

*From the Desk of...**Your Portfolio Manager*

## Investments

Here's a question for you: What do the 2<sup>nd</sup> quarter of 2009 and the 3<sup>rd</sup> quarter of 2007 have in common? Answer: stocks posted positive returns during both those periods. And yes, we have to go all the way back to 2007 to find a positive quarter for stocks as investors have suffered through 6 straight quarters of losses. That string was finally broken and in a big way as the S&P 500 soared 15.93% during the April-June period here in 2009. It was the strongest quarter for the S&P since the 4<sup>th</sup> quarter of 1998. Even better, the S&P 500 gained roughly 38% from March 9<sup>th</sup> to June 2<sup>nd</sup> as stocks made up some of the severe losses suffered over the past 20 months. The tech heavy Nasdaq gained just over 20% for the quarter while the DJIA rose 11%. Financial stocks rose from the abyss as deregulation talks subsided and firms posted stronger first quarter earnings than analysts expected. Government action, which included changes to the uptick and mark-to-market rules, and the Federal Reserve announcement that they would buy up to \$1.5 trillion in mortgage-related securities also helped provide a boost to equity markets.

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Economic reports released during the quarter came in "less bad" than previous ones, leading investors to take the news as signs that a bottom may be here and the economy was now on the road to recovery. Economic green shoots grabbed headlines leading some market commentators to suggest that the recession may already be over. Readings on industrial production, manufacturing, home sales and starts are all showing contraction but at slower rates than in previous months. Unemployment though continues to be a concern. The unemployment rate (a lagging indicator) moved above 9% with over 6,800,000 people receiving unemployment benefits. So far in 2009, 3.4 million people have lost their jobs. The average weekly duration of unemployment reached 24.5 weeks, the highest level in 60 years. On a positive note, the 4 week moving average for initial jobless claims (a leading indicator) has been moving downward and hopes are that this continues. The U.S. gross domestic product (GDP) was down 5.5% in the first quarter of this year but a better reading than the 6.3% drop in the fourth quarter of 2008. Expectations are for negative readings for the next two quarters but they should be incrementally better than the last two.

Market gains were realized pretty much across the board as both large and small cap stocks rose. The small growth sector gained just over 23% for the quarter while large growth stocks rose 15%. Value stocks also gained ground as financials rebounded over the past three months. In fact, the financial service sector was the biggest winner moving up almost 30% followed by media, software, materials and hardware up 25%, 22%, 21% and 20% respectively. Lower rated stocks performed better than higher rated ones during the quarter as investors appetite for risk increased. The same can be said about the bond market. Higher risk bonds such as high yield and corporate performed very well while low risk Treasury bonds lost money. Corporate bonds returned 9% for the quarter as spreads narrowed closer to pre-Lehman Brothers collapse days. US Government bonds lost 2.58%. In the commodity area, energy stocks gained as oil prices rose. Metal prices including gold and silver dropped slightly as investor's concern over near-term inflation abated.

Investments

As we look to the second half of 2009 and beyond, investors are faced with a number of issues critical to the success of increasing asset valuations whether they be stocks, bonds or real estate. Consumers have cut spending and are now saving money. The savings rate has gone from a negative number just a few years ago to 6.9% in May and could rise from here. In addition, consumer debt levels have dropped as individuals deleverage themselves from the easy credit received over the past 10-15 years. Consumer spending made up 70% of GDP in 2008 so slower spending means weaker GDP growth going forward. Homeowners will be reluctant to use their residence as an ATM machine as has been done in the past. The use of leverage will also be reduced. For example; Goldman Sachs was leveraged 30 to 1 before the collapse of financial markets last year. Today, estimates say they are levered just 10 to 1. New government regulations could change the game in many areas such as finance and health care. As we “re-regulate” industries, there will be less risk-taking on the part of investors.

Tax Consulting

Over the past few decades, investors have enjoyed a period of low inflation, lower tax rates, deregulation, globalization, and increasing uses of leverage to fuel consumption and enhance investment returns. As we look to the future, one could make an argument that these are going to be things of the past – at least in the foreseeable future. We know tax rates are going up for some, credit is less available, inflation could spike with all of the stimulus flooding the system and industry regulation will tighten. We still have solid prospects for globalization as newer economies continue to strengthen, but what has driven asset inflation in the past may not work in the future. We’ve witnessed two of the big three American auto makers enter bankruptcy and many other financial institutions and businesses are not out-of-the-woods yet. While a perfect storm sunk us in 2008, it will take almost a perfect storm to reignite sustainable growth in the future. Most observers, even the most bearish, believe that the worst is behind us. Both equity and credit markets are returning to pre-Lehman Brothers collapse normalcy which is a very positive sign. The utter panic in equity markets has decreased substantially with the volatility index (VIX) dropping from the 80’s into the 20’s signaling more normal conditions. Investors are now looking more at fundamentals to make decisions and the wave of forced selling has subsided.

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Thank you for your trust and confidence.



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