

INVESTMENT COMMENTARY

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2nd Quarter 2009

The Markets

Index	Quarter to Date	Year to Date	Trailing 1 Year	Trailing 3 Years	Trailing 5 Years	Trailing 10 Years
<u>Domestic Equity (Large Cap)</u>						
Russell 1000	16.50	4.32	(26.69)	(8.20)	(1.85)	(1.75)
Russell 1000 Growth	16.32	11.53	(24.50)	(5.45)	(1.83)	(4.18)
Russell 1000 Value	16.70	(2.87)	(29.03)	(11.11)	(2.12)	(0.15)
<u>Domestic Equity (Mid Cap)</u>						
Russell MidCap	20.80	9.96	(30.36)	(9.25)	(0.11)	3.15
Russell MidCap Growth	20.67	16.61	(30.33)	(7.93)	(0.44)	0.02
Russell MidCap Value	20.94	3.19	(30.52)	(11.07)	(0.43)	4.00
<u>Domestic Equity (Small Cap)</u>						
Russell 2000	20.69	2.64	(25.01)	(9.89)	(1.71)	2.38
Russell 2000 Growth	23.38	11.36	(24.85)	(7.83)	(1.32)	(0.89)
Russell 2000 Value	18.00	(5.17)	(25.24)	(12.07)	(2.27)	5.00
<u>International Equity</u>						
MSCI World ex US	25.86	9.32	(31.62)	(7.46)	2.87	1.63
MSCI World ex US Growth	21.84	7.57	(34.40)	(6.79)	2.85	(0.14)
MSCI World ex US Value	30.21	11.12	(28.71)	(8.23)	2.80	3.19
MSCI Emerging Markets	34.84	36.22	(27.82)	3.27	15.08	9.02
<u>Real Estate</u>						
Nareit Equity REITs	28.86	(12.21)	(43.29)	(18.02)	(2.74)	5.53
<u>Domestic Fixed Income</u>						
Barclays U.S. Aggregate	1.79	1.91	6.06	6.43	5.02	5.98

After six consecutive negative quarters in the U.S. equity markets, stocks came roaring back in the second quarter of 2009. Investors turned away from continuing weak economic news and chose to focus on our future economic recovery. Returns were strong enough in the quarter to bring most indexes into positive territory on a year to date basis. The exceptions are the value indexes, which suffered larger losses in the first quarter.

Investment Commentary is a newsletter dedicated to the issues, trends, and strategies surrounding both the individual and institutional investor. It is published quarterly by Larry Thompson & Associates, an independent investment management consulting firm based in Dallas, Texas.

Despite all the good market news this quarter, trailing period returns are negative, in some cases for as long as 10 years. Fixed income has only made moderate gains so far in 2009, but has averaged 6.0% per year for the past ten years, easily beating most equity markets. In fact, only emerging markets have beaten bonds over the ten-year period, while REITs were only slightly behind. There is a lot of end-point sensitivity to these returns, but they remain interesting.

All ten economic sectors in the Russell 3000 index posted positive returns this quarter, but only four are positive on a year to date basis. The second quarter was led by financials (up 29.0%), information technology (up 20.8%), industrials (up 20.4%), and consumer discretionary (up 20.0%). These sectors encompass both the “growth” and “value” segments of the equity markets, showing that the market gains were broad based. The weakest performers during the quarter were telecommunications (up 4.2%), consumer staples (up 10.3%), and health care (up 10.3%). Clearly, with these defensive sectors lagging the overall market, investors were positioning their portfolios for a recovery.

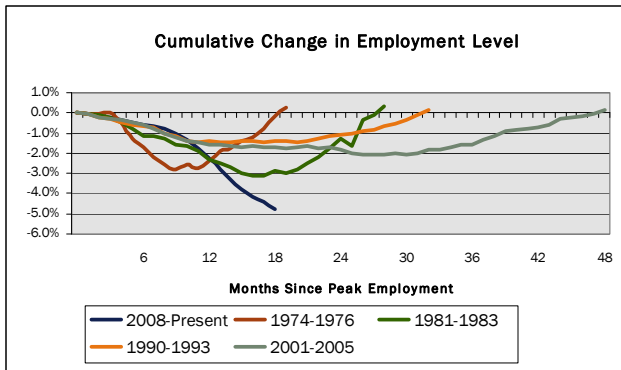
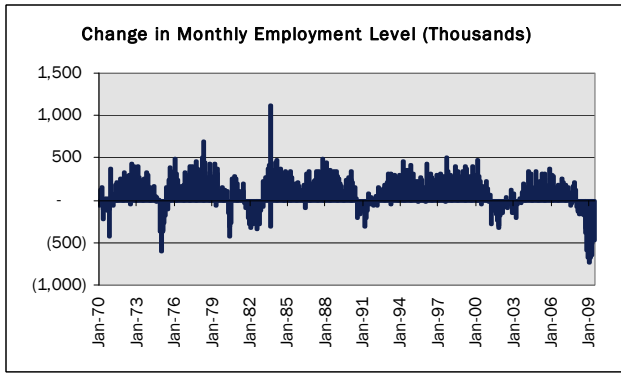
The Barclay’s Aggregate index gained 1.8% during the quarter, but as often is the case, returns among the various bond sectors varied widely. Most interesting is that AAA rated bonds lost value, while BBB (the lowest quality investment-grade bonds) gained 12.9%, further evidence that investors are adding risk to their portfolios. Collectively, Treasuries lost 3.0%, with intermediate Treasuries losing 2.1% and long term Treasuries losing 7.1%. The worst hit were Treasuries with maturities greater than 20 years (down 9.4%). Corporate bonds were strongly positive in the quarter, especially long-term bonds of financial companies. Within the asset backed bond sector, Commercial Mortgage Backed Bonds had the strongest returns, which is surprising given the continued weakness in the commercial real estate markets.

Internationally, a weaker U.S. Dollar drove equity returns higher. The Dollar losses were based on a growing belief that growing U.S. budget deficits and government actions will be inflationary. Furthermore, there is a growing belief among traders that the servicing of a record level of debt will become too expensive and the inflation will be used to lessen the “real” cost of the debt payments. A glaring contradiction exists between U.S. equity investors who see a strong U.S. economic recovery on the horizon and currency traders who think the economic situation is dire enough to force the Dollar lower.

The Economy

Who will ultimately be correct? It is difficult to say, but we do know there are several major issues that will continue to haunt the economy and financial markets. The good news is that financial markets are always forward looking. They can overlook today’s issues if they see a brighter future ahead. Some money that left the markets during last fall’s collapse chose to return to the markets this quarter. Recent press has pointed to institutional investors rebalancing back into equities from more defensive fixed income investments. There appears to be much optimism for future market returns and economic recovery.

Can the future hold up its end of the bargain? How can our economy recover when almost 10% of our workforce is unemployed? How will we fight off the inflationary pressures caused by massive fiscal stimulus and budget deficits? What about the effects of the almost inevitable higher taxes needed to pay down the deficits?

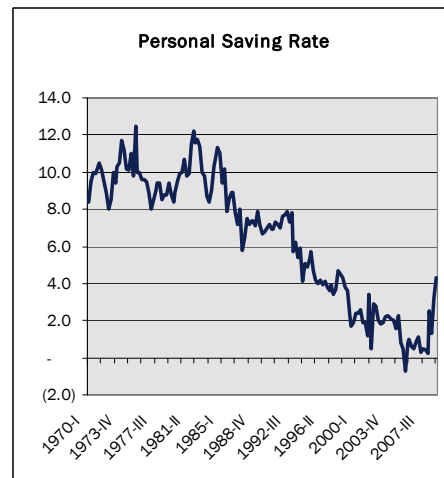


The two charts on the left show how poor our employment situation has grown. The official unemployment rate is currently 9.5%, but expected to rise. The first chart shows how many jobs have been gained or lost on a monthly basis since 1970. First, note that there have only been a few instances when jobs have been lost. The current cycle is unique in both the numbers of monthly job losses, but also the length of consecutive monthly losses. If there is any encouraging news, the pace of losses was lessening, until the June preliminary announcement. From January through May, the monthly job losses have been 741,000, 681,000, 652,000, 504,000 and 345,000. The markets cheered the slowing losses, but they remain massive. To put the “smaller” loss of 345,000 jobs in May in context, it would have been the largest monthly job loss since 1980, if not

preceded by the other months in 2009. The June estimated job losses were 467,000. Hopefully, this is a spike in the trend and not indicative of an increased pace of job losses. The equity markets reacted poorly to the news and ended July 2nd down about 2.5%.

Some astute readers will point out that there are more people employed today than in 1980, so focusing on the total number of losses is misleading. The second chart shows the cumulative job losses in percentage terms during the past five periods of sustained job losses. The chart also shows how long it took for the job levels to return to their previous peaks. For instance, the red line shows the 1974-1976 job cycle. Employment peaked in July 1974 and bottomed in April 1975, nine months later. However, the employment level did not return to its 1974 peak until February 1976, 19 months later. This particular job cycle was the shortest in duration. The 2001-2005 cycle, while much milder in severity, lasted four years. Our current cycle peaked in December 2007 and has not yet bottomed. It is also the most severe of the last five. History tells us that we will not return to the December 2007 peak for several years. This could be problematic for our overall economic recovery as unemployed workers are not big spenders. As we have reminded our readers many times in the past, the consumer is the largest driver of our economic growth and will be critical to any economic recovery.

In 2009, the consumer has not lived up to its name and should now be known as the “saver.” In the 12 months ending March 2009, and for the first time since the government began tracking consumer spending in 1947, consumers spent less than they did the year before. This has also led to a large





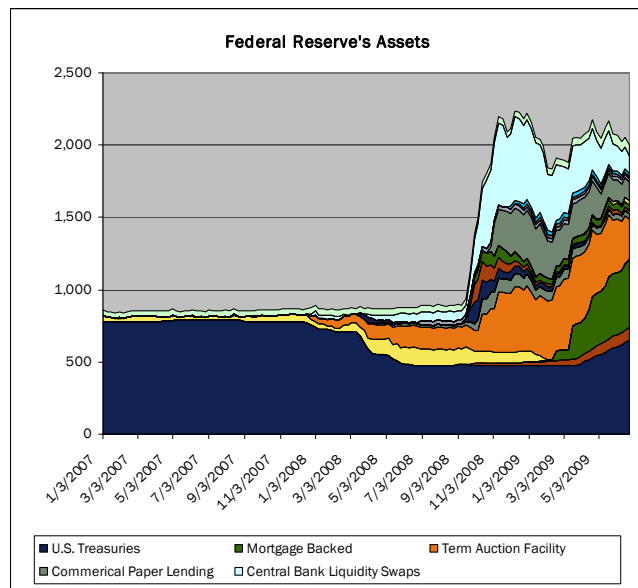
increase in our nation's saving rate. We saved 4.3% of our disposable income in the first quarter, the highest savings rate since 1998. On the one hand, our nation could practice better saving habits (excessive borrowing led us into this recession), but on the other hand, too much saving is not good for the economy. Every Dollar that is saved is a Dollar that is not spent.

Will all of these new savings be eroded by future inflation? Officially, according to the Consumer Price Index, we are in a period of deflation, or falling prices. However, removing energy and food prices from the equation and prices rose 1.8% in the last year. It was almost one year ago that we saw record high energy prices, which drove inflation higher. The current

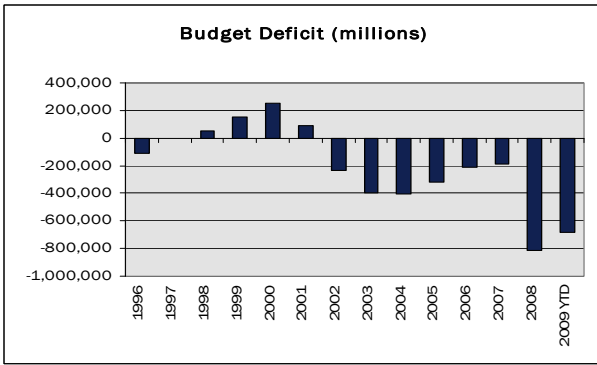
deflationary readings we have been seeing the past few months are simply the result of the sharp drop in energy prices in the last year. As we move towards the fall, the index will lose last year's high energy prices and inflation will probably rise, depending on how energy prices fare during the next months.

One of the biggest worries of our clients, and a popular debate, is how high inflation might rise given the government's large economic stimulus and increasing budget deficits. Those arguing for higher than normal inflation point to the quantity of money that the government and Federal Reserve have put into the economy over the past few quarters.

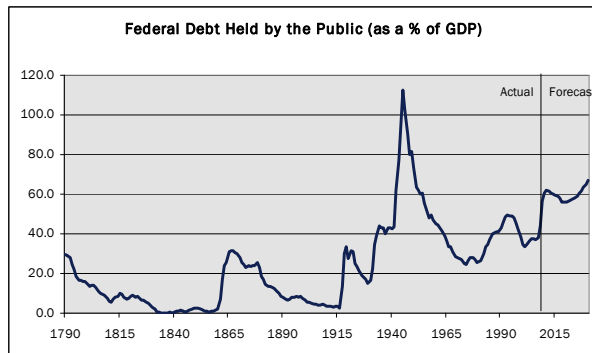
This chart shows the current assets of the Federal Reserve. For decades, the balance sheet was relatively simple with Treasuries being the largest asset. Beginning in 2008, the Fed lowered its holdings of Treasuries and began to expand into other assets. The total size of their assets grew to over \$2 trillion. I have highlighted only the major programs launched in the past few years. These include large purchases of mortgage-backed bonds, the Term Auction Facility, and the Commercial Paper Funding Facility. Included in the graph, but almost too small to see is \$43 billion given to AIG, \$62 billion to assist the liquidation of Bear Stearns, and \$25 billion for TALF (Term Asset Backed Securities Loan Facility).



In addition to the Fed's actions, the government (through the Treasury Department) has launched its own programs, with the Troubled Asset Relief Program (TARP) being the most notable. The biggest government action is simply spending more money than it is earning, creating a budget deficit. In calendar year 2008, our deficit was \$816 billion and through the first five months in 2009, we have run up a deficit of \$680 billion. Much of the deficit is due to fallen tax revenues, but increased government spending is a major contributor. These



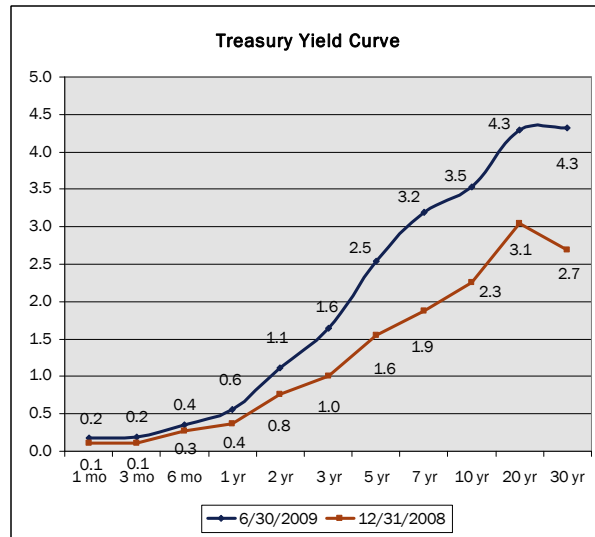
numbers do not begin to show how bad the situation could grow because of the looming crisis in Social Security and Medicare. We will save that discussion for another Investment Commentary.



As we discussed in last quarter's Investment Commentary, the government must finance our deficits with bond issuance. The Congressional Budget Office (CBO) estimates that the total value of our outstanding debt is equivalent to 56.6% of our nation's entire economic output (GDP). This is the highest level since World War II, when we had debt greater than the entire output of our economy. We will surely see increased bond issuance in the next few years and we should expect our outstanding debt to become much larger compared to our GDP. Fortunately, interest rates remain low, making servicing the debt cheap, at least for now.

There is a great amount of money entering our economy now and in the coming years, which will be inflationary. It will be up to the Fed to act quickly and eliminate the excess money before inflationary damage can be done. For the next few years, we anticipate the Fed walking a fine line between growing the economy and preventing inflation. Recent Fed statements have attempted to build investor confidence that they are aware of the looming inflationary issue and will take appropriate action when necessary.

As was the case in 2008, the inflationary "wild card" remains energy and commodity prices. The Fed can control the amount of money in our economy, which under normal economic situations, is an effective way to control inflation. When the inflation is driven by energy prices, traditional inflation fighting tactics have less impact. Again, the Federal Reserve is well aware of the impact of energy on inflation and focuses most of their attention on the "core" inflation index, which excludes energy and food prices. Of course, we cannot choose to ignore higher energy and food prices when we are filling our gas tanks and buying groceries. We hope the Fed will be successful in their inflation fight. Of course, we do not know if they will, but we do know it will be their top priority once the economy appears to have stabilized.



The bond markets are not so sure. The Treasury yield curve has steepened in

2009. Some of this could be the general trend of investors selling bonds and buying equities. Given the amount of debt coming into the market in the coming years, it will be critical for investors to continue to purchase this debt. The most important investors remain our large trading partners, especially China. China has made statements of their desire to decrease their U.S. assets in favor of more diversified holdings. Whether they actually do so is up for debate, but the threat of doing so is serious. As we discussed in last quarter's Investment Commentary, the U.K. had a failed government bond auction. Each U.S. bond auction is now being scrutinized for declining bond demand. So far, no significant demand decline has been noticed. If we reach a point where supply exceeds demand, interest rates will need to go higher to entice buyers. Of course, higher interest rates make servicing the country's large debt load that much more expensive.

Given the increasing debt to GDP ratio and the amount of new debt expected to enter the market, there is a risk the U.S. could lose its long held AAA bond rating. Moving from AAA to AA is a long way from being on the verge of a default, but it would be a psychological blow to the bond markets. According to Moody's, there are currently 18 countries with AAA credit ratings, seven of which are Euro zone countries. The United Kingdom, despite its bond troubles, is also an AAA rated country. The next ratings level down is AA, which includes Belgium, Ireland, Hong Kong, Italy, Japan, Kuwait, Portugal, and Taiwan. These are hardly countries with economic problems, but not a group the U.S. would like to join.

Essentially, there are two ways for the U.S. to improve its debt to GDP ratio – less debt or more GDP. Unfortunately, a country's GDP is a product of its current economic scenario and most economists are predicting only modest economic growth over the next few years. The “less debt” angle is more intriguing. Many would argue that the unprecedented debt levels that we are seeing today are simply a product of runaway government spending. The answer to too much debt is to simply spend less. It is probably obvious to all readers by now that less government spending is not in the cards – at least not any time soon. Therefore, the real question is “how does the debt get paid back?” The answer is no doubt obvious – today's debt will be paid back with tomorrow's taxes.

In Summary . . .

It was encouraging to see the markets recover somewhat from their early March lows, especially since there is not a lot of positive economic news at the moment. We are concerned that investors may have returned to the markets too soon and too quickly. Hopefully, they will remain committed for the long term. If not, the markets could be volatile until the economic news improves. There is still a lot of uncertainty as to what our economy will do in the future. As we have stated in the past, investors can be very cautious investing in a market when the future is unclear. We hope that inflation will not be a major issue. We hope the employment picture will improve. We hope the government will not issue as much debt as it appears they will. For now, these remain hopes. Until we see more clarity, it will be difficult for the market to sustain a strong rally.