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Market Commentary

A Review of the Markets and a Look into the Future

Matching Your Mindset to the Cycle

“To everything there is a season, and a time to every purpose under heaven.”

Ecclesiastes 3:1

Overview: Optimism or Pessimism?

Recently I have been thinking about how many cycles there are in life. Day follows night, which follows day. Fall follows summer, which follows spring, which follows winter, which follows fall. Your children grow up and go off to college, like you once did.

The thing about cycles is that they take you, in some sense, back to where you started.

The economy has its own cycle – the business cycle. Sometimes (the past couple of years, for instance) it takes us on a wild ride. And it is a hard ride to predict. Nonetheless, there seems to be broad agreement about where the business cycle now stands. The recession has ended, and recovery begun.

As investors, the new question we are wrestling with is: What will recovery look like? Optimists are predicting a powerful recovery that will take us to new heights of wealth. Pessimists are predicting a slow, sputtering return to growth, one possibly even spoiled by the appearance of that much talked about but rarely seen animal, the double-dip recession.

In weighing the merits of these two camps, it is helpful to remember radio personality Paul Harvey’s adage that he had “never seen a monument erected to a pessimist.” On the other hand, pessimism does have its purpose. Scientific research has linked pessimistic personality traits with creativity and diligence. Sometimes a pessimist will spot dangers an optimist misses.

So which side do we go with, the optimists or the pessimists? Let’s consider the evidence before deciding.

Economy: Dizzying Data

One reason the state of the economy has been hard to get a handle on recently is that reports of new economic data have been following a cycle themselves. It seems like as soon as we build up enough good news to feel good about the recovery, some bad news comes along to bolster those with a more pessimistic view.

For instance, optimists can report that the service sector, which represents 80% of U.S. economic activity, expanded in September for the first time in over a year, according to the Institute for Supply Management.

But pessimists can counter that the U.S. economy lost 263,000 jobs in September, according to the Bureau of Labor Statistics. This helped raise unemployment to 9.8%, the highest rate since 1983.

On the other hand, The Conference Board’s Employment Trends index improved in September for the first time since January of 2008. And the first week in October, new jobless claims dropped to the lowest level seen since early January.

But the latest data on U.S. durable goods orders showed an unexpected drop in August.

Yet new home sales rose in August. And the Reuters/University of Michigan Index of Consumer Sentiment rose to 73.5 in September.

This much back and forth could make a person dizzy!

Overall, much of the bad news is coming from the jobs market. While some have seized on this to argue against a recovery, lagging jobs data is not at all unusual in a recovery.

A more worrisome factor is the debt overhang the U.S. economy is dealing with. American consumers, accustomed to letting other nations do their saving for them, have now begun consuming less and saving more to work off this imbalance.

Likewise, continuing government deficits imply the need for fiscal belt tightening and possibly higher taxes at some point in the future, either of which could slow growth.

The degree to which this debt overhang, private and public, will dampen the recovery is the linchpin to expectations. Some claim the worry about debt is overblown. They point to the unexpected speed at which deficits were turned into surpluses by the economic growth of the 1990’s.

But most commentators are less sanguine. While a recent survey by the National Association for Business Economics found that over 80% of economists believed the recession is over, most also felt that the recovery would be more moderate than usual. Presidential economic adviser Larry Summers said that “lack of demand” will constrain “output and employment in the American economy for the foreseeable future.”

If this scenario plays out, it would definitively end a period known by economists as The Great Moderation. In the early 1980's, a long fight with inflation was won by U.S. policymakers. An era of low inflation, long expansions, relatively short recessions and loosening regulation followed. During this time, investors took on greater leverage and returns to risk were high. If this period has truly ended, we could see a secular economic environment marked by slower growth, inflation uncertainty, increasing regulation and smaller returns to risk.

A bright spot in such a scenario would likely be found in emerging economies such as India and China. The recession has had less of an impact on them than on the developed nations. And without the overhanging debt problems of the U.S., they are expected to recover robustly. The key to this will be whether their domestic demand can grow fast enough to take up slack left by less demand abroad.

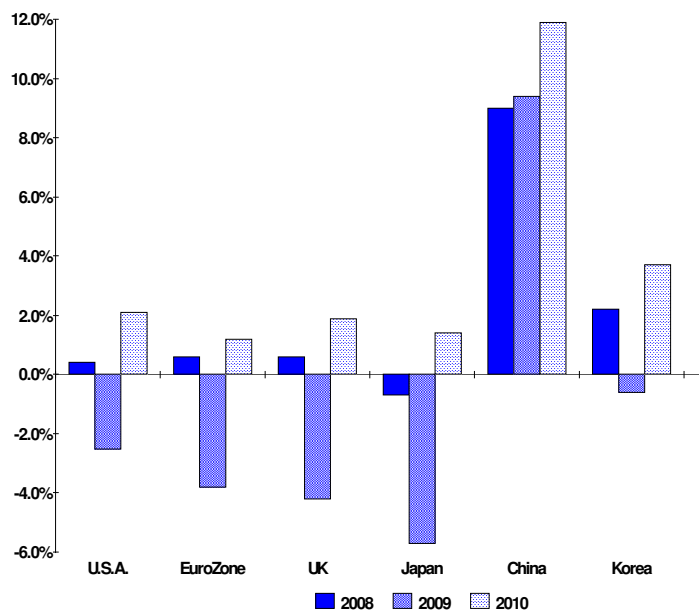


Figure 1. Annual GDP growth in six different nations/regions, estimated and projected, for 2008-2010 (source: Goldman Sachs Economics Research).

Figure 1 above gives a satellite's eye view of how things look in several important economies around the world. As the legend at the bottom of the chart shows, the bars lighten in color for each nation, representing the years 2008, 2009 and 2010. Especially notable is the strength of China in the recession. It merely slowed their growth rate into the single digits. Hardly a recession at all!

Stocks: Gains Now, Opportunities Ahead

Since we last spoke, performance by domestic equities has continued strong, taking the S&P 500 to 1,076 as I write this. Upcoming earnings reports are on everyone's minds now, and will go a long way to determining how the year finishes.

Another hot topic is price/earnings (P/E) ratios. Since the March low, the S&P 500 market P/E has increased by some 30%. Recent research by Goldman Sachs found that market P/E ratios expand on average by 34% in the first ten months after a bear trough, and then remain mostly flat for the next twelve months (though the market may keep rising on earnings growth).

An additional 4% of expansion in the S&P 500 multiple by year end (which would mark roughly 10 months since the March low), would imply an S&P 500 value of 1,140. The Goldman study notes that the authors actually expect a slower than average recovery and therefore a smaller than average ten-month P/E expansion. They feel more earnings are needed to drive fourth quarter market growth. But some market watchers are more bullish, and expect there is considerable upside in the fourth quarter, with P/E reverting to its long-term average of 15 or more, which would imply a year-end S&P 500 value of 1,200 or higher.

In our view, either of these scenarios is entirely possible. According to a Bloomberg report of Investment Company Institute data, Americans are still holding a hefty \$3.5 trillion in cash, so there is fuel for additional near-term gains. But at the same time, our focus is longer term, and we would prefer to see any fourth quarter gains built on the top of earnings growth and continuing demonstrated economic recovery.

Much of the long term growth potential in domestic equities will depend on the nature of the economic recovery. Low inflation and sustained positive GDP growth are the critical components, probably more so than any particular shape for GDP growth (U, V, etc.). Even a restrained recovery, in which debt imbalances are slowly worked off, would still be likely to offer good growth opportunities in stocks.

The anticipated economic strength in emerging markets should also create opportunities in firms that export to those nations, many of which can be found in the European Union (EU).

Overall, we remain cautious but bullish on equities, both domestic and foreign.

Bonds and Interest Rates: Is the Low Hanging Fruit Gone?

It has been quite a year in corporate bonds. Over \$1 trillion worth of issues have been sold so far in 2009, a record pace. According to Merrill Lynch & Co.'s U.S. Corporate and High Yield Master Index, corporate bonds have returned 23% thus far in 2009, better than any full year since 1997.

Corporate yield spreads over treasuries have narrowed recently, but in general remain wider than in 2007. With the premium to risk narrowing, opportunities in this market are getting harder to come by. But we remain convinced that there are still opportunities to be found in corporates, especially in the high yield sector.

Meanwhile, interest rates are staying low under the continuing liquidity of monetary stimulus. It is unlikely the Federal Reserve Open Market Committee will raise rates anytime soon. Nonetheless, higher interest rates and inflation remain a concern for the U.S. in the long run. Large existing deficits, healthcare reform and an aging population all raise the specter of fiscal and monetary difficulties that could slow economic growth in the years ahead.

The Dollar and Commodities: More Storms with Silver Linings

The dollar's slide continued in the third quarter as it declined 6.55% relative to gold. It also declined relative to most major currencies except the British Pound and the Hong Kong dollar. This trend of weakness appears likely to continue through the fourth quarter and 2010.

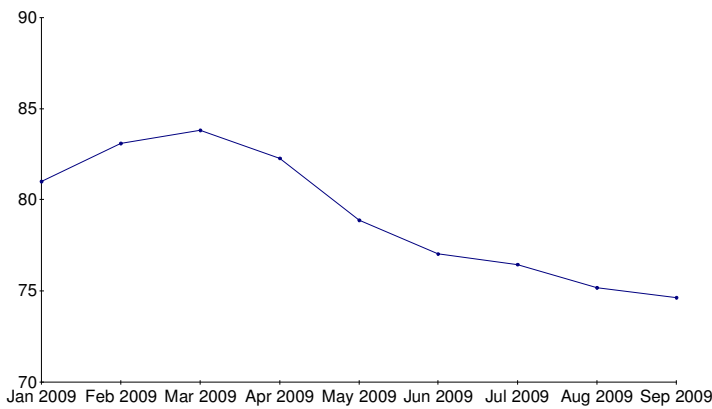


Figure 2. The dollar against major currencies in 2009, Trade Weighted Exchange Index: Major Currencies (Source: St. Louis Federal Reserve Bank)

Much of the weakness is coming from investors who view the U.S. as lacking fiscal discipline, and who worry that inflation could eventually result. The silver lining remains that every decline in the dollar helps U.S. exporters restore lost trade balance. And while inflation remains a long-term concern, there is little sign of it yet. High unemployment indicates the amount of slack still present in the U.S. economy. It will be hard for inflation to gain traction until that slack is tightened up.

Many of the long-term fiscal challenges the U.S. faces (aging and retiring population, rising health costs, etc.) are shared by other developed nations. Hence, emerging nation currencies appear to be poised for continuing relative strength.

The dollar's fall has become oil's rise. It recently closed near \$74 per barrel, a six-week high. Oil is priced in dollars on international markets (though international sentiment to change this has been building, stay tuned). International investors whose currencies are rising relative to the dollar find oil getting relatively cheaper. In addition, oil and commodities in general are benefiting from projected healthy demand as the world economy recovers. Demand from BRIC nations (Brazil, Russia, India and China) continues to be strong.

Many investors are worried about the overhang from large, coordinated stimulus spending in developed nations, and are looking to commodities as an inflation hedge.

All of these factors point to continued strength in commodities into 2010. The major factor which could derail commodities' climb will be weaker than expected recovery in the world economy.

The Bottom Line: What Season is it?

We arrive back at the question we started with. As we enter a new phase of the business cycle, which view of the recovery should we adopt, optimistic or pessimistic?

As always seems to be the case, both sides have their merits. Pessimists can point to this recovery beginning from a point of weakness. Extraordinary fiscal and monetary stimulus, while likely staving off a worse disaster, has also spawned legitimate worries of higher taxes and inflation that could water down the recovery.

Pessimists can also lay blame at the optimists door for getting us into this situation. As in all booms, in the recent one optimism became a dangerous kind of self-reinforcing group-think. It kept investors from seeing the real value of assets they were leveraging into the air. Optimism, as always, was in oversupply near the top of the boom. A strong dose of pessimism was exactly what was needed then, and it was ignored.

But therein lies a strong rebuttal to the pessimists. To everything there is a season, and the business cycle can be a great guide to where your mindset as an investor should be. The top of the business cycle is the season when the smart money will turn to pessimism, even though everyone else is rejecting it.

Now we are at the bottom of the business cycle, just starting a new upward ascent. This is a season when the roles are reversed – pessimism is typically in oversupply, and smart money turns to optimism. So, while we remain cautious about the legitimate worries that face us in the short and long-term, we believe this is a season for making optimism, not pessimism, our core mindset.

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. 🐕

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