April 10, 2009

Dear Clients and Friends,

"The pendulum of the mind oscillates between sense and nonsense, not between right and wrong"
- *Carl Jung*

The stock market's pendulum swung to extremes in the first quarter of 2009, down sharply at first as the bears ran rampant, and then up strongly in the final weeks as the bulls came out of hiding. News from the markets and Washington continues to alternate between good, bad, and confusing. Some leading economic indicators are creeping higher even as the near-term corporate earnings outlook remains punk. The global credit freeze is thawing, yet it remains difficult for many businesses to obtain funding. The government has committed hundreds of billions of dollars to re-inflate asset prices, yet the latest readings suggest homes continue to lose value. Some banks and car makers may be reorganized; while others will make it through the morass and emerge stronger. With all of this economic back-and-forth, the market has reacted in kind.

In the near term, we expect the following:

- First quarter earnings will be very weak, though probably not as weak as in the fourth quarter of 2008
- The Treasury and Federal Reserve programs to segregate troubled financial assets will proceed as planned, though not without a few bumps in the road
- A number of firms, largely in the financial and real estate sectors, will need to raise capital and roll over maturing debt – their ability to do so will likely determine their viability
- Volatility will remain above the historical norms, though seems to be trending lower
- Consumer spending will remain weak as housing tries to find a bottom and unemployment rises – recently a Federal Reserve official said the unemployment rate could rise to 10%
- Dividends will, on average, continue to be under pressure; the first quarter marked the worst ever decline in corporate dividends, and there is little chance they will start to climb any time soon.

With these points in mind, the markets will likely gyrate without clear direction over the next several months.

Longer-term, we are more optimistic, for the following reasons:

- The normalized "earnings yield" on stocks is well above long-term average
- Cash on the sidelines is still at very high levels, representing potential buying power should pensions and other large institutional buyers return to the markets
- The 10-year rolling annualized return of the S&P 500 is now at the lowest level since the 1930s; a reversion to the mean level seen over the past 75 years is increasingly likely
- Mergers and industry consolidation will lead to better performing businesses; this is already starting in some sectors
- $800 billion in stimulus money will begin filtering through to the economy

While we have been selectively buying a number of stocks and bonds over the past few months, we continue to believe a cautious approach is warranted. In particular, we are moderating our view on dividend-paying stocks, as a growing number of companies have cut their dividends outright or started paying them with stock instead of cash. It will be quite some time before dividends become the important factor they once were, so for now the relative weighting on dividend yield is not as high for us as it has been in the past. Indeed, in many cases, high dividend yields may actually be a sign of trouble, rather than of company strength. At some point such nonsense will have played out, the pendulum will swing, and dividends will again play an important role in total portfolio returns; in the meantime we will be necessarily more selective.

Sincerely yours,

Mitch Schlesinger