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Financial Market Commentary 3rd Quarter 2009

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Summary

Stocks continued an impressive rally off their March lows, gaining an additional 15.6%¹ last quarter. Investor sentiment improved over the summer as concrete signs emerged that the recession was easing. Low interest rates and an improving economy are the classic conditions for a stock market rally². At the beginning of the year the economy looked wretched and investors punished the stock market accordingly. The firms least likely to survive got hit the worst. The government came in with subsidies and the Federal Reserve (Fed) kept credit cheap and eventually the investors saw that the worst case scenario would not come to pass. While the economy is still losing jobs, the losses are nowhere near the levels of nine months ago.

To a large extent, the companies that were priced for failure had the most to gain. Many of these companies are small and mid-size. Mid-size companies led the rally during the quarter with a 20.0%³ gain. Small company stocks gained 19.3%⁴ on average. By contrast, the largest, most stable companies rose just 14.3%⁵. Overseas the gains were greater because the positive change in profit expectations were greater (many foreign countries are already out of recession). In addition, U.S. investors were aided by currency gains. Technology performed well last quarter as investors focused on the need for businesses to invest in technology to improve productivity in a difficult economy. Real estate also posted strong gains, but it was another case of investors speculating on improvement before any real evidence is apparent. The weakest sector was utilities, which is traditionally a defensive sector. Last quarter investors were anything but defensive.

Perhaps the biggest surprise of the quarter was how well bonds performed. While many expressed fears about a resurgence of inflation, the bond market was more concerned about *de*-flation. Government bonds gained (about 2%) because the economy stayed weak enough to force the Federal Reserve to assure everyone that easy credit would continue for the foreseeable future. Corporate bonds rose (more

¹ S&P 500 total return, per Morningstar

² It is important to note that stocks move in *anticipation* of a change in corporate profits. By the time it is clear that the economy has turned the corner, savvy investors have already gotten in. The biggest rewards come to those who see the turn first; because they take the risk that the dawn is a false one.

³ S&P 400 total return, per Morningstar

⁴ S&P 600 total return, Morningstar

⁵ S&P 100 total return, Morningstar

than 8%)⁶ because investors gauged the risk of default to be considerably less than they previously thought. Moreover, a great deal of the cash the Fed was providing to banks was not being lent out but was instead used by the banks to speculate in the bond market. That is why we have been so high on bonds this year. It is not often that you can get stock-like returns with bond-like risk. There really wasn't any part of the bond market that didn't gain. Just like in the stock market it was a case of more risk, more return. High yield corporate bonds led the way with a 14.2%⁷ gain.

Activity

We are very pleased with our performance this year as we know you will be. For all of clients we significantly reduced the risk in your portfolios approximately one year ago due to our concerns about the economy. We explained that we were willing to accept lower returns in exchange for taking less risk. As it happened, we hardly gave up any return at all! We reserved our risk-taking this past year to a small percentage of your portfolios in specific stocks that we had a high degree of confidence in. That strategy worked out better than we could have expected. Gains in our stocks enabled us to post very strong quarterly results even though the majority of each portfolio was invested quite conservatively.

For our more aggressive investors we increased the weighting in international equity mutual funds due to the combination of deficit spending here and faster growth abroad which made it a near certainty that the dollar would decline. In adding to bonds and international stocks, we drew down cash (money markets) from your portfolios to the lowest level since early 2007.

It is important for our clients to note that we have not changed our primary investment strategy of capital preservation first with lower risk and growth a secondary but still important component of our investment management strategies on your behalf.

Given the magnitude of the stock rally it became difficult to resist the urge to take profits. By September the stock market had achieved our target for the year, but because the Fed has created an unprecedented amount of money to fight the deflationary effects of the downturn we concluded that the stock rally could go even higher. Excess liquidity feeds bull markets but it is both an opportunity and a concern; the Fed has to drain liquidity at some point unless it wants to have a big inflation problem or another asset bubble on its hands. We are beginning to take profits as the Dow Jones Industrial Average has topped 10,000.

Outlook

Bonds were clearly the low hanging fruit going into 2009. Basically, corporate bonds have given investors more than an average year's worth of return over the last four months which will not continue indefinitely. At some point bond prices

⁶ Barclays Capital (both Government and Corporate), per Morningstar

⁷ Barclays Capital US High Yield, Morningstar

will fall because the Fed's effort to stimulate the economy will have been successful. We will have to shift money that is now in bonds either into stocks or into cash. Stocks are more appealing short term because of favorable liquidity and momentum, but they are over-valued unless we are going to see a strong cyclical recovery in earnings. Businesses that sell to other businesses might in fact do quite well, but we cannot imagine that businesses that sell to consumers will. Unemployment is too high and consumer balance sheets are too stretched.

Money market funds yield next to nothing right now, which is part of the reason bonds have done so well this past summer and why it is hard to be bearish on stocks right now. However, the "yield" argument only goes so far. If the economy stalls and stocks head lower again, the 0.1% money market yield will suddenly look attractive again. Since stocks have bounced back a long way in a short time, a market corrections of down 5 to 10% could take place at any time. That is the risk you always take as a stock investor. What we try to avoid are the serious downturns like last year. We do not see that as a possibility right now, but we continue to invest your money in a way that would give you greater protection even if that did happen.

At some point stocks are going to do poorly again. How poorly probably depends on how far up they go in the short run. The higher prices go the more risk you have – a fact many investors forget. Because of the speed at which markets move these days, we have to try to be early. This means we will almost certainly be underweighted in stocks at the peak of the rally. Our timing is never going to be perfect, so we are always going to err on the side of caution.

Investing in the (Unfortunately) Old Normal

Pacific Investment Management Company (PIMCO), the world's largest managers of bonds, has coined the term "New Normal" to emphasize the fact that we will have an economic recovery, but it will be far less robust than the recent economic expansions (1993-99 and 2003-07). Unemployment is 9.8% (measured by the Labor Department's *most optimistic* series). This is much higher than the peaks of the previous recessions, so the consumer spending contribution to the recovery is probably going to be subdued. Hallmarks of the New Normal include a higher savings rate and lower economic growth throughout the cycle, and a much less robust hiring cycle once the economy turns. Interest rates may be held down in the short term, but eventually the size of the debt will be a problem as the amount of money required to service the debt will put upward pressure on interest rates. So if this comes to pass, what are the implications for investors?

That is almost impossible to answer. The truth is that investment performance and economic performance have become less linked over the past two decades. The main reason for this is monetary policy. While the economy tends to be fairly stable over time, investment returns have swung wildly. Stock prices actually correlate much better to the Fed monetary policy (in other words, the Fed's efforts

to expand or contract the economy) than to growth in the economy. It works like this – weakness in the economy causes the Fed to lower interest rates in order to make it cheaper for businesses and consumers to borrow. Major investment banks also are traders for their own portfolios. So for example if the Fed lowers the interest rate at which it lends money to JP Morgan to better enable JP Morgan to make loans, JP Morgan may instead use that money to buy stocks, bonds, real estate, etc. The lower the rate is that they can borrow from the Fed, the greater the spread between cost and investment return, and therefore the more profit there is for the bank. This is how Citigroup was “rescued” in the early 1990s, and it is a major component of their recovery strategy today.

The problem with very low rates is that they encourage speculation and speculative cycles don’t end well. In the 1990s excessively low rates led to speculation in (tech) stocks; early this decade they fed a speculative frenzy in real estate. Moreover, when the boom ends there are usually a fair amount of financial institutions in trouble and they scream for the Fed to lower rates again. The markets are going through boom and bust cycles driven not by the economy but by the financial sector’s ability to use its political clout to get the Federal Reserve to do its bidding.

Here is where that leaves us right now. The Fed is making money available to primary banks at 0.25%, the lowest levels since the Depression. In addition, through TALF, TARP, PPIP, and its bailouts of Fannie and Freddie and its buybacks of mortgage securities the government is putting an estimated \$6 trillion into the financial sector⁸. With that kind of money sloshing around out there it is just not easy for financial assets to go down. Those inclined to speculate have a better than average chance to be rewarded, *until they aren’t*. We have recently seen how fast a speculative market can pop; remember how crude oil soared to \$147 per barrel on 7/2/08 only to plunge below \$32 on 02/18/09. The Fed has created ample liquidity for now, but the collapse of liquidity after the Lehman debacle in mid-September 2008 was a warning that if a market is not backed by strong economic fundamentals then investment gains can turn into losses with frightening speed.

Using monetary policy to save individual institutions and the financial sector creates its own problems. The financial services industry learns that its greed and/or stupidity are not going to be punished, so it goes back to its old behavior. Investors grow to realize that financial markets are more like casinos so they adopt (momentum) trading strategies rather than buy and hold. Other industries that had nothing to do with the crisis are nevertheless affected by widely varying cost and availability of credit.

The Fed has assured markets that it is ready to take that liquidity back out of the market when it is clear that the economy is growing. If it does, stocks are likely to be negatively impacted (as will gold), but the dollar and bonds will benefit. On the other hand, if Fed Chairman Bernanke repeats Greenspan’s mistakes and allows

⁸ Cliff W. Draughn, Financial Exigency: Capitalism to Fascism (Advisor Perspectives, Oct. 9, 2009)

liquidity to build into a speculative bubble, certain stocks and/or hard assets (emerging markets, oil, and technology) will soar and the dollar and bonds should be weak. Either way, investors are forced to be speculators. We can either try to get it right by identifying the areas most likely to be driven higher in a speculative frenzy (and how to get out before it ends), or we can try to make sure that we don't get it wrong by selling into strength such that we are under-weighted at the top. As we have stated many times, we take the latter approach.

We estimate that stocks are over-valued by 3-8% based on our expectations of corporate earnings and future economic growth. Given the previously mentioned high level of liquidity, modest over-valuation is not a concern. Stocks can and probably will go higher in the short term. The question for advisors and their clients is at what point do they give up sectors of the stock market to the speculators because prices cannot be justified by economic fundamentals? In certain sectors, we believe we may already be there. We are going to continue to focus on preserving our gains and looking for opportunities in slower growing, more stable areas of the market that don't tend to attract speculators. We are going to emphasize dividends and reasonable valuation over growth and momentum. It may mean lower return in the short term, but we will have a much better chance of keeping what we make.

A Personal Note

The period from September 2008 to March 2009 was as trying as any investors have faced in at least 25 years. It is one thing to face the prospect of a meaningful economic contraction. It is quite another to have faith when the stock and bond markets completely cease to function in an orderly manner. We tried very hard to make sure our clients understood that at the end of the day stocks and corporate bonds represented real companies making real products businesses and consumers wanted and needed and would continue to buy - regardless of what Wall Street currently said they were worth. The vast majority of you had faith in our economic system and faith in us when we said that things would get better. And they have, even faster than we had predicted. *We want to thank you for your continued confidence in our judgment and let you know we are grateful to have you as clients.*

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