Green Investment Management, Inc.

309 W 7th Street • Suite 101 • Fort Worth, Texas 76102-6901

Toll Free (800) 950-8004 • Phone (817) 335-1178 • Fax (817) 877-0741

Web Site: www.GIMlink.com

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Market Commentary

A Review of the Markets and a Look into the Future

Will March Bulls become April Fools?

"I'm no model lady. A model's just an imitation of the real thing."

-Mae West

Overview: Is this Rally THE Rally?

One of the most interesting things about the Internet is how it has made so much of our own past readily accessible. For instance, while pondering the March rally in equities, I found myself trying to figure out if it was the beginning of a sustained climb, or just a false alarm that will pay its gains back in April.

This reminded me of the old ad campaign for Memorex audio and video cassettes. The tagline for the campaign was, "Is it live, or is it Memorex?" Fifteen years ago, this train of thought would probably have vanished out of my head as quickly as it appeared. But with the Internet as close as my keyboard, I navigated to YouTube and in a matter of seconds was actually watching one of the old Memorex commercials.

In it, a woman is touting the quality of Memorex video tapes. Then the camera suddenly pans out to show that the "real" woman is sitting next to a television. The image of that TV was all you could see a moment ago. The concept of the ad was that the quality of the recording is so good you can't tell the difference from live.

This is an apt analogy for the current stock market rally. It is hard to tell a lasting rally from a false alarm, for the simple reason that they can both look very similar.

So what is the verdict on this rally, live or Memorex? Let's consider the evidence.

Economy: Like water in the desert

Late in the first quarter, unexpected good news brought some much appreciated refreshment to the economic desert we have been trudging through. Some of the news came from a surprising place, the housing sector.

According to the Federal Housing Finance Administration, U.S. home prices rose 1.7% in January. It was the first rise in ten months. In February, existing home sales registered an increase of 5.1%. New home sales for February rose as well, as did single family housing starts.

Much of this news may be due to the Federal Reserve's ongoing purchases of Treasuries and mortgage backed securities, which have brought mortgage rates down 131 basis points since August. But regardless of the cause, signs of strength in the housing market are especially welcome because this is the market from which our current troubles sprang. A firming up of housing will be important to a general recovery. In fact, we could see a sort of reverse domino effect. The declining mortgage rates have brought refinancing back as an option for many households. A rough estimate out of Goldman Sachs is that some $5 trillion in outstanding mortgage debt could be easily refinanced at current rates. As that happens, the savings should feed into the rest of the economy in the form of more consumer spending and investing.

There was also good news to be found outside of the housing sector. February durable goods orders increased 3.4%, breaking a string of seven straight down months. And the Discover Small Business Watch, an index of the confidence of small business owners, rose 6.3 points in March, to 78.2. This was its largest increase in nine months. In the survey, an increased number of respondents saw economic conditions for their businesses improving.

Could all of these encouraging indicators be signaling the end of our long walk through the arid trough of the business cycle, or nothing but a mirage? Most likely, the truth is somewhere in between. I would look at this round of good news as an oasis, a place to take some welcome refreshment that will get us through the remainder of the journey. Challenges and difficulties still await before we see a truly healthy economy.

As a reminder of that, the first quarter had its bad news as well. Among the worst was learning that Gross Domestic Product, the best overall measure of the health of the U.S. economy, declined in the fourth quarter of 2008 at a 6.3% annual pace. This was much worse than the third quarter decline of .5%, and a sobering reminder of how surprisingly hard the recession has hit us.

But the good news of March reminds us that upside surprises are possible too. Sometimes things turn out better than we realize. Goldman Sachs economist Binit Patel, illustrated this point well in recent comments:

"On balance, we continue to expect to see the trough in the current world cycle being reached in the middle of this year. But unlike a few months ago when we argued that the risks on global growth prospects were firmly skewed to the downside, we are seeing reasons to be a bit more optimistic. Indeed, in a recent Global Economics Weekly, we listed a number of factors that could 'go right' and provide upside surprises in the world economy. These included signs of US consumer strength, earlier stabilisation in US and UK housing markets, a reacceleration in China's economy on the back of significant fiscal stimulus and more effective policy action to resolve continued banking sector issues. We concluded that all of these are potential sources of upside surprises to our global views."

Patel's forecast of a mid-year bottom to the economic trough seems to be the majority view among economists right now. Most think the economic recovery will start off slowly, adding pace as it moves along.

A potential negative wild card in this scenario is a new round of protectionism. But this became less of a worry after the recently completed G-20 meeting. World leaders were able to successfully agree to a coordinated $1.1 trillion plan to shore up the global economy and boost trade.

We are encouraged by this outcome of the G-20 meeting, as well as by America's domestic policy responses to the recession. While actions have appeared clumsy at times, that is the nature of economic firefighting. They are chasing a target that constantly moves. The important thing is that the authorities have not been sitting on their hands. They have been taking fast action on both fiscal and monetary policy fronts. We believe this will pay off in an avoidance of a multi-year calamity such as the Great Depression or Japan's lost decade. While there could be a price to pay in terms of an inflation fight down the road, we expect that would prove a bargain compared to the alternative.

One of the frustrating things about the fast policy response is that it has resulted in programs and plans, some named with imposing acronyms, which can be hard to keep straight. It doesn't help matters when those in the media throw these terms around loosely, as they sometimes do. So here is a short primer on the key pieces in America's recession response puzzle:

TARP: Enacted in 2008, the Troubled Asset Relief Program allows the U.S. Treasury to purchase or insure up to $700 billion of "troubled" assets held by financial institutions. The intent is to help banks shore up balance sheets and start lending again. Some of the TARP funds have subsequently been used to buy actual ownership shares in financial institutions.

TALF: Enacted in 2008, but after TARP, the Term Asset-Backed Securities Loan Facility is a program crafted by the Federal Reserve. It authorizes up to $200 billion in loans to be made to private investors to help them buy asset backed securities. These kinds of securities fund considerable consumer spending in the economy (auto loans, student loans, etc.). TALF was a response to a severe loss of liquidity in this market.

Stimulus Package: The technical name of this is the American Recovery and Reinvestment Act of 2009. It is a bill signed into law on February 17, 2009 which provides for additional federal spending as well as tax cuts to fight the recession. Its cost is $787 billion, which filters into the economy over a period of years.

PPIP: The Public-Private Investment Program for Legacy Assets is the plan outlined by Treasury Secretary Timothy Geithner in March of 2009. It will pair money from TARP with private investor funds to buy up to $500 billion (could expand to $1 trillion over time) worth of troubled assets from financial institutions. As with TARP and TALF, the objective is to loosen up credit markets and get credit flowing freely again. The day the plan was announced, U.S. stock markets rallied some six percent.

Monetary easing: This is when the Federal Reserve lowers short term interest rates, which they have done in response to the current recession. They primarily do this by injecting new money into the economy through purchases of Treasury Bills. The lower interest rates are intended to spur borrowing and spending by both consumers and businesses.

Quantitative Easing: This works like monetary easing, except the Federal Reserve purchases longer term securities and does not try to achieve a specific interest rate. In March the Federal Reserve announced a plan to buy up to $300 billion in longer term Treasury securities as well as up to $850 billion in mortgage backed securities. One reason this quantitative easing was chosen over traditional monetary easing was because the short term interest rates targeted by monetary easing had already been brought near zero.

Stocks: In like a lamb and out like a lion

After a poor performance in January and February, U.S. equities came into March like a lamb, with major indices well down compared to the start of the year. Fortunately, equities went out of March like a lion, with the Dow posting its fastest 20% rally from a low since 1938. Having seen so much bad news of historic proportions, it's nice to know we can still see history on the upside as well.

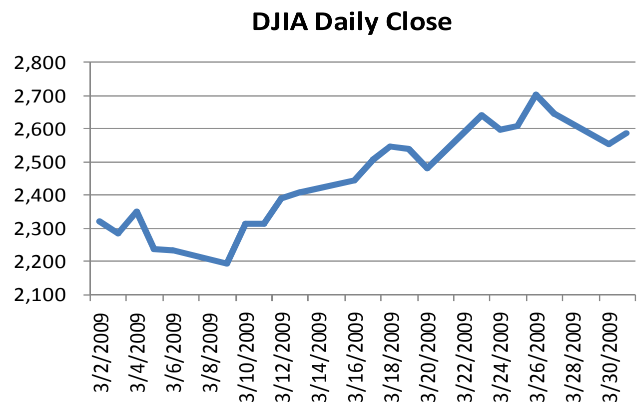

Figure 1. The Dow in March – in weak, out strong

But the big question is will this March lion turn into an April bull, or an April Fool? As of this writing, in early April, the earlier market gains are holding, buoyed by the productive G-20 meeting. There was also an encouraging announcement of an accounting rule change by the Financial Accounting Standards Board on how to price assets. This change should benefit banks.

In other good news appearing in early April, there was an increase in U.S. factory orders in February. On the downside, an employment report appeared in which the unemployment rate increased to 8.5%, the highest level seen since 1983. From the stock market's point of view, this news can be taken with a small grain of salt, as jobs are the last thing to recover from a recession. In fact, the shedding of jobs is what prepares firms for the next round of growth, when they will start hiring again.

All in all, the diversity of the good news that has supported this rally has many people thinking it is the one that will transition us to the next bull market. There is a sense of anxiety from insiders who haven't bought in yet.

In support of such a view, there is certainly plenty of money on the sidelines to fuel a long run. According to a Bloomberg report, at the end of 2008 there was some $8.85 trillion in cash, bank deposits and money market funds. That amounted to 74% of the total market value of U.S. companies, the highest ratio since 1990.

But amidst this newfound good sentiment, it is important to remember that this rally is still fragile. In fact, a little cooling off period would probably be a good thing at this point. A string of bad news could still turn this market on its head quickly. Plenty of uncertainty still remains in the economy. And the way forward, while promising, is not without its potential pitfalls, such as inflation and deflation, which we discuss below.

Bonds: A different outlook for Treasuries and Corporate Bonds

A sustained stock market recovery has the potential to suck large amounts of money from the market for Treasuries. For that reason we consider Treasuries to be a risky place to be right now, as odd as that statement may sound. Corporate bonds are another story. A stock market recovery should drive gains in that market, especially the high yield segment. So we are continuing to seek out opportunities there.

Inflation and Deflation: Two worst-case scenarios

The recovery path out of the economic desert runs between two frightening pits of quicksand. Falling in either would be disastrous, but our view is that the government and monetary authorities appear to be navigating us well enough to avoid both.

The first pit represents a deflationary dive. Sharp, widespread price declines were a hallmark of the Great Depression, and the most pessimistic prognosticators have made the case that we will soon be in for a similar experience.

Deflation is the natural result when demand contracts and is unable to absorb an economy's supply of goods and services at the existing price level. The recent housing market gives a perfect example of this. House prices have fallen drastically since the mortgage bubble burst in an attempt to coax out the squeamish demand.

A general deflation, which has so far not happened, would be devastating because it would cause real household debt levels to automatically increase as prices fell. Each dollar going to pay off existing debts becomes more and more valuable during deflation. With consumers and businesses already holding tightly to their wallets because of high debts, a sustained deflation could have catastrophic consequences. Treasuries appear to be the only investment that would be safe in such an environment.

But with the fiscal and monetary policy actions we have seen in recent months, a general deflation seems like an unlikely scenario to us. Federal Reserve Chairman Ben Bernanke is a noted student of the Great Depression. He is well aware of the disastrous effects of deflation on an economy. He is also aware that expanding the money supply is the way to avoid the problem. He has been aggressively doing this through monetary easing and now quantitative easing. Figure 2 (next page) shows the effect these actions have already had on the most basic measure of the money supply, M1.

With such a rapid increase in the money supply, and one that should continue further before it is done, we believe that the deflationary danger to the economy is small at this point. But that brings us to another question. Has the Federal Reserve, in its zeal to avoid deflation, steered us to the edge of the other pit of quicksand, that of inflation?

Inflation is the natural result of an excessive amount of money flooding the economy until demand for goods and services

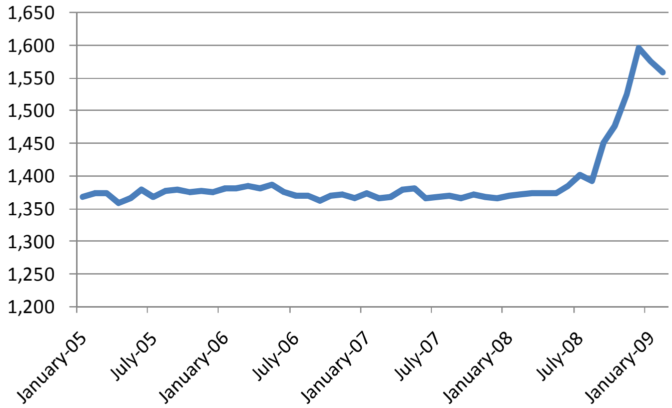

Figure 2. The Fed's actions cause a jump in M1 (Seasonally adjusted, in billions).

overwhelms supply. Too many dollars chasing too few goods, as they say. There has been worry expressed that the current aggressive monetary policies of the Federal Reserve, when combined with expansionary fiscal actions such as the stimulus package and TARP/TALF/PPIP plans, not to mention similar expansionary policies in other countries, will ignite an uncontainable wildfire of inflation as soon as economic recovery begins.

We are not terribly concerned about this scenario at present. Recent inflation figures have been negligible. In fact, the Federal Reserve wants to create mild inflation (1.7%-2.0%) with its current policies. This would show that the policies are working in terms of boosting demand in the economy. Inflation beyond that, it is presumed, could be fought off with a policy of monetary contraction, the reverse of the current expansionary policy. In that scenario, the Fed would simply sell the securities it has been buying back into the free market. The money the Fed receives is removed from circulation, so the money supply shrinks and interest rates rise.

But some commentators have spotted a potential problem with this fix. The Federal Reserve, through quantitative easing, has begun buying assets outside of its usual range of short term Treasuries. For instance, it is currently buying large quantities of mortgage backed assets. If it tried to sell these to fight inflation, the resulting increases in mortgage rates might generate stiff political resistance.

In addition, TALF and PPIP programs entail a monetary expansion that cannot simply be reversed at will. The money involved is being placed into the hands of private investors through loans, so it will effectively leave the Fed's control.

Despite these concerns, we still feel the worries of the inflation hawks are a little exaggerated at this point. There is considerable slack in the economy, and probably will be at least through 2009. Evidence of this is clear in the worsening unemployment data. This slack should help steer newly created money to productive uses rather than inflation as we begin the recovery. Once the recovery gets underway, inflation could always develop. But like always, we know its dangers and how to stop it. It will just take political will.

In general, those who want to look for dangers to focus on in our economic path will find no shortage of them. Concerns such as falling into deflationary or inflationary spirals always exist. And since economic foresight is imperfect, economic policy is never perfect. But we feel that the policy responses that have been taken since the credit crisis became clear in 2008 have on balance been appropriate. We feel that as things currently stand we have an excellent chance of navigating successfully between deflation and inflation to better economic times ahead.

The Bottom Line: Live or Memorex?

I began this commentary with a question, is the current stock market rally live, the real thing? Or is it Memorex, a false alarm that will soon reverse itself and put us back in the equity doldrums?

Between there and here I have presented some evidence supporting the possibility that this rally is, in fact, live. But the evidence is certainly not conclusive at this point. Our point of view is that for investors with a long term horizon, the question is not critically important (although it is certainly interesting!). We feel that the important pieces of the economic recovery puzzle are in place. Even if the current rally were to turn back, we believe the lasting rally and the next bull market are on their way. Our primary focus is to have our portfolios in a position to profit when it does.

We know these are volatile times, and we will continue watching the situation closely here at Green Investment Management in order to respond quickly to any changes in outlook. As always, we send thanks to those of you that are our clients. We appreciate the trust you have placed in our firm to manage your money and we sincerely appreciate your business. If you have any questions or concerns, please don't hesitate to give us a call.