



Borrowing to Buy a Car is Not Growth

Monthly Outlook: November 2009 The 3rd Quarter Advance GDP estimate is just in and it is a strong +3.5% growth. Pundits are quick to call the recession over – all is well – green shoots! While we would like to share the optimism, we’re not sure the details support the call quite yet. Over 90% of the 3rd Quarter growth came from government stimulus programs, primarily auto and housing incentives that are not sustainable. Think of it this way – GDP is basically the measure of all spending. If your neighbor (not you of course) goes out and borrows

Market Indices	YTD -	
	Sept 2009	Sept 2009
S&P 500 large cap	- 2.0%	+ 14.7%
Russell 1000 large cap	- 2.3%	+ 16.1%
Russell 2000 small cap	- 6.9%	+ 12.7%
International Markets		
Europe	- 2.3%	+ 20.9%
Japan/Asia	- 3.2%	+ 15.4%
Emerging Markets	- 3.4%	+ 50.4%
Bonds & Real Estate		
U.S. Interm. Bonds	+ 0.3%	+ 3.45%
U.S. REITs	- 5.0%	+ 8.9%

money to buy a new car – are they richer or do they just appear to be? 3rd Quarter GDP was almost entirely made possible by government borrowing and the use of personal savings. To have sustainable growth, we have to collectively produce more, save more, and invest wisely. That just takes time and focus. Nearly every modern recession has had at least one positive GDP print along the way that did not prove to be the end of the recession. Finally, the equity markets didn’t seem fooled by this GDP number either with equity markets down a couple percent since the news release. Our take is that it is still unclear that the recession is over and yet the equity markets have not only priced in the end, but a robust “V-shaped” economic recovery. Equity markets, however, seem to be slowly coming to terms with the slow-growth reality and have been topping through September and October. A pause in the equity rally seems to be developing currently, which will likely push the proceeds back to less risky assets

like Cash and US Treasury Bonds over the short term. A pause in the equity market rally or even a small equity market correction would give the slowly recovering economy a chance to grow into the lofty valuations that are embedded in equity prices today.

Following the massive credit bubble that peaked (and popped!) in 2007, we are now in the slow process of deflating back to the “new normal” economy. Bank credit is currently still contracting at a 15% annual rate and banks now hold about \$1.3 trillion on their balance sheets. Most are stockpiling cash (buying US Treasuries) for their loan loss reserves and not lending for now. Who can blame them given rising defaults and real estate illiquidity? 115 banks have failed in the last 12 months and many more are close. Corporations and Individuals, alike, are doing what they can to reduce spending, increase savings, and hold on. Only the U.S. government is bucking the trend by borrowing and spending. But even as massive as the government stimulus is, it still isn’t enough to offset the deflating bubble. It’s a tricky thing to let air out of a bubble slowly, and even more tricky to price it correctly. Markets are sure to under-value (March?) and over-value (October?) in the process. With every new economic report, investors get one more clue as to the real size of the new-normal economy and the real shape of the recovery.

As we start November, we see some very important shifts to the trends of world markets. After a very strong recovery rally in most markets for the past 6 months or so, we have some new signals in just the past week. US Large-cap Value (think Financials), US Small-cap, Japan, Foreign Small-cap and REITs have all turned down. US Large-cap Growth, Europe, and Emerging are all teetering and could turn downward any day as well. Only Investment Grade Bonds and Commodities are holding up well. We’ve positioned our portfolios accordingly as markets wobble from waning conviction about the recovery.