial markets once again moved to lower levels but most of them are not printable in this newsletter. I decided to do another newsletter right behind the one I just did because of the awful week and a day we just had and the ending of another depressing month in the financial markets. The other reason is the many great discussions I've had with clients in meetings, emails and telephone conversations this past week. I am drafting this newsletter a little differently, i.e. I am adding questions that we are asking ourselves, as we analyze where this economy and market are headed, as well as the questions that clients are asking.

Obviously, no one is reporting much good news out there right now. Dr. Doom has been front and center in all the headlines for the last week. Some negative comments have been centered on companies' earnings which have certainly been lower based on the current environment, some have been around President Obama's proposed budget which is certainly a very large number, and some have been discussions of the "lack" of definitive action on dealing with toxic assets on bank balance sheets.

I don't support everything in the budget but I do believe that some of the programs like healthcare reform are needed. I don't know what the overall impact will be at this point but we are currently paying for healthcare for everyone already but we are paying for it in a different way. Today, anyone who doesn't have health insurance doesn't get any level of preventative care. What they do is go to the emergency room when they have no other option and they must be taken care of there. So…….we are paying those costs already. Wouldn't it be more effective to invest in preventative care rather than emergency room care? I have had this discussion with many of you and some of you agree and some don't but I think continued discussion is very healthy and productive for all of us. So, I don't know if I will really like the final plan or not but I respect the courage it takes to try to move forward to fix a real problem.

Then there's the tax increase. Like everyone else, I am certainly not a fan of increased taxes but there aren't many ways to pay for things in this country and I'm not sure how we solve some of these problems without taxes increasing for some of us at some level. I would prefer another option but we will see what ends up coming out of Congress on this one.

I am concerned that President Obama is trying to fix everything at once and not focusing enough energy and money on the economy. As a small business owner, I don't believe he is paying enough attention to the fact that small business has been driving the economy for the last twenty years and will continue to be an important part of kick-starting the economy this time around. I have not seen enough in the current budget to show support for this sector of the economy. Hopefully, when the dust settles and the budget is approved there will be more attention to the needs and opportunities related to small businesses. I have seen some possible help for small businesses with the TALF that has been established this week.

Perspectives on When The Recession Will End

There are many views on when we will begin to come out of this recession and here are some of these perspectives:

The first few quotes are from *New York Times Sunday Opinion, Sunday, March 1, 2009.*

James Grant, the editor of Grant's Interest Rate Observer, and the author, most recently, of "Mr. Market Miscalculates," "....Today's low prices, painful though they may be, are the market's own shovel-ready stimulus. Before you know it, the stock market, and the residential real-estate market, too, will be on their way back up again—just don't ask when."

Eric Schmidt, the chairman and chief executive of Google, "..And the good news is that Congress and the President are pressing ahead in the knowledge that to stand still is no solution at all. The result, I hope, will be that by the late summer our economy will start to show signs of life, with a slowing rate of economic contraction and small but noticeable upticks in areas like auto sales and real estate. By the end of the year, we may see some growth, with gains in employment to follow a few months later.."

Marcelle Chavet, an associate professor of economics at the University of California at Riverdale, and Kevin A. Hassett, the director of economic policy studies at the American Enterprise Institute, "....Many of the key indicators look similar to what we've seen before. The decline in employment is above average for past recessions, but smaller than in the down-turns of 1960-61 and 1981-82. Industrial production and manufacturing and trade sales have also slowed more than average, but not nearly as much as during the 1973-75 recession, when they declined by 14 percent. And the drop in personal income has been below the average of previous recessions, and even trended up in the last quarter of 2008. So the history books give us cause for hope. "

Irwin Kellner is chief economist for MarketWatch and Distinguished Scholar of Economics at Dowling College in Scarsdale, NY, "Prosperity may not be just around the corner, but statistical evidence is mounting to suggest that the worst of this recession may soon be past. ……..If you want a policy to credit, it's monetary policy. The combination of liquidity that the Federal Reserve has pumped into the economy, along with its special lending programs and capital injections into the banks, is largely responsible." The following are some of the statistics Irwin cites: "1) The Conference Board's index of leading economic indicators has risen for two months in a row. 2) Producer prices have increased for two straight months. 3) Existing home sales have gone up. 4) Builder's confidence edged up this month. 5) Real hourly earnings rose 4.5% in December following a 3.3% increase in November. 6) The decline in consumer credit moderated in the latest month. 7) New orders for consumer and nonmilitary goods went up in January. 7) The money supply is soaring, a sign that there's plenty of liquidity in the economy. 8) The 3-month London Interbank offered rate, a measure of banks' willingness to lend to each other, has dropped to 1.2% from close to 5% a number of weeks ago. 9) The corporate-bond markets are thawing out, too; some $127 billion in dollar-denominated debt was issued in January, the most for any month since last May." Kellner goes on to state that … "the economy is still a long way from a pink-cheeked state of health. But remember, you've got to crawl before you can walk. And it looks like the economy is about to do just that."

Are We There Yet?

It certainly didn't look like the economy was getting close to the end of this recession in Monday's market, but the reality is that sometimes this market acts like a very spoiled child. Obviously, the news was not what the market was looking for in several cases. The first was AIG and how much more money the company will require, and the second "excuse" was the comment that Warren Buffett made concerning the markets remaining in chaos for the rest of 2009. What is happening right now is that people are selling, but it is not huge volume selling. The issue is really that many folks including Lassus Wherley are sitting with a lot of cash that isn't buying at this stage. It isn't because the dollars aren't available but because we are all waiting for more stability to return and a "sign" that this market is moving based on fundamental value and not on "whim." So we aren't there yet but we are certainly close.

To answer the question I got from a client this morning….no it isn't the end of the world as we know it. Yes, it has been the worst recession in our lifetime and it has certainly been the worst market. But we know that the economy will rebound and the markets will recover. This market will probably not recover as quickly as it recovered in 2003 based on current data. However, we still expect it to recover within a two to three year time frame.

Here are some of the representative returns for the year as of 3/2/2009:

US Large Cap	- 20.66%
US Small Cap	- 24.10%
Intl Large Cap	- 23.16%
Europe	- 21.68%
Global Real Estate	- 23.55%
Short-Term Bonds	.28%
Inter-Term Bonds	- .89%
High Yield Bonds	1.43%
Emerging Markets	- 17.33%
Muni Nat'l Inter	3.39%
Long Government	- 10.13%

Source: Morningstar Fund Category Returns.

Here are some of our core funds and how they have performed year-to-date.

Harbor Bond	- 1.68%
Vanguard Short Term Corp	1.72%
Vanguard Interm Tax Exempt	3.10%
Vanguard Ltd Term Tax Exempt	1.42%
Hussman Strategic Growth	1.96%
EAS: Genesis I	- 4.04%
Vanguard Div Growth	- 18.32%

There are many unknowns in our discussions today and some of them are covered in the questions we answer below. Many may not be be answered for several months.

Question: *If the S&P 500 drops another 20% what would that do to my account?* **Answer:** It depends on the percentage of equity funds you currently hold in your overall portfolio. If you have 50% in equity then the worst case would be a 10% loss assuming all other asset classes stayed basically flat. If you have 40% in equity - that would equal an 8% loss. If you have 30% in equity - that would equal a 6% loss. If you have 20% in equity - that would equal a 4% loss. That is why we continue to maintain broad diversification so that there is some protection in other asset classes including cash. I know that losing money at any level is painful and we continue to look for better ways to manage risk.

Question: *Since we have become much more defensive how do we know when it is time to move dollars back into the equity funds?* **Answer:** That is the question we are spending a lot of time discussing right now. We are looking for stability, like seeing the big late day moves disappear and watching the trading get a lot more boring. There isn't any specific indicator that will tell us the right time. As we see **TALF (**Term Asset-Backed Securities Loan Facility) and other programs unwind and the credit system continue to heal, we will make a decision on a week by week basis on what we need to do. That decision right now is to remain defensive. We will let you know when that position changes.

Question: *Do you really believe we are close to starting a recovery or are you saying that to make us feel better?* **Answer:** Yes. I do believe we are close to stopping the downward movement of the markets and the economy. There are many moving parts and there is always room for another one of those shoes to drop from that problem centipede but we have experienced many of the end-of-the-world scenarios already. It doesn't take much to start a rally and we could see a reasonable one in the near future.

Question: *When will the stimulus begin to have a positive impact on the economy and will it be enough?* **Answer:** Different parts of the stimulus package will kick in at different times over the next three years. The economy will recover with or without the stimulus plan but the stimulus and things like **TALF ???** will help move it forward more quickly. We expect to begin seeing the impact sometime later this year.

Question: *Where will unemployment peak and when?* **Answer:** We don't expect unemployment to peak for at least 12 months well after the economy has turned and it will probably hit double digits before it begins to come back down. The more important part of this equation is starting to see more new job creation from the stimulus.

Question: *When will we be able to stop putting money into the big banks?* **Answer:** That is a very tough question. If it were up to me it would be done differently. I would have begun purchasing the toxic mortgage backed securities last year and set up a separate organization to begin the process of marketing these securities. I think that not taking action quickly on this issue is costing us much more than it should. I would also basically shut down Citigroup and spin off the pieces to bring it down to a manageable level while backstopping depositors with the full faith and credit of the US Government. I believe the current administration needs to be more decisive in this area and less willing to prop up all the banks. There are some truly difficult decisions that need to be made before we can move on.

Question: *When will consumers begin to spend again?* **Answer:** Actually, the January numbers show that consumer spending has already picked up. The open question is will it continue. We know that consumers are saving at a much higher rate and spending less. That means that at some point pent up demand will seek a release. We also know that the average life of cars owned today is 9.5 years. All of those things point to consumer spending starting even if it is at a slower rate.

Question: *What are we going to do about the car companies?* **Answer:** I hope we are going to end up with one company. I think Chrysler's management will have to figure it out for themselves. I would expect Ford and GM to end up as one company with a lot of downsizing required. As painful as it may be, the only thing that makes sense is to do a controlled downsize to bring them back to a profitable operating level. The worst case here would be that the US government continues to provide funding without an end game objective. I would not expect to see that as an outcome. And yes...there will be negative impact on small business as a result of the downsizing.

Question: *Is commercial real estate on the brink of a major collapse based on retail struggling so much?* **Answer:** Commercial real estate is probably going to continue to feel pain as long as retail businesses are suffering. The biggest risk is cash flow because they have a hard time finding refinancing at a reasonable price. One of the solutions to assist Real Estate Investment Trusts (REITs) with cash needs is the issuance of stock dividends vs. paying out cash dividends. This is certainly no benefit for shareholders in the short-term but it is a pretty good solution to give the REITs breathing space on raising money and it is a very cost effective way to finance their short term needs. The healthier REITs are already taking advantage of this. We will probably see valuations continue to come down for the next 12 months or so.

Question: *What are we going to do about the toxic assets that are still on the books of many banks and pension funds?* **Answer:** Secretary of the Treasury Geithner has many choices here but can't seem to make up his mind. My recommendation has been to establish a third party trading mechanism that operates like our futures exchange or options exchange to establish market values. Once you have a "real" market value you know exactly where you stand in terms of the need for capital for most of the banks. The current uncertainty is driving much of the volatility of the financial markets these days. As I have stated before, there is nothing worse than facing the unknown. The markets really hate that uncertainty. I did see that TALF or Term Asset-Backed Securities Loan Facility is finally being rolled out so hopefully that will help move some of these assets back into the mainstream. That's a very long discussion for the next newsletter.

Question: *When is residential real estate going to begin to move in a positive direction?* **Answer:** We are beginning to see the current inventory of previously owned homes move in the right direction. This certainly doesn't mean the world is going to be fixed overnight but if buyers are able to get financing that is a really good sign for the state of the real estate markets. Obviously it is going to take a long time to work through the inventory but it is turning out to be a great opportunity for those who could not previously afford to buy a home. That is a good start to resolving the problem.

Question: *Is credit card debt the next shoe to drop for banks?* **Answer:** There is an increase in defaults on credit card debt. Some of it is a self-fulfilling prophecy on the part of the credit card companies. When they believe there is an increasing risk of default they have the ability to raise interest rates on your credit card. Guess what? If you are already having a hard time paying your credit card bills and someone raises your interest rate, it might make it a bit more difficult to pay them. I have never understood the logic behind the companies' policies in this area. So I would expect that defaults will increase before the pain is over.

Question: *Is credit beginning to loosen up for small business and individuals looking for a mortgage or credit line?* **Answer:** Loans are being made at the local level through community banks and through regional banks. The issue really revolves around the larger banks. It is frustrating to see so much money being invested in Citigroup when they really aren't moving money back to businesses to help the economy. I know they employ a lot of people and that is a good thing in this environment, but we really need to increase the dollars going to small business to kick-start this economy. Small business has been the primary driver of growth for many years and will be the key to moving this economy forward in the future.

Question: *What is the worst case that you see today and how would that impact investment portfolios?* **Answer:** As I was watching the markets go south yesterday, I was thinking about how to answer this question. My answer today is slightly different than my answer would have been two weeks ago. I think the worst case today is that President Obama tries to do everything at once and the financial markets don't get enough detail on anything quickly enough to digest it. This could keep these markets depressed for longer than fundamental reasons would.

Much Food for Thought

We will continue to face many challenges in 2009 BUT the reality is that the economy **will** rebound, probably more slowly than we would like. We also know the markets will rebound but the pain we have felt in these new lows will take a long time to erase. We will continue to stay more defensive with our allocations until we are convinced that there is a higher level of stability in the financial system and that the markets are functioning with investors and not traders. It means we will hold higher levels of cash and bonds and increased hedge strategies funds to balance the risk of the equity markets. This means different things for different clients in terms of how much cash we raise or how much we reduce the equity exposure. We will also continue to edge dollars into various markets **when** we believe it makes sense.

Keep those questions coming in. If you are wondering about something, the odds are pretty good someone else may also be thinking about the same topic. When you ask—we get the chance to share our thoughts on the topic with others.

For those who have asked if you can forward our newsletters to others who are worried, please feel free. We also keep them on our website if you would like to refer someone to it at **www.lassuswherley.com**.

Please let us know if you have any questions or concerns. We are definitely looking forward to the recovery in the economy and the markets. Hopefully sooner rather than later.

Diahann

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