



Rally Based on V-Shaped Recovery. But It's Not Happening.

Monthly Outlook: October 2009 The rally in equities that started in mid-March may have finally peaked in mid-September. And what a rebound rally it's been – up about 56% or so. We normally don't see that much return off the lows until we're 2 or 3 years into an economic recovery and 2.5 millions jobs have been created. Instead, it's still very unclear that the recession is even over and employment continues to worsen with the worst unemployment (9.85%) since 1982. Last month, we noted the current barbell trade that is taking place beneath the more focused-on rally in broader equity markets. That is, the recent shift to buy safe-haven US Treasury Bonds and sell risky-assets like Emerging Markets, Commodities, and High Yield Bonds. Is this shift a harbinger of a correction in broader equity markets to come? We think it is, but we have to admit that the 6-month equity rally has held up a month or two longer than we thought it would, given the lack of economic data

they've lost 50%. It takes a 100% gain to go from 50 back to 100 and that's asking a lot.

The current stock market rally has had an impressive 56% rebound based on assumptions that the economy has begun an impressive and strong "V-shaped" recovery. Sure, the financial crisis was real, it was scary, but we're going to magically bounce right back to where we were, and soon? That sounds great, but it's just not happening. Stocks today are priced for 4% GDP growth next year, a 35% rebound in corporate earnings, and valuations are now higher than they were in October 2007 right before the whole thing started. No, the stock market rebound rally has not yet given us a "sell" signal, but it's risky to be long stocks now. While Stocks remain euphoric, the Bond market smells risk. In the past – 1987, 1994, 1998, 2000 & 2007 – when Stocks & Bonds diverge like this – the Bond market has won.

Market Indices	Oct 07 Mar 09	Mar 09 Sep 09	Oct 07 Sep 09
S&P 500 large cap	- 56 %	+ 56 %	- 32 %
Russell 1000 large cap	- 56 %	+ 58 %	- 32 %
Russell 2000 small cap	- 59 %	+ 76 %	- 28 %
International Markets			
Europe	- 65 %	+ 79 %	- 38 %
Japan/Asia	- 57 %	+ 63 %	- 31 %
Emerging Markets	- 64 %	+ 95 %	- 30 %
Bonds & Real Estate			
U.S. Intern. Bonds	+ 3 %	+ 6 %	+ 9 %
U.S. REITs	- 72 %	+ 92 %	- 47 %

to support it. Maybe October will once again be the month that breaks a rally.

Here's a math riddle for you: What goes down 56%, then up 56%, and is still down 32%? The answer is the stock market! That's what the S&P500 has done from the peak in October 2007, to the low in March 2009, through the current rebound now on September 30th. The bottom line is that even with this rebound rally the stock market is still down 32% from its peak. This just points out how important it is to avoid losses. Think about it – if stocks go from 100 to 50,

The stock market and the economy are acting like two cousins that are related but not talking to each other. 3rd Quarter GDP will likely be positive thanks to government stimulus but is already showing signs of weakening again now that the shock therapy is over. The official NBER watches production & employment, sales & income. The Chicago Fed's production index is reliable and shows -0.90% for August signaling that the economy is still contracting. The employment figures for September showed another 264,000 jobs lost and an unemployment rate now at 9.85% and still rising (to 12% we think). House for sale inventory continues to build as would-be buyers either can't get the credit they need or don't have the income required. Our point is – the worst of the economic melt-down may be behind us, but we're certainly not seeing a "V-shaped" recovery that the stock market seems to be pricing in. The stock market will eventually "talk" with the economy and likely adjust. Stocks were probably over-sold on bad news in March, and are probably over-bought on recovery hopes today. Buy bonds – we already have.