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## Market Commentary

A Review of the Markets and a Look into the Future

### Awaiting the Next Move

*“Smile, breathe, and go slowly.”*

*-Thich Nhat Hanh*

#### Overview: A Critical Question

It's an age-old question: What does the situation call for, a breathless plunge forward into action, or a pause for contemplation and analysis? After a strong spring rally in stocks, the market seems to have decided upon the latter course. For the past month, the major stock indices have sidled along horizontally, as if trying to decide what their next move will be.

I can relate. The heat we are experiencing in Texas right now can give anyone a case of the summer doldrums. But market pauses do not last forever. At some point in the not too distant future, this market is going to decide which way to go, up or down.

Is that decision long overdue, or does an extended period for consolidating the gains of spring make sense? The answer to that question depends on the fundamental factors that are driving the market and the economy right now. Let's take a few minutes to consider those factors.

#### Economy: Counting our blessings

In the first quarter of 2009, we saw the first encouraging signs that the recession might be approaching a bottom. Stocks responded to these signs with a late-quarter rally that carried over into the second quarter (see Stocks section below for a fuller discussion). In the second quarter, we have seen additional signs of encouragement, but also some cautionary developments.

Among the encouraging recent developments, inventories laid low by the recession have sparked life in Purchasing Managers Indices, both in the U.S. and globally. Figure 1 shows the annualized quarterly change in private inventories in the U.S. since 2000 (source: U.S. Department of Commerce). The historically low levels shown recently help get purchasing managers on the phone and placing orders that will eventually drive an upturn in GDP.

Likewise, home inventories have dropped to pre-bubble, late 1990's levels. Many market watchers think existing home sales have bottomed, though there may be additional price declines ahead, particularly in some locales.

Change in Private Inventories (billions of dollars)

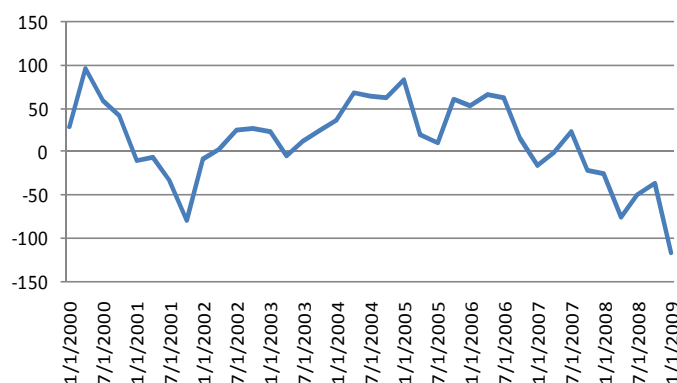


Figure 1. Depleted inventories set the stage for recovery

On the downside, there was almost universal disappointment with higher than expected June job losses of 467,000. On the other hand, the unemployment rate rose a little less than expected, to 9.5% when 9.6% had been the expectation. True to form, the bad news from the employment report was what was emphasized by the media.

U.S. consumer confidence, as measured by the University of Michigan survey, dropped unexpectedly in early July. Nonetheless, the broad swath of confidence indices in the U.S. and internationally indicates that confidence remains significantly higher than the lows seen early in the year. And the Financial Stress Index tracked by Goldman Sachs has dropped to levels not seen since before Lehman Brothers tanked.

A still-developing challenge to the domestic economy is coming from state and local government budgets. Since these governments are often constitutionally bound to square expenses with revenues, shortfalls often require spending cuts, layoffs and/or tax increases, none of which are good for the economy.

California is the most visible and egregious example of insolvency so far. Recently the state government actually began handing out IOUs in response to its budget crisis. And as rainy day funds dry up, more states and municipalities will find themselves facing budget problems. Federal stimulus money is being made available to help, but the situation still threatens to throw annoying wrenches into the looming recovery.

The majority view is that we remain on track for a recovery, meaning positive growth in real Gross Domestic Product (GDP), beginning in the third quarter of 2009. There is much debate, however, on just how strong the recovery will be. Most expect a so called “jobless” recovery of the type we have seen from the past two recessions. Unemployment may continue to climb well into 2010, peaking above 10%. Our view is that this might be beneficial to investors, as getting lean and mean is exactly what will allow firms to create the next stage of growth that will eventually put the unemployed back to work.

An anticipated need for continued de-leveraging by both consumers and firms is expected by many experts to lead to a weak recovery with output growth well below potential. In fact, Goldman Sachs Global Economics, Commodities and Strategy group forecasts that the U.S. economy will remain below its potential output until 2012.

But more optimistic outlooks, including robust 4.5% annual real GDP growth as early as 2010, are being voiced as well.

For our part, we expect that economic growth may be more moderate than what we usually experience coming out of a severe recession. But we should not underestimate the possibilities for surprises on the upside. Slack resources combined with an accommodating monetary policy have a way of coming together in productive ways. The important thing is that we lay the proper foundation for a long and healthy expansion. That means household savings need to continue improving, even at the cost of some short-term consumer spending. In May the U.S. savings rate hit 6.9%, its highest level since 1993. To put it another way, that implies annual savings of \$768.8 billion, the highest on record.

Talk of a new stimulus bill does not appear to have sufficient momentum to go anywhere at the moment. This is probably for the best, given that most of the funds from the first stimulus have not yet even filtered into the economy.

Overall, assuming that we are on the cusp of recovery, this recession has been a bad one for the U.S. But it could have been much worse, as the pain being felt in nations such as

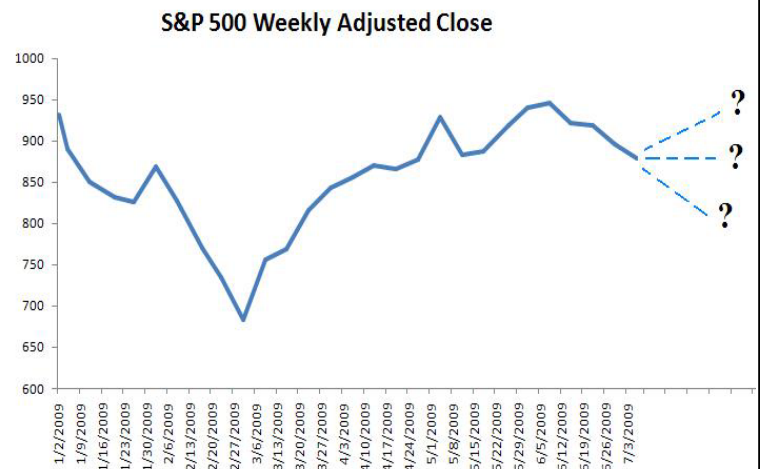
Germany and Japan illustrates. Germany’s annualized first quarter 2009 GDP decline was 14.4%. Japan’s annualized GDP rate dropped over 13% in each 2009’s first two quarters. America’s 5.5% revised drop in the first quarter doesn’t seem so bad in light of those numbers. And most expectations are that the second quarter figure will be even better, or at least, as they say these days, “less bad.”

There are countries that are outperforming during the recession as well. For instance, the OECD is forecasting 7.7% growth this year for China, and 9.3% in 2010. Nevertheless, I would still say the U.S. stands in a pretty good position right now, considering that less than a year ago a number of respected people were predicting that we were in for a second Great Depression.

It always pays to count your blessings!

### Stocks: The lazy days of summer

As Figure 2 shows, equities have had quite a year. After a dismal decline to start the year off, the S&P 500 was down 25% by March 9. A rally followed that brought it up 35% through May 8. Since then we have been consolidating. The question everyone is asking is: What comes next?



**Figure 2. The S&P 500 in the first half of 2009**

Our view is that the consolidation we have been experiencing since the rally ended is very healthy. Wells Fargo Chief Market Strategist Alfred E. Goldman called it a “pause to refresh.” It is an apt description. More definitive evidence of recovery is needed before the markets can confidently take to new heights. Upcoming corporate earnings are still uncertain, with widely varying estimates from different analysts. And a rally that gets ahead of itself always risks a debilitating stumble.

After what may turn into a summer’s rest, we expect equities to finish the year strong. Bob Doll, Chief Investment Officer for equities at BlackRock Investments, forecasts a 2009 year end S&P 500 value of 1,000, which would mark a double digit annual gain. Doll also expects U.S. stocks to outperform those of Europe, with energy, healthcare and IT sectors leading the way.

Some other forecasts are coming in more conservative. For instance, the S&P Investment Policy Committee predicts an autumn correction for the S&P 500, down to near 800, followed by a rally to 1,015 by the end of next June. That would mark a 13% gain for the coming 12 months.

In their recent mid-year conference call, Ned Davis Research also displayed a bullish outlook. They are currently overweight on stocks by 15% in both domestic and global allocations. They expect commodity (materials and energy) and information technology sectors to be particularly strong.

Overall, we expect that the current bull market has a long way to run yet. Nonetheless, we may employ some hedging to compensate for continued summer doldrums. We feel a fall correction is certainly in the realm of possibility, but looking at the long term, equities still appear to us as a very strong place to be, and we anticipate a resumption of the upward climb before 2009 ends.

Market rallies almost always pay off big to early entrants, as we saw this spring. But remember that the typical bull takes 24 months to pay out the first 52% of its gains. If this market holds to that standard, there are still plenty of gains to be made.

#### **Bonds and Interest Rates: Opportunities and a long term challenge**

A stance in favor of corporate bonds over treasuries continues to be borne out by the market. According to Merrill Lynch data, investment grade corporate debt returned 9.2% in first half of 2009, besting treasuries by 13.7% for the period, the biggest differential on record.

We believe there are still great opportunities to be found in higher yield segments of the market as well as investment grade. But caution is necessary to separate the diamonds from the dirt, as some bond market watchers, such as Dianne Vazza at Standard & Poors, expect speculative grade default rates to increase into 2010.

Regarding interest rates, the Federal Reserve is likely to hold policy steady through 2009. A reversal of its current expansionary stance will likely wait until unemployment begins to decline noticeably, which appears unlikely before 2010.

In the long run, upward pressure on interest rates has to be a concern for investors. U.S. budget deficits have now officially broken the \$1 trillion barrier. As Roger Bannister proved in running the mile in less than four minutes, once a barrier is broken it sometimes gets trampled into the dust.

An aging population and rising health care costs will put additional pressure on the federal budget in the coming years. And it is currently unclear how this issue will be dealt with politically. Continued deficits and the interest rate pressure they create have the potential to sap some of the strength from the recovery as it unfolds. Nonetheless, we think excessive

worry about this is unwarranted in present circumstances, as stimulative spending is needed to drive recovery. But as time goes by it is a factor we will continue to monitor closely.

#### **The Dollar: The benefits of downward pressure**

Oil prices recovered unusually early in this recession. This has re-opened the U.S. trade gap and put new downward pressure on the dollar. But the dollar has been strong in 2009 against the yen, with Japan being hit especially hard by this recession. It has also been holding its own against the Euro.

The stronger emerging market currencies appear poised to outperform the dollar, the yen and the euro in the near term. But the bright side is that any downward pressure on the dollar will help the U.S. get its trade deficit worked off, paving the way for strength in the longer run.

#### **The Bottom Line: Getting ready for the next climb**

As always, the future of the markets remains something of a mystery until becoming the present. Nonetheless, we have made an effort to clear up the outlook by laying out the key developments and concerns facing the market right now. I think the picture that we see before us is one in which stocks are behaving very rationally, just as we would expect them to. The equity rally of spring discounted an economic recovery that is getting closer all the time. Yet the exact speed and strength of the recovery is not entirely clear. Awaiting a little more information before making the next move is a rational and healthy thing for the market to do right now. As the Vietnamese Zen master in our top quote says, this is a time for the market to "smile, breathe and go slowly." That will allow it to better catch its breath for a climb to new heights down the road!

These remain 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. 🐾

*The views expressed are those of Byron Green as of July 15, 2009 and are subject to change. The information contained herein does not constitute investment advice or take into account any investor's particular investment objectives, strategies, tax status or investment horizon. Additionally, this publication is not intended as an endorsement of any specific investment. Information contained herein is derived from proprietary and non-proprietary sources. We encourage you to consult with your tax or financial advisor.*