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INVESTMENT - REVIEW LETTER

May 11, 2009

I hope this will be a useful analysis. It is not a particularly rosy picture but it is what it is. Economic growth is tenuous now and will continue to be tentative until it becomes self sustaining. This is an especially long letter (for my stated objective). Please forgive its length, but I felt that you wanted, and are entitled to, a more thorough review of my reasoning with regard to my investment recommendations: specifically, 1) to look for a short term trading strategy, and, 2) to wait to invest in the stock market until it is clear that the economy is getting growth traction.

Summary:
After 8 weeks of a good rally, the market is overbought and due for a set back. There are too many reasons that this rally should not go much higher. For those who are worried that they have missed their opportunity buy into the market at its lows, it is likely that you will get at least one, and probably more than one, chance to buy at very low prices. This should be a long term market consolidation that is dependent upon underlying economic conditions shaping our future.

The stock market is dependent upon these underlying economic conditions. Until the economy gains traction and begins to grow steadily, the stock market valuation will be limited to a trading range between 650 and 1000 based upon the S&P 500 Index. This is a tradable range, but it is not time to invest for the long term. The time for investing in equities for the long term, will come only when it is clear that our next round of GDP growth is sustainable. Our investment management models are recommending that we wait.

For now, all of our economic indicators are pointed toward a worsening economy. The stock market cannot continue to go up when the economy is worsening.

Our Financial Model should provide the timing for reentry into the stock market. In the meantime, almost all of our portfolios are making money with yields between 4% to 6%+ and they are very stable.

The yields on Mortgage Backed Securities (government guaranteed) have dropped below 6% and are now trading between 4.5% and 5.5%. To supplement these yields, we are investing in "survivor" companies whose debt securities have yields between 6% and 11%, all investment grade companies with strong cash flows and balance sheets, even in these difficult times. As of this writing, we have virtually no client investments in the stock market. All of your investments are in fixed income securities. For money that is to go back into the stock market in the future, that money is warehoused in one or two GNMA mutual funds waiting for a signal to begin dollar cost averaging back into the market.

Analysis:

Even though it is a nice warm "fuzzy" to have had a 35% rally off of the bottom from last March, don't let this rally convince you that it will endure. Our government, the Federal Reserve, and our financial system managers, have succeeded in pulling us away from the brink of a Great Depression II.

This does not mean that the U.S. economy will go back to "normal growth", as we have come to expect over the past 30 years. There have been fundamental changes that have taken place since 2007. The most important fundamental change comes from the realization that we can control economic growth if we manage it in a way that prevents the excesses we have experienced during the last 12 years. This knowledge, and the academic research that will follow in the coming years, will be used to guide our system of entrepreneurial capitalism as we massage it toward a planned, consistent growth rate, and inflation rate.

For now, we will be walking a "tight rope", balanced between the potential disaster of another great depression and another fearful hyperinflationary crisis. Impressively, the Treasury Secretary, Mr. Geithner, has managed this "walk" very well thus far, avoiding most pitfalls and laying the groundwork for the future regulation of the financial system in order to prevent the failures that have occurred during the last 10+ years. But, with interesting foresight, he and the Federal Reserve Chairman are designing a structure of forward looking analytical processes that will detect potential failure points for new financial instruments, that will surely be created in the future, laying this responsibility at the feet of those who want to implement these new designs.

Consider the following: [1]

a. Housing starts have plunged 80.4% in the last 3 years to 358,000 annually.
b. Most of the GDP gain foreseen in the 4th Quarter, 2009 will be statistical "nonsense". (Jim Welsh, Mauldin OTB, May 4, 2009)[1]
c. "The most important issue in the next 12+ months is whether the rebound in the second half of 2009 and early 2010 will gain enough traction to launch a self sustaining economic recovery." [1]
d. In the 1st Quarter, 2009, there were more than 2 million new unemployed workers.
e. Today, that number is over 3 million new unemployed workers.
f. Even if the monthly job losses go from 670,000 to 325,000, this will mean almost 3 million more jobs will be lost before year end. [1]
g. This would take us over 10% unemployment.
h. Job losses result in home foreclosures – (10%-15% of those family homes are foreclosed and come onto the market for sale.) [1]
i. The bank "stress target" is 10.3% unemployment.
j. Home prices have fallen over 28% since September 2005.
k. The likely high rate of future foreclosures will cause prices to fall another 5%-10%.
l. This price decline, when added to the decline in home prices since 2005, places many homes under water from a financing standpoint. Owners may well walk away from their debt on these homes. [1]
m. It is the magnitude of job losses that is impacting the housing, banking, and credit card industries. This is our economic Achilles heal.
n. Treasury tax receipts (payroll withholding tax receipts), year over year, are down 8.2%. This says that family incomes are falling every week. [1]
o. The loss of jobs drives all of these numbers.
p. Consumer loan delinquencies are rising and are the highest since this data began tracking in 1970. Job losses are driving these delinquencies.
q. Bank quarterly earnings appear to be quite good. However, these numbers are fictional when the accounting standards used to come up with them are analyzed. FASB and regulator accounting rules and standards can be manipulated to suit the needs of almost any analysis.
r. Small businesses that use credit cards to charge against, for operating capital loans, are experiencing a sharp contraction in the amount of their credit lines on those cards.
s. Business capital investment is going to be very weak in the coming months and years, affecting the economic recovery timeline. The current manufacturing excess capacity will take much longer than expected to return to a normal level. Thus, capital equipment investment will be delayed until excess manufacturing capacity is relieved, at least to the producers' cost effective level.
t. The personal savings rate has gone from 0% to about 4%+ and is likely to go even higher.
u. Consumption is falling due to the loss of jobs, weak credit availability, zero mortgage equity withdrawals, higher savings rates, and debt repayment. It is clear that the consumer will not provide the engine that drives our economy out of this recession/depression.

v. Household debt has more than doubled in the past 25+ years. [1]
w. Interestingly, the functional leverage of each dollar of debt has dropped, as it relates to GDP growth. “The diminishing boost given to GDP from each additional $1.00 of debt since 1966, strongly suggests that adding more debt will not return the economy to prosperity.” [1]

[1] Jim Welsh, Mauldin OTB, May 4, 2009

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