

April 2009

Did S&P 500 bottom at 666 (on 3/6/09)?

Answer: It will likely take the rest of 2009 to know the answer. This symbolic market index number appears to be the latest bottoming call for the growing multitude of in-print and on-the-air callers, some of whom have been calling for more than a year. (Some even said they 'smelled a bottom'... in print, no kidding... as early as February 2008.) Unfortunately, we failed to keep a count of them for you. Such dead-wrong, but easily forgotten, market calls prompt us to recite one of our favorite rules from the Official Forecaster's Game-Book: *If you must make forecasts, make them often.*

Green market-sprouts of spring?

The equity markets were cheered up by banks' and Wall Street's first quarter bottom-line profits now being reported. But a look at the sources behind those positive numbers gives some pause. In many cases, there are major, one-time revenue items that muted the otherwise noisy drumbeat of continued asset value write-downs.

On the debt side, a broad index of leveraged (bank) loans to businesses in the US had a robust 7.4% return in January and 9.8% for the first quarter which does seem to indicate the kind of thawing action that everyone has hoped for. A major reason for the big return seems to have been that new defaults slowed to a crawl, which probably needs to continue to improve in order for the loan index to hold onto those first quarter gains.

What do 'THEY' know?

Even if March 9 turns out to have been a distinct US stock market turning point, late-March public statements of hope by President Obama, his Treasury Secretary and various banking executives were perhaps sincere, but generically amounted to pep-rallying. Despite the daily limelight shining on various newly empowered financial engineers in the

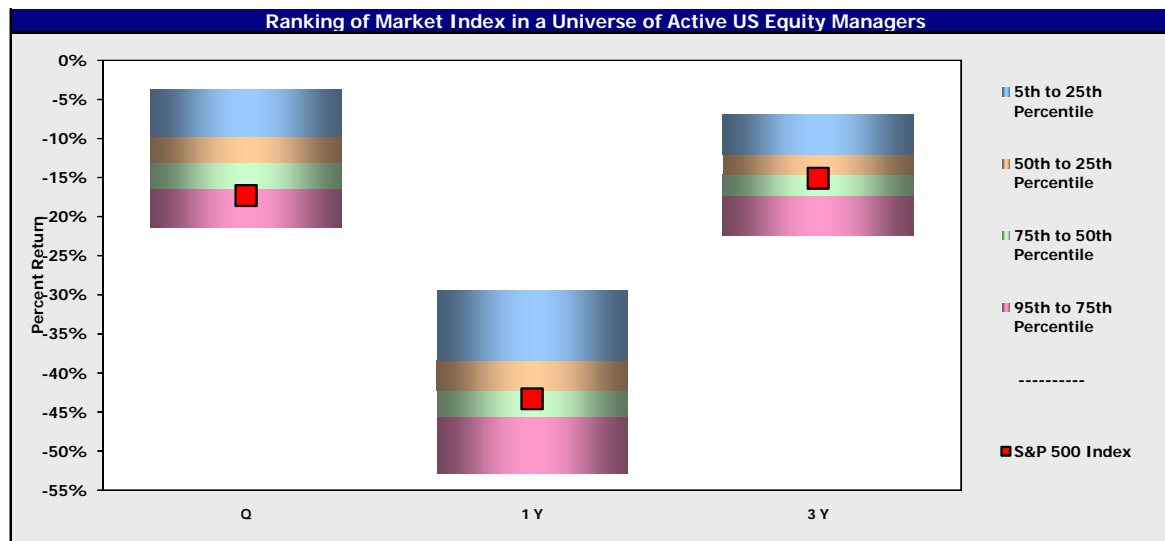
US government, the cold, underlying fact is that *none of them has, or could have had relevant experience to confront the current situation.* They cannot be sure that their ideas will work; indeed, they thus far seem unable to discern whether major plans will find acceptance in the marketplace.

Meanwhile, on the toxic front.....

TARP...the granddaddy of all rescue plans for "toxic (mostly mortgage) assets" was completely reneged within its first month. The recently announced Public-Private Investment Program (PPIP) which we might call Son of TARP was rejected immediately by some major would-be banking participants. They are apparently shunning the PPIP because they have already seen enough of ex-post risks involving re-writings of the plan rulebook, in addition to insidious government control of board membership, naming of CEO jobholders and, the big one for them: executive pay.

Twin disasters for active equity portfolio managers

The world's equity markets returned a negative 40-50% during the 12 months ended February 2009. So: Did the world's inventory of bright equity managers manage to salvage something for their clients? Most of them claim to have done so....nearly all reported that their portfolios had "beat the market" by several hundred basis points. Normally, such a statement would be impressive, but when the market provided a 12-month doormat return that was down 4,300 basis points, not many clients were favorably impressed by their portfolio's return of, say, minus 4,000. There were some cases of superior loss-prevention in long-only equity portfolios, but they were few.



Bad as things were in their clients' portfolios, traditional equity managers' own business revenues have declined in the space of one year by 30-50%. As we indicated last quarter, FiduciaryVest is staying actively tuned to the nature and size of reactive workforce reductions in managers' organizations.

Hedge funds: The 2008-early 2009 stock market tanking was an excellent occasion for long/short hedge funds to prove their mettle. Many failed. But, the funds-of-funds preferred by FiduciaryVest performed at a level that was within expectations and would likely have been outstanding, if shorting of financial stocks had not been halted by the SEC during the crucial month of October.

Accounting makes unfortunate headlines....again!

One of the ongoing wars in financial circles is between accounting purists and their market-sensitive critics. The critics firmly believe that accounting treatment can and does change market behavior. Indeed, they have maintained all along that mark-to-market-value accounting for illiquid securities investments, led to the dismemberment of the financial markets.

We have always tended to agree with the accounting purists. But, this time there is room for great doubt. In mid-April, the blue-ribbon CFA Institute issued a scathing rebuke of the FASB, the US's accounting pronouncements body, for its caving in to "political interests" when it rather openly backed off of its mark-to-market accounting requirement that securities investments must be accounted for at their

current market values.....the rule that emasculated the balance sheets of most of the world's banks and Wall Street firms, when mortgage-backed securities turned toxic, beginning in 2007.

A wry twist now comes at the Global Shareholder Activism Conference in London. William Isaac, former FDIC chairman (and longtime fair-value accounting abolitionist) made a speech pointing to an upside-down comparison between first quarter 2009 financial reports of Morgan Stanley and Citigroup Inc. Citigroup, following accounting rules, booked a profit on the market value *decline* of its own debt. Conversely, Morgan Stanley (MS) reported a loss under the same accounting rules, because the market value of its debt had *increased*. The accounting bottom line: An increased investor confidence in a company, expressed by an increase in market value of its public debt causes a decrease in its reported earnings (and vice versa). The same accounting rule that caused gain-reporting due to reduced investor confidence in Citi's public debt caused MS to record a loss from the improved market value of its debt. Go figure.

An asset allocation footnote

FiduciaryVest was not surprised to find that client allocations to long/short futures and managed timberland both performed well in 2008, not only relatively, but absolutely. Even though timberland is partially real estate equity and its cash crop is directly related to new housing demand, it has built-in biological growth.

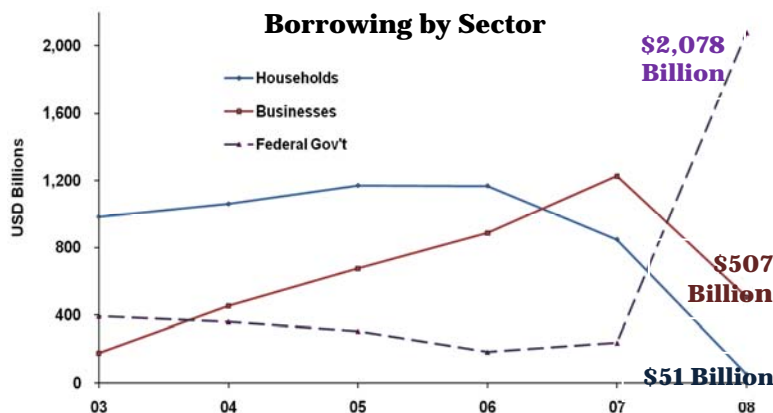
Equity investing (including real estate equity and real estate-related debt investments) has experienced “Biblical” devaluation. In the aftermath, it seems an appropriate time for most investors to pay abnormal attention to the apparent opportunity for favorably affecting long term future returns, via aggressive current equity asset allocation (within policy limits, of course).

Looking for growth?

This commentary was drafted April 15, 2009, a day on which total US Government debt stood at \$11.172 trillion. [Perspective: *Every 1% of interest on that debt adds \$112 billion per year*; if, you stacked \$100,000 bills at the rate of one per second, it would take more than 35 years to build a \$112 billion “1% interest-only pile”.]

The Treasury’s total debt figure does include its sadly non-marketable \$2.5 trillion of IOU paper that is held by the Social Security System as its sole “investments”. All White House occupants since 1969 have annually budgeted and spent every dollar that would have gone into investments by Social Security’s piggy bank. Its “trust funds” consequently represent an unconcealed Ponzi scheme, complete with detailed, make-believe accounting, all of which can best be described as Madoff-on-steroids.

Total US Government debt has increased by almost 19% from one year ago today and 56% from 5 years ago. But, there’s more: As of now, the US has yet to fully launch its promised \$2-3 *Strillion* borrowing binge that will fund current operating deficits and kick-start the economy. The official US debt figure additionally does not include the Federal Reserve Bank’s recent money-printing tsunami that caused a blowout of the Bank’s liabilities from only \$919 billion to \$2.1 trillion in the past 12 months. None of this money pumping requires Congressional approval, or creates any federal budget accountability. The graph below, though dramatic *could* be titled “You Ain’t Seen Nothing Yet”.



There are two die-hard thought-schools about the Fed’s and the Congress’s debt production machine:

1. The government is a last-resort provider of economic liquidity; if it does not do so, the economic decline will spiral without end and modern society as we know it will suffer a crippling, possibly mortal blow, **OR**
2. Excessive leverage and debt burden are what got us here; more of the same will stretch out the pain for many years to come and, without doubt, lead to a level of hyper price-inflation that may drag the entire society under.

Outlook for US global market position

The US’s dramatic economic setback in 2008 was indeed shared by many of its trading partners. That said, are the future growth graphs for all major economies likely to be parallel....or can it even be hoped that the US will rebound more quickly than the others? Unless the US can miraculously make a global growth industry out of greening-up its use of coal, a more probable outcome is that the US’s transformation from a manufacturing to a services/ technology-based economy in the 1990s will choke-back its future opportunities for continuing to rule the global economic roost. If so, the US Dollar will reflect that weakness in comparison to currencies of environmental polluters (who intend to remain that way) for the foreseeable future, notably China and other Asian countries.