



Two Important Decisions We Must Make

Stewart R. Massey
stewart.massey@masseyquick.com
(973)-525-1000

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“When investing, pessimism is your friend, euphoria the enemy.”
Warren Buffett

The Biggest Loser

Reality TV has become pervasive. While I don't have much time for television, some shows can be rather compelling (like slowing down to examine a car wreck on the other side of the road). *The Biggest Loser*, a popular reality show, takes people who are grossly out of shape and transforms them through a strict regimen of diet and exercise. The metamorphosis can be remarkable. Some contestants have lost over 150 pounds, improving their health dramatically. Perhaps we could use a similar show for the world's economies. Pursuing this analogy, our economy is currently a 400-pound man who has lost 50 pounds. It's a start, but there is a long way to go until we are healthy again. The stock market is acting like this 400-pound man has lost 200 pounds. The rally in equity prices is anticipating prompt and swift relief from the core problems that ignited the worldwide recession. Those core problems still exist. There is much work to do for our 400-pound economy to lose the next 200 pounds. We'll get healthy again, but it will take some time. We are not in the early stages of a "V"-shaped recovery.

We're Looking for a Pullback But See Opportunity

Our belief is that the recent stock market rally, bringing the S&P 500 from a low of 666 into the low 900s, will run out of steam at some point and we will experience a pullback into the 700s. As we stated in our strategy letter dated February 6, 2009 (*2009 – Hangover or Hope*), “We would begin to allocate to stocks in the 750 range of the S&P 500.” Assuming an earnings estimate of \$50 for the S&P 500 in 2009 with a blurry outlook for 2010, a price/earnings ratio of 15 times this year's earnings gets us to a range of 750-800. We still share that sentiment. The bumpy ride isn't over yet.

We continue to favor unleveraged long/short equity and fixed income strategies. If we are wrong about the direction of the market, we believe these managers will produce strong risk-adjusted returns in our portfolios. We are beginning to participate in TALF through a dedicated fund offered by one of our managers. We are being shown a stream of highly distressed opportunities, especially in the real estate sector, which we are beginning to find attractive. We like fixed income, especially municipal bonds, but are keeping maturities short and are working with managers that have outstanding credit research teams in place. The investment landscape isn't totally barren. The financial crisis and recession are creating opportunities.

The following chart depicts the price action of the S&P 500 over the past 6 months:

Courtesy of Bigcharts.com



The stock market's significant decline took place as fundamentals detached from stock pricing. Equities were being driven by macro events. The baby was being thrown out with the bathwater. No distinction was being made between "The Good", "The Bad," and "The Ugly". To refresh you on our scenario:

- Listed companies will be placed into three categories: The Good, The Bad, and The Ugly.
- "The Good" will be companies with strong balance sheets, supportive dividends, strong business franchises, and sustainable and growing free cash-flow. They will be well-positioned to feed on "The Bad" and "The Ugly". They will gain market share and pricing power. "The Good" will be the first movers when markets turn.
- "The Bad" will have weaker balance sheets and financing needs that will serve as an overhang on their stock prices. A thaw in the credit markets will help these companies the most.
- "The Ugly" may not make it. They will have too much debt, a weak position in their industry, and the fear of counterparty risk hanging over their heads.

While we still believe "The Good" will prevail, fundamentals have not yet reattached to stock pricing. One of the reasons we view this rally as suspect is that "The Bad" and "The Ugly" led the way. To quote one of our core managers:

“The most fascinating aspect of this two-month rally has been the fact that the best performing stocks are the ones with arguably the worst fundamentals. The Fed’s announcement of the stress test plan created a massive short covering rally in the financials. Furthermore, the “new” thinking that the economy was not going to fall off a cliff also forced anyone significantly short the consumer discretionary space to cover their positions. Some consumer-oriented stocks have advanced 70% to over 100% in the course of just two short months. So much for the efficient market hypothesis. How can the business value of a company change hands one day for let’s say \$10 per share and literally in 8 weeks go for \$20 per share and yet both prices were deemed correct at their respective times? Mr. Market’s wisdom is truly something to behold.”

We’re not traders. The best investment results come when working with a reasonable (3-5 year) time horizon. That being said, we have been reducing long equity exposure at these levels with the belief that we will have a more attractive re-entry point later this year.

Inflation Will Be Back

The correlation of inflation-sensitive assets (TIPS, Oil, commodity index ETNs, etc.) to the stock market has been remarkably close over the past 12 weeks. The same people that were betting that a quick turn in the economy would benefit “The Bad” and “The Ugly” also moved up the price of inflation-sensitive investments. We don’t disagree that inflation will be an issue again. It isn’t a matter of if, but when. Our scenario calls for the economy to bump along the bottom for some time before showing signs of a meaningful turn. Like equities, we are waiting for the right time to add inflation protection to our portfolios. That point in time will probably come when we reach a cyclical low in the stock market. The realization that the economy is not turning as quickly as some had hoped will cause the bulls to head home as they lose patience with the pace of the recovery. Bad news is still out there. We would not be surprised if we had one more round of recession/deflation fear before this bear market ends. The price of United States Oil Fund, a domestic exchange-traded security designed to track the movements of light, sweet crude oil, has risen by over 40% over the past three months.

Courtesy of Bigcharts.com



Similarly, the price of TIPS (Treasury Inflation Protected Securities) has seen a dramatic move since mid March. The chart below depicts the price of the iShares Barclays TIPS Bond Fund over the past 90 days.

Courtesy of Bigcharts.com

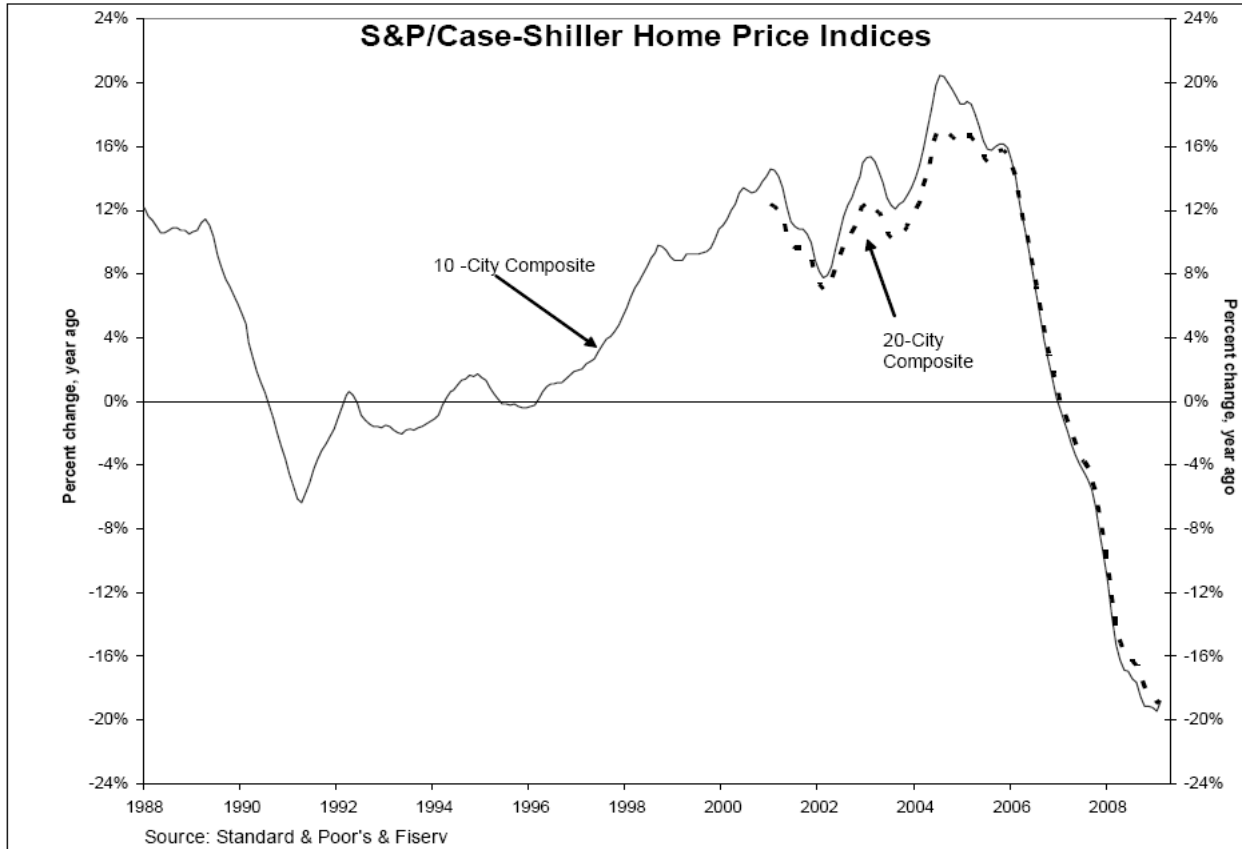


In the case of both the stock market and inflation-sensitive assets, it's too much too soon. We would rather stay in our defensive position than add risk to our portfolios through these two asset classes today.

Problems Still Exist

While the market is hoping that the massive amount of government stimulus will jump-start a swift recovery, the real economy is still healing. The main issues that we will continue to face include:

- The global financial services industry is still in need of cleansing. Banks, insurers, and finance companies are still going through a stage of rehabilitation. The next set of pressures will come from commercial mortgage defaults and the inability of leveraged consumers to service their credit card debt. Some of the stronger institutions are paying back their TARP money, but their inability to leverage balance sheets that are still in the process of repair will dampen earnings prospects.
- The housing market has yet to bottom. April statistics showed a 13% drop in housing starts, a 46% fall in multi-family starts and a record low in building permits. Inventories around the country remain high, but consider that many homeowners want to sell their homes, but find current market conditions unacceptable. According to Zillow.com, 21.9% of all homeowners in the United States are in negative equity and one in five homes sold in the past 12 months was a foreclosure. A recent Zillow.com survey indicated that almost one third of all homeowners may list their homes when we see some evidence of price stabilization. This "shadow inventory" could depress a housing recovery. Homes comprise a large portion of household wealth. The wealth effect of depressed home prices will continue to suppress consumer spending. The following chart depicts the change in home prices as recorded by the S&P Case Schiller Index.



- Consumer spending remains constrained. While we saw a slight uptick in spending in January and February, very little discretionary spending is taking place. Small retail businesses are closing. Merchandise is being marked down aggressively in an attempt to spur demand. The U.S. economy needs the consumer to start spending again, yet there is a secular change taking place. Households will remain frugal.
- Domestic unemployment, currently stated at 8.6%, may continue to rise after a period of slight improvement. We expect unemployment to peak between 9 and 10% before moving decidedly in the other direction. This will continue to impact consumer confidence, household spending, and the housing market.
- Government stimulus programs may provide a temporary band-aid, but their long-term impact is suspect. Further down the line, true economic growth will have to replace the short-term impact of government spending.

Never Let a Good Crisis Go To Waste – The Two Most Important Decisions

The Warren Buffet quote at the top of this piece, “When investing, pessimism is your friend...” couldn’t be more appropriate. The hardest part of our job today is to keep our clients focused on the long-term. We will emerge from this period of economic decline. Looking back on 2009 three to five years from now, I suspect we will reminisce about the boatload of investment opportunities that presented themselves. As many of you know, we have taken a rather defensive posture for our clients over the past 18 months, increasing allocations to fixed income and unleveraged long/short strategies.

The most important decisions we must guide our clients through are when to increase allocations to long- only equity and when and how to build inflation protection in our portfolios. Now is not the time, but the day is coming soon. I'll close this letter with some quotes from recent manager letters we have received.

"Probably the single biggest drag on the economy over the next several years will be the massive write-down in perceived wealth...In the U.S., the total market value of housing, commercial real estate, and stocks was about \$50 trillion at the peak and fell below \$30 trillion at the low...No longer as rich as we thought...we will enter a less indulgent world, if a more realistic one, in which life is to be lived more frugally."

"Inflation is the furthest thing from most investors' minds during this deep recession and financial crisis. It should not be. The unprecedented size of the government's spending programs, entitlements, guarantees, and lack of strategic thoughtfulness point to an inflationary potential that is unique in the history of this country."

"While government intervention to keep "losers" alive keeps excess capacity in place that dulls profits, winners continue to gain relative ground in adverse conditions."

"The takeaway from an analysis of the current environment is that uncertainty is higher now than ever before in our lifetimes; however, a highly active government tackling the problems with enormous amounts of money and great persistence will almost surely save us from a great depression. The real debate is when the recovery from recession begins and the duration of the subsequent inevitable period of slower than normal growth."

"...my biggest long term concern is trying to identify the economic engine that will propel the economy forward. In the 1990's it was technology; after the bear market of 2000-2002 it was housing and consumer spending; but what will be the major force this time? Over the short term it will be the government stimulus program, but what private sector force will take over when that is done?"

"Just like stocks were pricing in a Depression like economy in the first quarter, our view is that they are now pricing in a return to normal economic activity. The truth lies somewhere in between."

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stewart.massey@masseyquick.com
joseph.belfatto@masseyquick.com

les.quick@masseyquick.com
dwight.massey@masseyquick.com

jack.kemp@masseyquick.com



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