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## **Financial Market Commentary 2<sup>nd</sup> Quarter 2009**

### **Summary**

**July 21, 2009**

The Dow Jones Industrial Average declined from just under 13000 in August 2008 to 8600 by the middle of December on the fear (and realization) that the U.S. economy was going into a significant recession. It fell further, to 6500 in early March, on fears we were headed into a new Depression. Fortunately, those fears have not come to pass. The sense of relief felt by investors that the economy had come back from the brink led to a very nice recovery last quarter. Stock gains were especially strong in those areas that were the most affected by Depression fears – energy, materials, financial services, and travel & leisure. Investors tended to trade out of safer, dividend-paying stocks now that the worst of the crisis has apparently passed. I say apparently because the economy is still shedding jobs, credit delinquency rates are still climbing, and housing prices are still falling –just not as fast as before.

U.S. stocks gained 15.9% last quarter as measured by the S&P 500 Index. That pushed the year to date return into positive territory (3.2%). Small and international stocks were even stronger. The Russell 2000 small cap stock index rose 20.7% and the MS EAFE foreign stock index rose 25.4%. The big story was the huge effort that China made to stimulate its economy. Global investors bid up energy and materials prices on anticipated Chinese industrial demand. Emerging markets stocks were the best performers with a gain of 34.7%. Note that these gains were coming off a very low base. Each of those sectors is down more than 25% over the last twelve months.

The preference for return over safety also permeated the bond market. Corporate bonds are riskier than government bonds but they yield more, so last quarter investors got higher yields plus appreciation if they moved from government bonds to corporate bonds. In fact, longer term government bonds lost money during the quarter because investors worried about the potential for higher inflation next year and beyond because of all of the government borrowing. Overall bonds gained 1.8%, but there was a big difference between the winners (high yield bonds, up almost 23%) and the loser (long-term government bonds, down - 11.6%)

## Activity

The biggest contribution toward our success last quarter was the moves we made back in March. They reduced the risk levels in portfolios but still gave us a chance to participate if the market rallied. In the Balanced portfolios we benefited from three of the stocks we added last October -- Leucadia National and the two Teekay shipping companies. The rally in energy and materials prices really helped those companies. Other than that, we were fairly defensive in stocks because we don't believe the economy is out of the woods yet. We chose to be more "aggressive" in the bond part of the portfolio because corporate bonds fell to levels that offered stock-like returns without the risk of stocks.

Bottom line, we made some adjustments during the quarter but we are still defensively positioned. The magnitude of the decline last fall caught us by surprise. We made significant changes, which allowed us to lose a lot less during the first quarter. We didn't make as much as we might have during the rebound last quarter, but that was a conscious trade-off. *We are absolutely not going to let what happened last year happen again.*

With this in mind and the Dow Jones nearing the 9,000 level, a level that capped the rally attempts in early November and late December 2008, we want to make sure we don't give back a large percentage of the ground gained over the last five months. Therefore, we have decided to add a position that will make your portfolio as a whole more defensive. The position is the Federated Prudent Bear Fund (BEARX). It combines a short (bearish) position in stocks and with long (bullish) positions in gold. We have used this fund in our most conservative portfolios to hedge a small part of the long stock mutual fund position. Because it was a small part, it hedged only a modest part of the portfolio and we were able to participate in the stock market rally since March to the extent of your risk tolerance. By adding (increasing) the position in BEARX, we are reducing upside potential and downside potential in the portfolio. The holding will be more effective if the market decline that we are guarding against is accompanied by rising inflation instead of falling inflation. However, because the part of the fund is invested in gold this would also be of benefit.

## Performance

Our CSFC Portfolios have performed quite well this year particularly given the difficult stock market environment. As you know we created substantially new portfolios last October and more definitively during the first quarter of this year which have served our clients well. The CSFC "Benchmark" Balanced Portfolio, now *The Balanced Income Portfolio* returned 11.89% in the second quarter and is up 7.06% for the year to date. To provide a better sense of our performance Vs the major indices please see the following chart. While most of our clients' portfolios performed similarly to these models it was dependent on when we made the actual changes to the new portfolios and as a result your portfolios performance may vary.

## Outlook

After the rally last quarter the stock market is back to being priced for a modest recession. As long as that describes the current condition, prices will probably stay in a trading range close to where we are. Prices could break out to the upside if investors believed that the economy would soon begin growing again. However, if the time it takes for the economy to recover is longer than investors expect, perhaps a third to a half of the gains from March to June may be given back. Expect a tug-of-war this summer with no clear cut direction.

Economic growth depends on more than just how much money is circulating; it also depends on how fast that money circulates. Since the financial crisis started, the velocity of money has slowed down considerably. If the banks cannot re-establish their lending and securitizing functions, the next economic expansion could prove fairly disappointing. This is why our current investment strategy is not so much in anticipation of the next bull market as for the present recessionary environment.

## Commentary – The Stock Market is a Battlefield

Sometimes the market can seem like a battlefield, where the forces of greed (bulls) and fear (bears) are constantly attacking and retreating. Unlike a real battlefield, where soldiers almost never switch sides, bulls and bears do so frequently. After all, every buyer has to sell at some point, and every short sale eventually has to be bought back. The reason for this comparison is that a portfolio strategist has to have some of the skills of a military commander. They have to see the whole battlefield and know when to attack, when to fall back, when to press an advantage and when to consolidate gains.

Think back to the U.S. Civil War. The North had the advantage of more troops and resources (food and ammunition). On the other hand, the South was usually fighting on its home soil. That meant it knew the terrain but more importantly, it meant that it already held the land the two sides were fighting over. In order for the North to win it had to beat the South and take its land. The South only had to hold its ground and eventually support for the war in the North would dry up. Knowing their respective advantages, each general had a different strategy. Union General Ulysses S. Grant could accept a 1-1 casualty ratio so he engaged in battle wherever he could. Confederate General Robert E. Lee could not afford to fight to a tie, so he did battle only when he believed he had the advantage.

As investors we also have to survey the “battlefield” as it were and determine how we are to proceed. We have to assess both our own situation (return objective, time horizon, tolerance for loss) and that of the market to determine how much market risk we are willing to accept. Are conditions in the economy favorable? Are prices fair relative to the risk of loss and the opportunity to gain?

As we see it, there is a lot of opportunity right now but also a considerable amount of risk. While stock prices are still more than 25% below the levels of one year ago and more than 35% below their all-time highs, we are facing an economic environment more challenging than any we have faced since the 1930s. Can we avoid a Japanese style-deflation? Do our rising deficits doom us to hyper-inflation? Right now we believe the answer to both questions is “no”, but we aren’t going to risk all of our “troops” on that belief.

For most people therefore, we are going to approach the market more like General Lee (in other words, choose our battles carefully). There is nothing wrong with the “Grant” approach if you believe you are in a bull market and therefore most of the risks you take in stocks are going to be rewarded. If stocks begin to move in an area that has modest risk, say consumer staples, we can take some chances there. In volatile areas like energy, technology, and emerging markets we are only going to overweight those areas if they go out of favor and prices get cheap. Our primary objective is to first protect your assets and then with appropriate risk grow your portfolio. In a bull market growth is best achieved by a good offense. *In times like these, however, a good defense is more important.*

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