The Oarsman Outlook

First Quarter 2009

Despite a welcome respite in March, 2009's first three months marked the sixth consecutive quarter of declines for global stock markets in what has become an epochal bear market. The depressing effects of deepening recession and persistent financial-system dislocation were exacerbated by the inevitable discontinuities presented by a U.S. presidential transition. U.S. stock benchmarks plumbed new bear-market lows in early March, and ended with double-digit three-month declines (though these have been trimmed in the first few days of April). Non-U.S. markets generally fared somewhat better, and some important emerging markets (Brazil, China, Russia) finished the quarter with gains (although a rising dollar hurt performance of U.S.-based investors).

Despite rising Treasury yields (the benchmark 10-year note ended the period at 2.68%, up from 2.24% at yearend), most corporate and municipal bonds provided solidly positive returns, as risk-aversion moderated from extreme late-2008 levels. Treasury Inflation-Protected Securities (TIPS) also gained as deflation fears receded.

Among U.S. stocks, the best-performing sectors were Basic Materials, Consumer Cyclicals, Energy and Technology; stocks in the Capital Goods, Financial Services, Health Care and Utilities sectors lagged the overall market averages.

Benchmark Performance – Equities

	First Quarter 2009	Last Twelve Months
S&P 500 Index	-11.0%	-38.1%
Dow Jones Industrial Avg.	-12.5%	-35.9%
Large-Cap. Core Mutual Fund Avg. (Lipper)	-9.8%	-37.3%
Small-Cap Stocks (Russell 2000)	-15.0%	-37.5%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	-11.0%	-46.1%

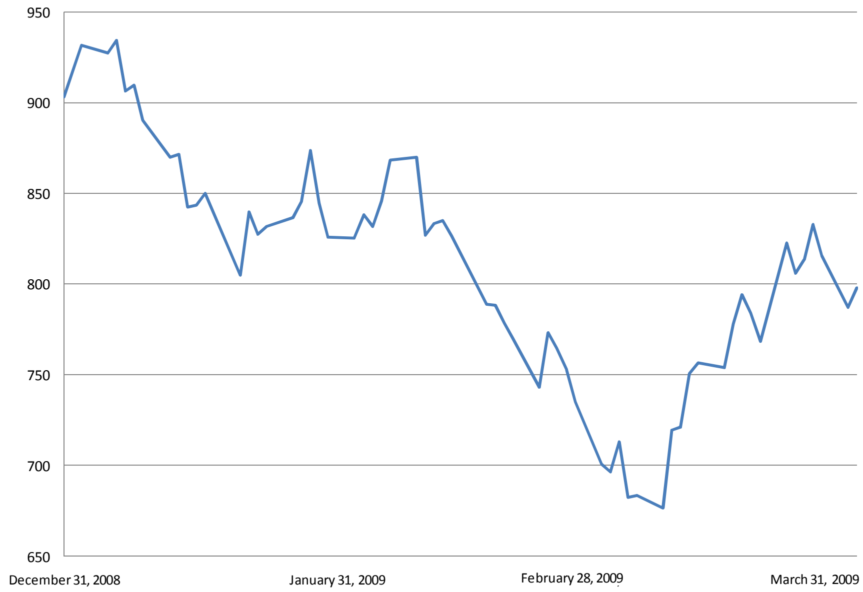
Benchmark Performance – Fixed Income

	First Quarter 2009	Last Twelve Months
Barclays Intermediate Gov't/Credit Index (taxable)	-0.1%	+2.0%
Barclays Municipal Bond Index (tax-exempt)	+4.2%	+2.3%

Review

After a brief year-end/New Year rally, stocks resumed their 15-month slide during the second week of January. Plausible causes included renewed concern about the health of U.S. banks and mounting evidence that the recession was likely to be deep, long and global. Depending on one's political views, the impending advent of the new American presidential administration was also at least in the back of mind. U.S. markets hit new closing lows on Inauguration Day, after which they enjoyed a modest three-week rally that brought them back near both yearend levels and where they stood in mid-October.

S&P 500 Index (daily closing price)



On February 10th, however, Treasury Secretary Geithner announced the outlines of the Administration's plan for resuscitating the banking system. These were widely criticized as lacking both boldness and detail, and precipitated a renewed market downturn that intensified over the next several weeks, fueled by a news cycle increasingly dominated by dismal economic statistics and frustrating political squabbles over both near-term economic stimulus measures and longer-term spending (and taxation) plans.

By early March, the market had again reached new lows, off more than 25% since yearend and more than 55% from the October 2007 peak. There was more than a hint of panic in the air as CNBC's Rick Santelli called homeowners facing foreclosure "losers," John Stewart blamed CNBC's Jim Cramer for the financial crisis, and on-air and op-ed pundits debated the Administration's "socialist" agenda.

Beginning around March 10th, a number of subtle and not-so-subtle changes set in motion a rally that continued into early April: several large banks reported they were profitable in January and February; the major U.S stock exchanges began lobbying the S.E.C. to reinstate a modified "up-tick rule" to rein in short selling; the Financial Accounting Standards Board (FASB) announced it was considering a relaxation of so-called "mark-to-market" accounting rules for financial entities; and there was a slight but noticeable improvement in the economic data. Probably more important were key actions taken by the Federal Reserve and U.S. Treasury: the Fed announced several aggressive, new monetary policy initiatives (and the expansion of some existing ones) aimed at restoring the flow of credit, while the Treasury announced much-needed details of its Public-Private Investment Program (P-PIP) aimed at removing distressed and unmarketable "legacy assets" from bank balance sheets. The modest change in the tenor of news flow, coming at a moment of peak investor anxiety, was sufficient to ignite a 20%+ rally, the third since October.

Outlook

The March-April rally, which has been led by financials and other economy-sensitive sectors (energy, consumer cyclicals and, most recently, capital goods), has prompted many (though by no means most) market observers to "call" the March 9th low as the bottom of the current bear market. There are certainly reasons to place some credence in this call (although we believe it is far from a "slam dunk"):

- Markets nearly always reach their low point a number of months before unambiguous improvement in the economy; most observers expect the latter during the second half of 2009, suggesting the correct timing for a market bottom.
- Various measures of investor sentiment were extremely negative, billions of dollars were being withdrawn from stock mutual funds every week, and stock holdings as a percentage of total investments had reached a very low level.
- As a result, cash holdings (money market funds, CDs, etc.), measured in dollars or as a percentage of stock market valuation, were very high; moreover, the prospective return on cash-equivalents had dropped to near zero, meaning the "opportunity cost" of holding cash was unusually high.
- Stock market valuation – measured by ratios of price-to-earnings, price-to-book value, price-to-replacement cost, and total market value-to-gross domestic product – had reached low readings not seen since the 1990-1991 (i.e., before the last bull market); the dividend yield on stocks exceeded the yield on 10-year Treasury notes for the first time in 50 years.
- Corporate insiders were buying stocks aggressively.

In addition to these market-timing indicators, a number of recent glimmers of hope from the "real" economy suggest that the rate of decline has begun to slow, which is surely a prerequisite for a resumption of growth. Purchasing-managers surveys have flattened, and some of the more forward-looking components have turned up; a number of housing-related statistics have stopped deteriorating; March auto sales were less grim than feared; and consumer confidence has ticked up ever so slightly. In addition, after some deterioration early in the quarter, credit markets seem to be firming up again, at least for high-quality borrowers.

Despite these incrementally positive developments, the present downturn is by no means typical, so it seems imprudent to expect a normal recovery. Even if financial-system dysfunction is remedied sooner rather than later (remember that it took Japan the better part of a decade to deal decisively with its banks' problem loans in the 1990s) and economic growth returns later this year – two <u>big</u> "ifs" – longer term uncertainties will continue to cloud the outlook.

First, it has been widely asserted that the current downturn will inaugurate a "new era" of meaningfully changed consumer behavior characterized by less spending and more saving. The days of the "home-equity-line ATM" are over, and the massive loss of wealth over the past two years will, at least for a time, induce an increased propensity to save. But we are always skeptical of forecasts that call for a sudden *and lasting* change in any long-standing trend – and Americans have been spending freely for a <u>long</u> time (that's why we have come to call ourselves “consumers”). For large numbers of Americans whose jobs and/or homes are not in jeopardy, recent developments have substantially *increased* disposable income: lower energy prices, attractive mortgage refinance rates and new tax-withholding schedules have put $500, $700 or even $1,000 per month into their pockets. Moreover, we believe most Americans have high personal “discount rates,” making it easier to rationalize high spending today (or next year) even if it likely means a lower standard of living in retirement (10, 15 or 20 years hence). In short, we are not ready to eulogize the American consumer, and will be watching the personal-income, -spending and -savings statistics with keen interest in the months ahead.

A second long-term uncertainty involves “unintended consequences” of, first, unprecedented government and central-bank market interventions and, second, the related massive increase in government deficits and borrowing. We believe the deficit/debt issue is the less worrisome. The U.S. has a relatively modest amount of outstanding government debt in relation to the size of its economy – well below the G-20 average. The increase in debt *resulting directly from the recession and financial crisis*, while substantial, will likely place the U.S. only slightly above that (rising) average. Moreover, the new borrowing is at very low rates (probably less than 3%, on average), so the incremental debt-service is relatively trivial (3% of $1 trillion is “only” $30 billion – when was the last time we fretted over spending an incremental $30 billion?). Finally, U.S. federal tax revenues are currently substantially lower as a percentage of total economic activity than they were as recently as the late 1990s (and lower still relative to other advanced economies). Accordingly, *if the political will can be mustered*, there is ample room for increasing tax revenue without harming our economic prospects (recall that the late 1990s were a period of sustained above-average growth).

We are considerably less sanguine, however, regarding the prospects for an uneventful “unwinding” of the mind-boggling array of market interventions. Here the government and central bankers will truly be in uncharted waters, and it is anybody’s guess how smoothly or otherwise that process will proceed. About all we can say at this point is that it will be… interesting. We will be watching this closely, as well.

Given these substantial near- and longer-term uncertainties, we feel portfolio balance is all the more important, even as stock markets stabilize and rise. Market performance over the past decade seems to validate our long-held contention that most investors should maintain meaningful exposure to non-equity investments, in the form of high-quality bonds, high-income vehicles, and real-estate- and commodity-related securities. These investment categories provide not only a volatility-reducing anchor in the worst markets, but also possess attractive absolute-return potential in their own right (in contrast to, for example, cash/money-market funds). As we move through the uncertain times ahead, we will continue to be vigilant for appropriate opportunities to reduce our average commitment to traditional equities in favor of these and perhaps other investments.