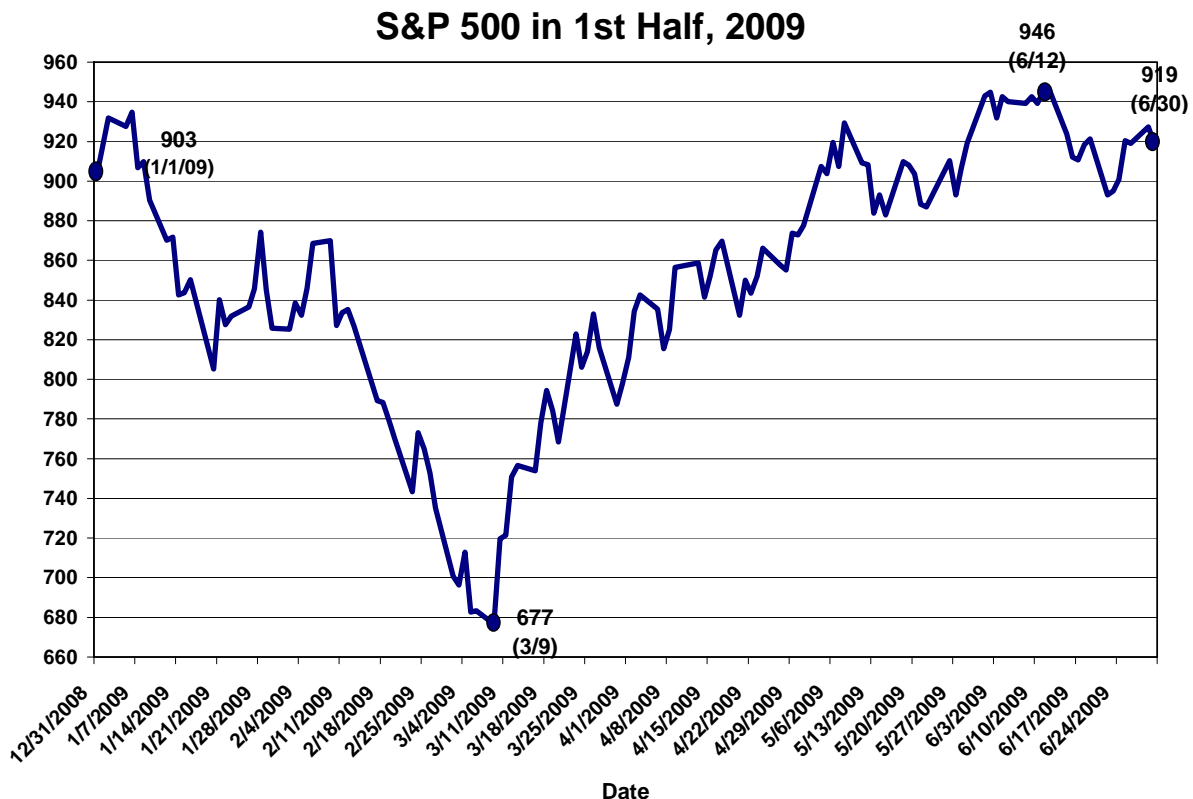


*Q2 2009 Commentary:
The Slowdown Slows Down & Markets Surge,
But When Will Housing Pick Up?*

*By Bob Marshalla
July 10, 2009*

A Powerful Market Rebound

Since our last quarterly commentary the market environment has surely improved. The economy has showed signs of bottoming, as economic activity continues to worsen but at a decreasing rate. For stock markets that had been extremely oversold, this was apparently enough good news to induce many investors back into the market and ignite a powerful rally. The S&P 500 advanced by 16% in the second quarter, after falling 11% in the first quarter. But use of calendar dates dilutes the true intensity of the turnaround. The market had actually fallen 25% by March 9, this on top of the bad results from the year before. But in the three months between March 9 and June 12, the S&P staged an incredible rally and gained 40%. And some other asset classes did even better.



Even though using calendar quarter dates somewhat obscures the strength of the recent market moves, the second quarter gain of 16% was the best quarterly gain for the S&P 500 in more than ten years! Table 1 shows the returns for the second quarter and the year-to-date for the full set of asset classes we track regularly. We can see that mid and smaller cap domestic stocks outperformed their larger counterparts, rising between 21% and 25% in the second quarter. International stocks did even better, with EAFE (large cap, developed markets) gaining 25% and emerging markets 35%.

It is also interesting to view the performance by economic sector. The best performing sector within the S&P 500 in the second quarter was Financials, up 35%; the worst was Health Care, up only 8%. The scariest and worst performing sector throughout the recent crisis was the best place to be since March. Meanwhile, the supposedly recession resistant and relatively safer sector was the worst place to be.

The year-to-date market results are of course far less rosy than the quarterly results due to the very bad performance in the first two plus months of the year. For the year-to-date, domestic equity asset classes gained between 3% and 10%. The EAFE index was up 8%, but small caps in developed countries and emerging markets did manage to generate robust first half gains of 21% and 36%, respectively.

The commercial real estate and commodity indices we track had stories similar to the equity asset classes, very bad first quarters followed by an excellent second quarter.

Fixed income markets are usually relatively sedate and boring compared to the asset classes discussed so far. Generally, that is what we want and expect of them since fixed income is supposed to serve as a safety buffer in our portfolios. But fixed income was ground zero of the financial crisis, and it has been anything but sedate since last year. Last year, the indices for high yield bonds, bank loans and emerging currencies were down 30%, 26% and 15% respectively. This year, all three have snapped back smartly and gained 29%, 30% and 11%, respectively in just six months. Perhaps more surprising, U.S. Treasuries, which were the only safe place to be last year, have actually been the worst performing fixed income securities this year, with their Barclays index showing a 4.3% loss year-to-date. The risk factors in fixed income investing have most to do with credit risk and/or interest rate risk. The flip in performance by category we have seen has everything to do with changes in how investors have perceived those two factors.

What Needs to Go Right – A Focus on Housing

Early this year stock and bond valuations were so low that investors seemed to be expecting a depression, or perhaps a never ending recession. The facts that the financial system stabilized and the economy's descent showed signs of slowing down were enough to convince market participants they had been too pessimistic. I do think the snapback in market prices has been warranted. Still, I do not expect it to continue. Equity valuations are now within a reasonable range of fair value, so that future gains should depend upon earnings growth, not further P/E expansion. But earnings growth and economic recovery go hand in hand, and I'm afraid we still have a long slog ahead of us in the economic recovery. An economy that is still slowing down, but at a lesser rate, is hardly an economy that is out of the woods.

A number of things will have to go right before we can resume a healthy rate of economic growth, and even in the best case, growth faces a strong headwind as consumers, and at some later point, the public sector, deleverage their balance sheets. This process will take several years at least to play out.

Market Returns - Second Quarter 2009

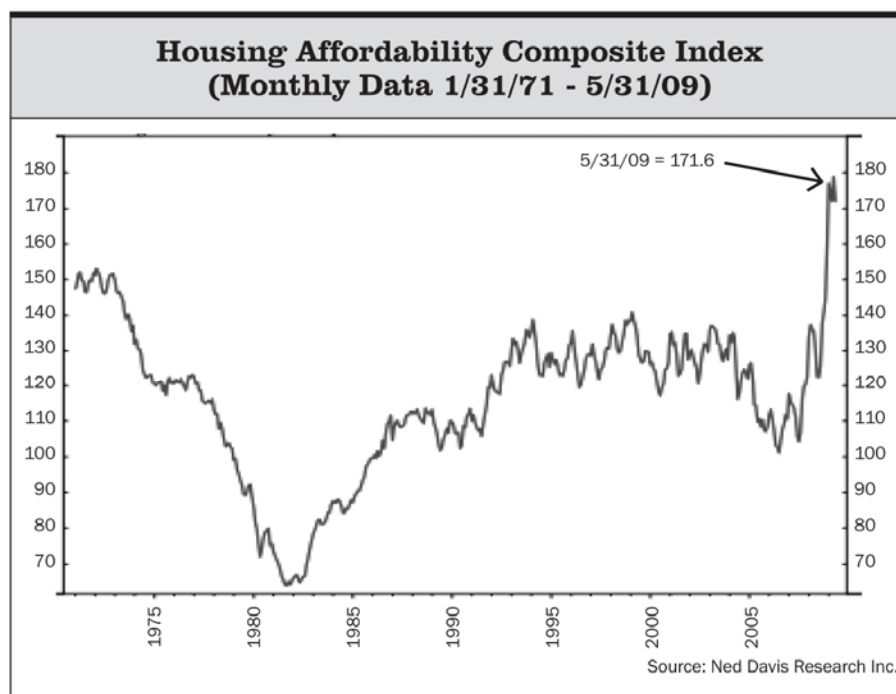
	Representative Index or Fund (blue font)	2nd Quarter 2009	Yr-to-Date 2009
U.S. Equities			
Full U.S. Market (98% by MC)	Russell 3000	16.8	4.2
By Market Cap			
Large Cap	S&P 500 (incl. dividends)	15.9	3.2
Mid Cap	Russell Mid Cap	20.8	10.0
Small Cap	Russell 2000	20.7	2.6
Micro Cap	Russell Microcap	25.0	6.0
Value & Growth			
Growth Stocks	Russell 3000 Growth	16.8	11.5
Value Stocks	Russell 3000 Value	16.8	(3.0)
Economic Sectors			
Best in Q2 2009	Financials	35.1	
Worst in Q2 2009	Health Care	8.3	
Best in for YTD 2009	Information Technology		24.1
Worst in for YTD 2009	Industrials		(7.7)
International Equities			
Large Cap	MSCI - EAFE	25.4	7.9
Small Cap	MSCI - EAFE Small Cap	34.3	21.4
Emerging Markets	MSCI - Emerging Markets	34.7	36.0
Real Estate			
Equity REIT's - Domestic	NAREIT Equity Index	28.9	(12.2)
	Morgan Stanley US Real Estate*	30.0	(8.1)
Equity REIT's - Foreign	EPRA Global ex US Index	38.9	18.2
	Eur. Investors Int'l Property*	47.8	26.8
Commodities			
Commodity Futures	Dow Jones AIG Com Index	11.7	4.6
	PIMCO Commodity Real Ret*	15.5	14.5
Fixed Income			
Investment Grade Bonds	Barcap Aggregate Bond Idx	1.8	1.9
Inflation Protected (TIPS)	Barcap US TIPS	0.7	6.2
	PIMCO Real Return Fund*	4.0	10.4
High Yield Bonds	Barcap High Yield Corp Bd Idx	23.1	30.4
Floating Rate Bank Loans	Eaton Vance Floating Rate*	19.0	30.1
Int'l Bonds, Developed Mkts	PIMCO Foreign Bonds*	13.5	7.2
Emerging Mkts Currencies	PIMCO Developing Local Mkts*	15.9	11.3
Short Term Money	3 Month T- Bills	0.1	0.1

* Based on mutual fund returns. Others are costless market indices.

Perhaps nothing is more critical getting out of the recession than is recovery in the very sector that got us into this mess in the first place: the housing sector. As long as housing prices continue to decline there will be more defaults that will cause more financial industry losses and that will further reduce consumer spending. Since the housing bubble burst there has been more than \$5 trillion of lost home equity. And Moody's estimates that more than one fourth of all homeowners with a mortgage are now "under water", owing more than their homes are worth. This is a number I find to be truly incredible!

Right now, there are a number of hopeful signs for housing, but at the same time a number of formidable negatives¹. Among the hopeful signs:

1. Much Better Affordability - Lower prices and interest rates have dramatically improved affordability, which is now at record levels (See chart below).
2. No New Stock Being Added - New residential construction has virtually shut down and is far below post-World War II lows. This helps avoid worsening the supply glut.
3. Sales Rate Decline Slowing Down - The rate of decline in home sales has been moving lower for months and is much improved in the weakest markets as bargain hunters are buying foreclosed properties.



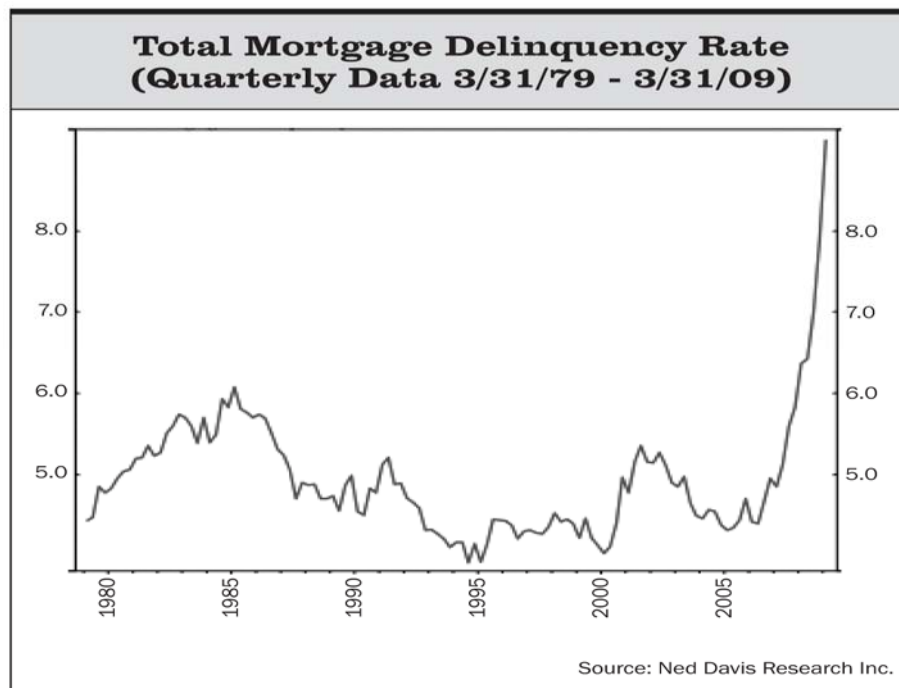
Higher points indicate greater affordability.

However there are still a number of formidable negatives:

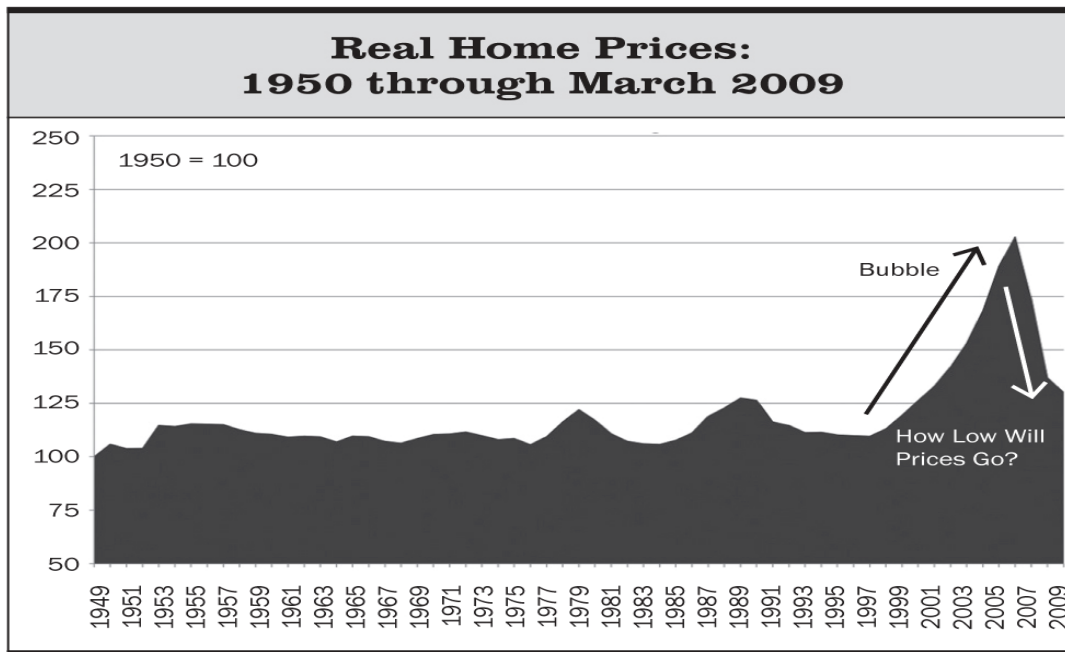
1. Buying by Speculators - A lot of the recent demand is from investors seeking to take advantage of low foreclosure sale prices rather than long-term owners. Most of the rest is first-time homebuyers so there is less activity in the middle- and higher-priced markets.

¹ The source for these "hopeful signs", as well as the "formidable negatives" that are listed later, was Advisor Intelligence's Monthly Investment Commentary for July 2009. Advisor Intelligence is a service for advisors to which I subscribe, and consequently have full rights to use all materials provided in my own client communications.

2. Mortgage Rates Up, Terms Tougher - Mortgage rates have blipped up in recent weeks and that won't help. And while rates are still generally low, loans are also harder to get as underwriting standards are much tougher than they have been in years (as they should be).
3. Few "Move Up" Buyers - The middle to high-end markets are at risk because potential move-up buyers don't have the equity in their homes they need to help finance a move up to a higher priced property.
4. For Sale Inventories Still High - The inventory of unsold homes is off its peak but is still very high, reflecting a fundamental imbalance of supply and demand.
5. High Unemployment - Unemployment is still getting worse. Historically home prices don't start to keep pace with inflation until unemployment peaks and that is likely to be months away.
6. More Foreclosures Coming - Finally, there are waves of foreclosures yet to come. Delinquencies on prime loans and Alt-A loans (those with no income verification) are surging higher. There are about \$3 trillion worth of Alt-A and Option ARM loans and most will reset at much higher payment levels over the next three years. A large percentage of these are likely to default, setting up the market for many more foreclosures over the next couple of years that will further add to the inventory of homes on the market.



Most credible observers seem to believe that housing prices will fall another 10% to 15% or so in most areas and will not bottom out for 6 to 12 more months from now. However, there are some who believe that prices will overshoot and suffer an even bigger decline with the middle and upper-end markets hit the hardest from this point. Prices typically bottom before foreclosures peak. There is also a general belief that prices will not rebound quickly. The magnitude of the ultimate decline and the amount of time before we get to a bottom will have major impacts on the timing and strength of the coming economic recovery.



As for the Rest of the Economic Situation

Of course the housing market is not the only factor driving the prospects for recovery. We must also be concerned with:

- the efficacy of our and our trading partners’ stimulative monetary and fiscal policies in sparking spending and staving off deflation,
- the degree to which the seeming stabilization of the financial sector “sticks”, and that new financial sector regulatory regimes hit the right balance, and
- the willingness of banks to lend, consumers to spend and companies to invest.

A little further down the road, it will be time to worry about the effects of huge federal deficits and a possible resurgence of inflation. In this regard, policy makers have to walk a tight rope – being careful not to pull in the reins to soon as we did in 1937 and the Japanese did in the 1990’s, but not continuing the stimulative policies too long, lest we re-ignite inflation and create debt burdens of a size that sap up the capital we need to build productive capacity.

It sounds very scary when you list all the problems we face and all the things that could go wrong. But my overall impression is that we have succeeded in side-stepping our worst fears of just a few months ago. The financial system is not going to melt down. We are not about to experience another 1930’s style depression. And while we are experiencing the nastiest of recessions in a long time, it does appear that we are zeroing in on the bottom. The investment markets have reacted this spring with a powerful, even if not long lasting, rejuvenation. While I do not expect (though I would welcome) any more rallies of this magnitude in the immediate future, I do think it is reasonable to look forward to better times for the economy and respectable returns in our portfolios in the quarters to come.

Best Regards,

*Bob Marshalla
Your Financial Advisor*