



## Montecito Private Asset Management, LLC

MPAM

### First Quarter 2009 Recap / Second Quarter 2009 Preview

The first quarter of 2009 was a period of significant volatility, with stocks basically driving lower throughout the quarter, through the first week of March. We established a major intraday low on March 6<sup>th</sup>, and a closing low on March 9<sup>th</sup>. Here are the performance results for the four major stock indexes:

INDEX	1Q09 Closing Values	4Q08	March	1Q09	End of 3Q to present	Recent Low closes (March 9, 2009)	From Recent Lows (March 9, 2009)	Recent Highs (10/9/07: DJIA and S&P 500; 10/31/07 NASDAQ; 7/13/07: RUT)	From recent Highs	2008 CHANGE
DOW	7608.92	-19.12%	7.73%	-13.30%	-29.88%	6,547.05	16.22%	14,164.53	-46.28%	-33.84%
S&P 500	797.87	-22.45%	8.54%	-11.67%	-31.50%	676.53	17.94%	1,565.15	-49.02%	-38.49%
NASDAQ COMP	1528.59	-24.27%	10.94%	-3.07%	-26.59%	1,268.64	20.49%	2,859.12	-46.54%	-40.54%
Russell 2000	422.75	-26.51%	8.67%	-15.36%	-37.79%	343.26	23.16%	855.77	-50.60%	-34.80%

In the table above, we see that the performance of the major stock indices for the month of March was very strong, even considering that the first week of the month was very negative. However, we still ended the quarter with very poor performance for all but the NASDAQ Composite, which was still down 3 percent, but significantly outperformed the others. The outperformance of the NASDAQ highlights the fact that the Technology sector received a substantial amount of the cash inflows during the quarter. What this indicates is that investors are expecting the economy to recover, not in years, but in months, since the high-growth areas of the stock market, (technology stocks among others), tend to perform best as the economy transitions from recession to recovery.

The Financials sector also performed quite well after the March lows, rising right at 50 percent compared with the overall market (S&P 500), which gained 25 percent during the same time-period (March 6<sup>th</sup> through March 31<sup>st</sup>). Again, as with the Technology sector, this indicates that investor expectations are for a quick recovery in the economy.

Those of you who listen to my live radio updates will know that I have been calling for the economy to bottom sometime in the second quarter, with the first signs of that bottom appearing in the economic data in the third quarter. My expectations have not changed. I continue to believe that we will begin to see signs that the economy is starting to improve sometime in the second half of this year, and not years out, as Bill Watkins our local economist, or the likes of Nuriel Roubini, AKA Dr. Doom, would have us believe.

With this said, I feel that the stock market has gotten ahead of itself with this latest rally, and I have raised cash, trimming positions with the expectation of a pull-back. From a technical analysis viewpoint, we really need a test of the March lows, to establish those levels for the major indices as the true bottom. I would like to see the S&P 500 retrace to about 700 to 715 and then bounce, which would provide confirmation that the March lows are *the* bottom for stocks. Should we see this confirmation of the lows, I believe we could see stocks rally to new short-term highs, above the recent 845 or so we have seen on the S&P 500; possibly to 1,000 or better in the near-term. I am very bullish on stocks for the long-term.

## FIXED INCOME

The treasury yield curve is at levels not seen for over sixty years, with yields on the short-end at basically zero percent, and the 10-year treasury yielding 2.88 percent currently. These low yields are particularly impressive, given the potential inflationary impact of the massive stimulus and the expansion of the money supply undertaken by the government over the past six months or so. The dollar has actually increased in value against other major currencies, confirming that, as bad as things are in the United States, they are even worse elsewhere. Foreign investors, uncomfortable with the economic situation in their home countries, are dumping billions of equivalent dollar value into the U.S., and specifically into treasuries and gold (more on gold below).

In the past few weeks, money has begun to flow out of treasuries (and gold), as investors' appetite for stocks (riskier assets) has increased, and the fear bubble has begun to deflate. I would expect treasury prices to fall over the coming several quarters, as investors with growth objectives realize that they must take more risk to get a higher return, resulting in cash continuing to flow out of treasuries and into stocks.

The additional fear of inflation will force yields on all fixed income securities higher (prices lower). At some point, the Fed will have no choice but to raise short-term rates as well, once the economy starts to heat back up, and inflation becomes a concern. However, I do not expect inflation to be a real threat for several years, as we are currently in a deflationary price environment, which will likely not change for some time to come.

Corporate and municipal bonds are still under significant price pressure with uncertainty surrounding the credit markets still keeping investors on the sidelines. Yield spreads for these bonds as compared with the treasury curve are historically very high, with investment grade corporates at about 400 basis-points (four percentage points) above treasuries of equivalent maturities, and munis at about a 200 basis-point (a 2 percentage-point) positive spread to treasuries. Normally, investment grade corporates only have roughly a 100 to 200 basis-points spread to treasuries (a 1 to 2 percentage-point spread), while quality munis are typically at 100 basis-points (1 percent) below equivalent treasury yields. This means that both investment grade corporates and munis are very cheap in price / high in yields, given the yields of treasuries, and therefore represent good value. The tricky part is making sure the underlying company or municipality is solvent for the long-run.

Given the current spreads for quality corporates and munis, in the context of the potential for yields across the board rising over the coming years due to inflation concerns, I am buying investment grade corporates and munis with no longer than five-year maturities. I do not want to lock money into long-term bonds, given the current environment, and the possibility

that yields could rise significantly in the future, potentially pushing bond prices down, while at the same time offering opportunities to reinvest proceeds from maturing bonds at better yields down the road. (For more detailed information on bond strategies, please call me).

## REAL ESTATE

Home prices have fallen by an average of approximately twenty percent nationwide, and by almost forty percent in the county and the State. I expect a further decline of approximately ten to fifteen percent, both locally and nationally, but feel we are past the worst of the negative impact of the excesses that led us to our current economic troubles. Inventories are still extremely high, and prices will continue to fall as long as they remain high. I estimate that it will take at least another year before inventories and prices fall enough to form a bottom in the real estate market.

Even so, I do not expect prices to rebound quickly, and would not expect to see prices return to the recent highs we have seen for many years, and not ever in some markets. The bottom line here is, for those who want to buy a home as opposed to speculate on a house, the next few years will offer opportunities. As an investment vehicle, however, I do not expect real estate to offer attractive returns for the foreseeable future. Sales numbers are improving, but this is primarily due to foreclosure sales at very distressed prices. These foreclosure sales place pressure on housing prices across the board, as appraisals are directly, negatively impacted if a foreclosure sale at a distressed price occurs within a mile or so of the property for sale.

Foreclosures are likely to continue to build for several more quarters, even as homeowners scramble to refinance at better rates to lower their payments, to keep their homes. Refinancings nearly doubled in March, as the combination of lower mortgage rates and government-sponsored programs making refinancing easier take hold. Still, in my opinion, we are a long way from a bottom in prices or activity, and I am not investing in real estate at this point, and do not expect to be for the foreseeable future. If the last real estate debacle of the late 1980s / early 1990s is any indication, we will likely not see real estate start to recovery in any meaningful way, for at least five years. Santa Barbara will likely start to rebound before many other markets, but still, I would not expect to see things improving significantly, even here, for several years.

## COMMODITIES

Late last year, commodities prices hit their recent lows, with energy prices hit especially hard. Oil dropped from its high in mid-2008 of \$147 per barrel to the low \$30s at the end of the year. Since then we have seen oil prices rebound about 60 percent, to the low \$50s currently. As we are still in a deflationary price environment (go to any retail store and see how everything is on sale to confirm this), I do not feel that the recent run-up in commodity prices is sustainable, and I would expect some significant price declines for commodities in the short-run.

Gold has been a safe-haven destination for investors in recent months, especially going back to September when Lehman Brothers failed. Investors panicked, sending gold prices soaring (as well as treasury prices), and pushing gold up to around \$1,000 per ounce recently.

Over the past few weeks, as the fear bubble has deflated somewhat, cash has begun to flow out of gold and back into stocks, pushing gold down to around \$880 per ounce at present. I believe gold is dramatically overpriced, and would expect it to continue to fall back to at least \$650 per ounce, and likely much lower. I am short gold and treasuries right now, and have been since gold was near \$1,000 per ounce and the 10-year treasury yield was below 2.5 percent. I will remain short for the foreseeable future. I will look at resource companies and energy companies in terms of buying their stocks, but only after they pull-back from current levels to more attractive prices.

## CONCLUSIONS

Given my analysis of all asset classes, I feel that stocks are the most attractively-priced asset class, as compared with bonds, real estate and commodities. I have purchased some investment grade corporate bonds and municipals, with maturities no greater than five years, and will continue to buy bonds with these parameters, as long as yield-spreads remain attractive, for investors whose asset allocations require fixed income weightings.

I have raised significant cash balances over the past week or so, anticipating a pull-back to around 750 or lower for the S&P 500. After the recent 25 percent rally in stocks, I feel we are due for a correction. My hope is that we will have a test of the March lows, but that we will not make new lows below the March 6<sup>th</sup> levels. I will begin to invest cash once stocks retrace to 750 or below on the S&P 500, working cash into stocks in a phased manner (in increments). Within stocks, I will focus on those sectors of the economy that benefit most from a recovery; sectors that contain the highest growth-oriented companies. These are: the Financials, Industrials, Technology, and Consumer Discretionary sectors. I am also focusing on U.S.-based companies within the stock market, as I believe there is more value here at home with less comparable risk.

Keep in mind that stocks anticipate recoveries in the economy, normally by at least six months. If I am correct, and the economy begins to recover in the second quarter, stocks have likely already set their true bottom in March, and are already in a bull market phase. Should we have a test of those March lows, and if we hold above those lows and bounce, I will feel that the March lows have been confirmed, and will expect to see stocks rally to new short-term highs within a few months.

We have just endured the worst financial crisis since the Great Depression, and we are not out of the woods yet. But, I feel we have seen the worst of the financial crisis, and I am very optimistic that the economy will start to recover by the second half of this year.

*I would like to invite you to attend my upcoming Fixed Income Seminar during which I will discuss my analysis of all fixed income vehicles and my expectations for each. I have not set a firm date or location yet. Please call me at 805.898.1400 or email me at [craig@mpam.bz](mailto:craig@mpam.bz) to reserve a seat or for more information. Please also feel free to contact me, should you wish to meet to discuss your portfolio, or to discuss the financial markets, or the economy.*

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