



Strong Rally Off Market Lows

July 23, 2009

Well, now, that was nice! In the second quarter, investors went from “Is it ok to look up from underneath the pillow?” mode to basking in the glory of a full-blown rally.

Whether or not the rally is something that sticks, providing a foothold for a sustained recovery, remains unclear at this point. However, it has at least provided a welcome respite from the seemingly daily drubbing the market was enduring for so long.

Spurred on by data suggesting that worldwide stimulus measures were having a positive impact, equities everywhere enjoyed sharp advances in April and May. Despite taking a breather in June, the market finished the quarter with impressive gains. The S&P 500 index rose 16%. Smaller stocks and international equities fared even better, including emerging market stocks, which posted stellar 33% gains.

On the fixed income side of things, with interest rates remaining low, investors in domestic, high-quality bonds achieved moderate returns. Global bonds, however, rose significantly, tallying 8% gains. Finally, with thoughts of a worldwide catastrophic meltdown beginning to wane, the high yield (junk) bond market made back some of its previously lost ground, gaining an equity-like 16%.

One of the most interesting things to occur in the second quarter was the enormous amount of secondary offerings that took place. Publicly-traded companies do offerings of stock to the public, most of the time, to raise additional capital. The market for such offerings completely dried up from August of last year through March. Not only was there no appetite among investors to buy stock in companies whose prices were in a free fall, but the companies themselves were not all that interested in selling their own stock at prices that they felt were undervalued.

However, once prices started rising again, the true need for raising capital kicked in and an absolute onslaught of offerings took place over the next two months. Many firms used the proceeds from their stock sales to pay back the TARP money they had borrowed during more distressed times in months prior. Others used the opportunity to shore up their balance sheets. The bottom line, though, was that all this capital raising activity played a distinct role in the run-up that we experienced.

Looking forward, it will be interesting to see how the economy responds after the federal stimulus package runs its course. It has had the desired impact, as there is growing evidence that the recession could be coming to a close. In fact, with the leading economic indicators pointing higher in both April and May, the recession could, technically, already be over.

One should not expect a continued straight line back up, though. A great deal of uncertainty still exists about the stability of the recovery. Of great importance will be the economy's ability to survive on its own after being taken off life support. Great concern remains with the difficult job market, combined with still-falling home prices – a prescription for more home foreclosure activity.

Governments around the world, large and small, have instituted their own stimulus measures. What we are seeing, though, is that the smaller, emerging economies are coming out of the global downturn quicker than their more mature counterparts – an indication that they simply have the ability to grow faster.

The Fed has indicated that we will remain in a low interest rate environment for the foreseeable future. This should provide those that have a large cash position with a level of comfort that it's ok to venture into the non-government bond area. Without the threat of rising rates, corporate bonds look to be a relatively safe place to be. The bond market has essentially returned to "normal" after a spectacular, unprecedented rise in fear and volatility last year. This means that you can somewhat comfortably receive 4-5% yields in high-quality bonds, with relatively little downside risk. While not earth-shattering, it still beats the big fat 0% return that most money market funds are currently paying.

By the way, we've received a handful of inquiries of late about the merits of jumping on the high yields currently being offered by California muni bonds. While they appear tempting, one must keep in mind that the reason they have to offer such high yields is because of the significant risk in owning them. One needn't look any further than the bankruptcy of Orange County in the mid-90's as a reminder of how bad things could get. Right now, California is simply a fiscal mess, despite the budget agreement reached earlier this week. With the number of previously "unthinkable" occurrences that have actually occurred over the last year, we would prefer to not take on such risks.

So, yes, there is still ample uncertainty as to how long it will truly take to put this historic financial meltdown into the rear view mirror. If nothing else, however, the rally we've seen since early March has at least restored the confidence of many wary investors who had come to the conclusion that the markets would simply *never* go up again. Yes, that was the sentiment of many when the Dow was hovering around the 6,500 level. Of course, no one here hopes that the markets will head back down again, re-testing the lows of earlier this year. However, should that occur, we believe that it would represent an opportunity to establish even better positions in the market, and would set investors up nicely for significant long-term appreciation.

As always, we welcome and encourage any comments or questions you may have.

Enjoy the rest of your summer!

Warm regards,

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President