

Wednesday, July 01, 2009

Second Half Update for Economic Outlook for 2009

Mid-Year Update Synopsis

Global Stock Market Trend

Trend: Global Bull Market (China, Brazil, and Emerging Markets in general are attractive)
Styles: Growth over Value
Market cap: Small-caps over Large-Caps
Risks: 2.5 month correction of 10-15% starting August/September (contact BMM for separate research report)
Rewards: Bear market bottom was made in March 2009 (contact BMM for separate research report).

U.S. Sectors & Industries

Overweights: Information Technology, Consumer Discretionary, Materials, Financials, Commodities.
Underweights: Telecom Services, Health Care, Consumer Staples

U.S. Economy

Economy: “Official” end of the recession is in sight
Inflation: Low inflation in 2009, giving way to much higher levels by mid-2010

U.S. Bonds

Corporate: Bullish (contact BMM for separate research reports)
Treasuries: Bearish (contact BMM for separate research reports)

It Feels Like 1974

I feel as if the June 15, 2009 Stock Market white paper “It Feels Like 1974” has stolen some of the thunder from this update as much of today’s economic conversation revolves around whether



or not the bottom is in for the stock market. As stated in that article, the similarities should not be taken too literally. However, the context gives a very realistic and highly probable trajectory for stock prices for the rest of the year and into 2010.

That column is available for your reading, so we won't exercise redundancy by repeating what was written, except for perhaps to highlight or remind. But *Berkshire Money Management* does encourage you to read that column as it is extremely important.

Berkshire Money Management's investment strategy in the first half of 2009 has been a dramatically different process than that of the second half of 2007. In November 2007 we urgently began reducing equity positions and started accumulating FDIC-insured certificates of deposits (CDs). By the time the stock market crashed in October 2008 client portfolios were virtually all cash and/or CDs. And the portfolios remained that way until we started buying investments in late-February and mid-March 2009.

Granted, we were not as brave this go-round as we were on October 10, 2002 – over seven years ago - when we jumped in to just about all equities from just about all cash. But the environment is also different this go-round. In 2002 we were nearly a full year removed from a very shallow recession. Currently, we remain in the worst recession since, depending on how you want to measure it, 1974 or 1982.

Economy - Recession Ending

That's the bad news. The good news? Using the uncaring, cold-hearted metrics we economists favor (the ingredients used to measure Gross Domestic Product, or GDP), the recession will be over by the end of Summer. That is not to say that foreclosures will cease or that we will even experience net new job creation. Nor is that to say a "V" shaped economic recovery will take hold. Actually, on the subject of economic recoveries, it is very popular nowadays to describe the potential shape of the economic recovery by using the alphabet, like a "V" (a strong rebound in economic output), a "W" (a quick rebound followed by a double-dip recession; think 1980-1982), an "L" (like the "lost-decade" of Japan's economic stagnation), or a "U" (where we bump along the bottom briefly before GDP turns back up toward trend-like growth of about 3%).

Berkshire Money Management expects something a little more non-alphabetical. We expect a saucer-shaped recovery where economic output stops contracting and remains very weak (below trend, at about 1% to 2.5%) for nearly a year (mid-2010) before US GDP growth gets to a point where it can sustain something closer to 3%.

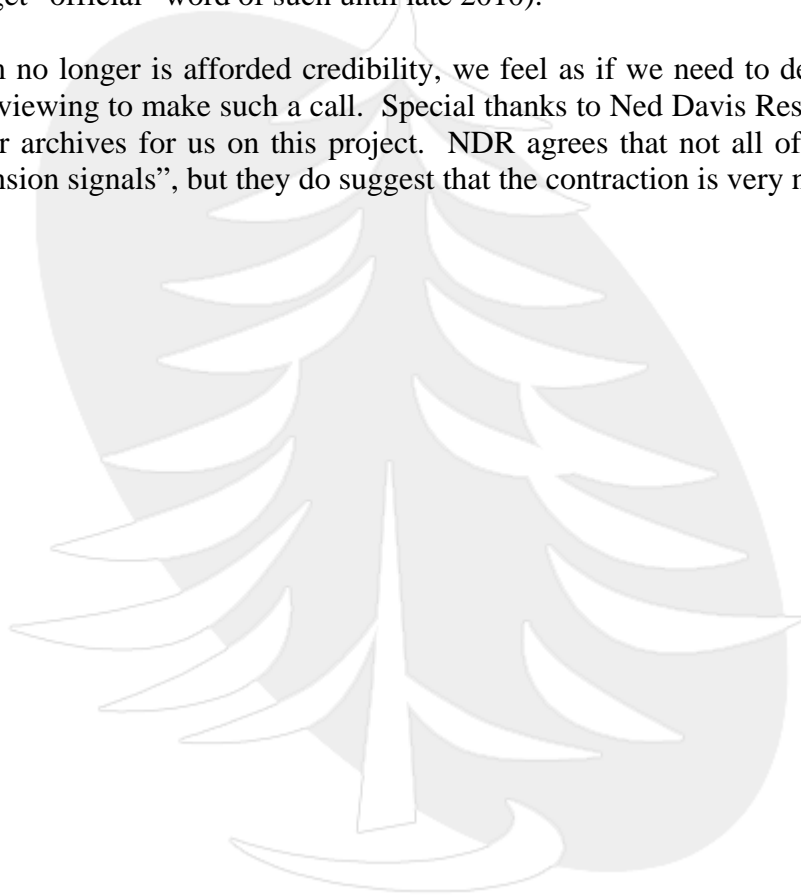
Folks are still very pessimistic, so it likely won't take too much convincing on our part to sell you the saucer-shaped recovery (as opposed to something more optimistic, like a "V" or even a "U"). So we'll just briefly mention the concerns: high unemployment, higher taxes, excess



housing and automobile inventories, business and consumer deleveraging, “speed-bump” regulation, etc., etc., etc.

Interestingly to me, although *Berkshire Money Management* was quicker than any other investment advisor we know to raise cash so as to help avoid the destruction of the 2008-2009 stock market crash, pessimism is still so high that there is just no credibility in optimism – even for us. We are calling an end to the recession over the next few months (note: the official arbiter of the beginning and end of recessions, the National Bureau of Economic Research, typically takes a year or so to pinpoint dates. So even if the recession officially ends this September 2009, then we may not get “official” word of such until late 2010).

Because optimism no longer is afforded credibility, we feel as if we need to detail some of the indicators we are viewing to make such a call. Special thanks to Ned Davis Research (NDR) for reaching into their archives for us on this project. NDR agrees that not all of these indicators “have given expansion signals”, but they do suggest that the contraction is very nearly at hand.



Economic Recovery Watch Indicators

Indicator	Median Lead Time to Recession End (Months)	Latest Trough/Peak
Financial		
1) S&P 500 Stock Index	4.0	03/2009
2) Moody's Baa minus Long-Term Treasury Yield Spread	1.5	12/2008
Employment/Compensation		
3) Nonfarm Payrolls (One-Month Change)	2.0	01/2009
4) One-Month State Diffusion Index	2.0	02/2009
Sentiment		
5) Reuters/University of MI Consumer Sentiment Index	2.0	11/2008
Housing		
6) New Home Sales	2.5	01/2009
Spending		
7) PCE on Durable Goods (Y/Y % Change0	2.0	10/2008
Manufacturing/Inventories		
8) ISM Index (PMI)	2.5	12/2008
9) Business Inventory-to-Sales Ratio	1.5	12/2008
Composites		
10) ECRI Weekly Leading Index	2.5	03/2009
11) OECD U.S. Composite Leading Indicator	3.0	03/2009
12) NDR Economic Timing Model	4.5	11/2008
Average of All Indicators	2.5	

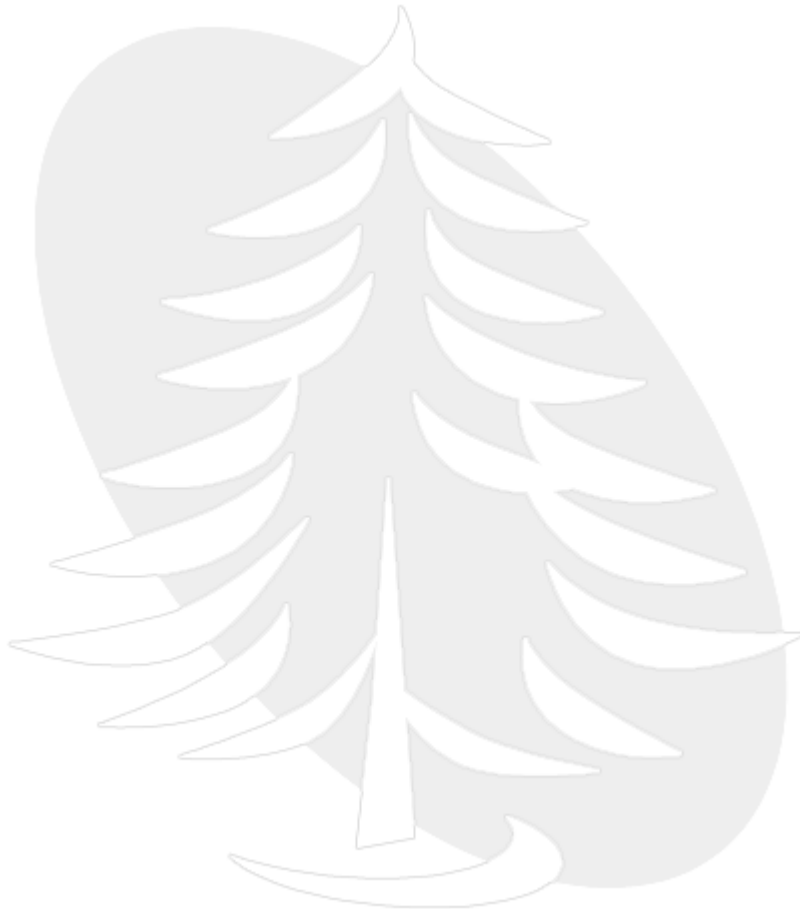
U.S. economic output in the third quarter of 2009 will be a toss up (+/- 1.0%), before turning mildly positive on a sustainable basis. This will keep inflation (as measured by both the Consumer Price Index as well as the Producer Price Index) very low for the rest of the year. The long-term risk for inflation, however, is severely skewed toward higher inflation.

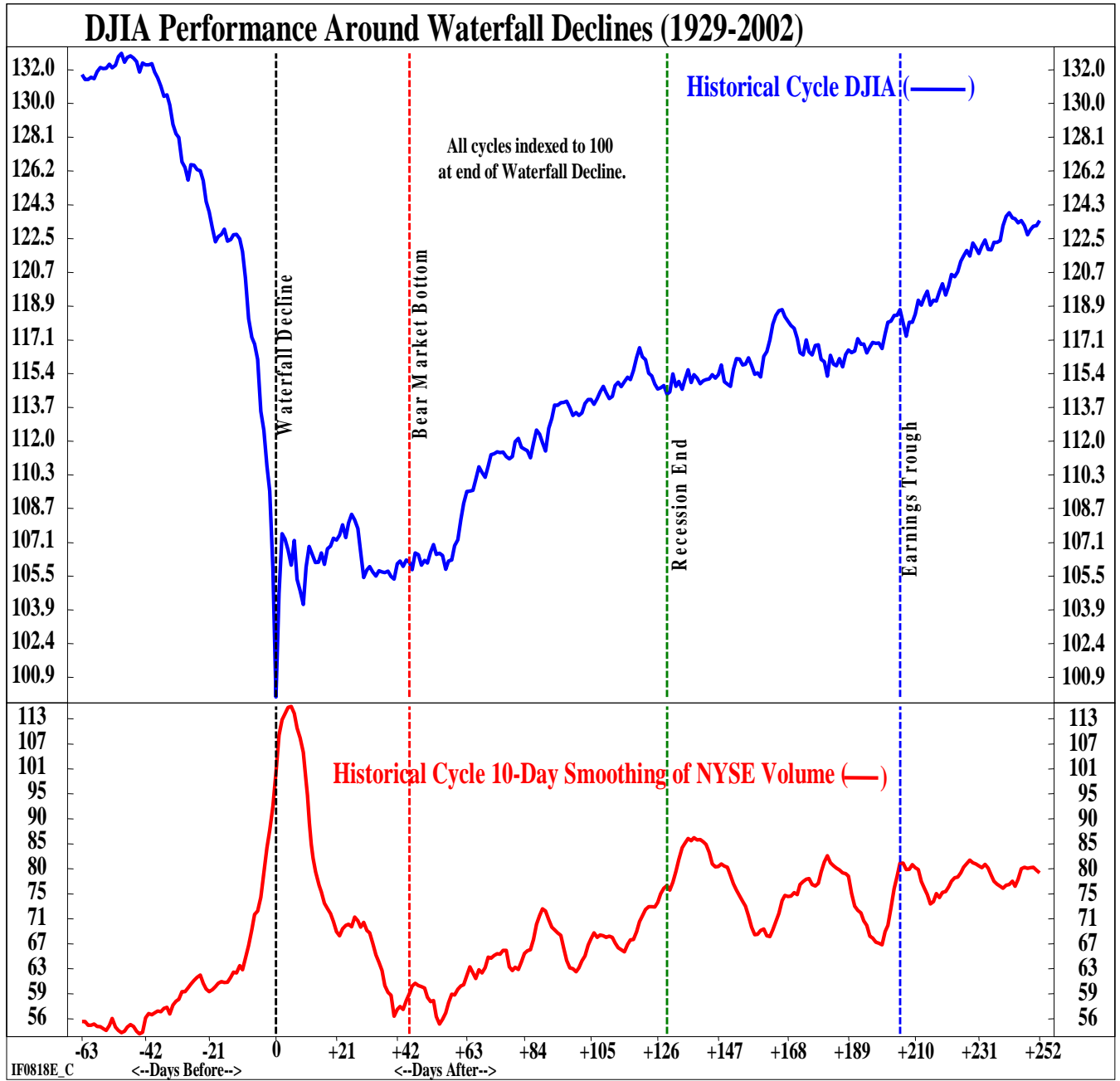


Stock Market – Bear Market Ended

While we're on the subject of Ned Davis Research being able to do a great job archiving information (If you call to subscribe, tell them Allen sent you), we wanted to share the following composite graph of past "Waterfall Declines" over the last eighty years (this graph excludes the October 2008 Waterfall Decline, but includes nine other notables from 1937 to 2002).

All cycles are indexed to "100" at the end of the Waterfall Decline (dashed vertical line).





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For purposes of this discussion, let's focus on the top part of the chart (the blue line) and break it down into three phases. Phase 1, the point of the Waterfall Decline to the Bear Market Bottom, typically lasts 1-2 months. The bottom of the Waterfall Decline in this cycle was October 10,



2008 and the Bear Market Bottom was March 9, 2009. So instead of 1-2 months it was five (5) months.

Phase 2, the point of the Bear Market Bottom to the Recession End typically lasts 3-4 months. Historically, that puts the recession's end at, well, right about now. That is consistent with *Berkshire Money Management's* expectation that the recession will end this summer. And that leads us to the six-month duration of Phase 3 (through 2009 and into 2010).

History suggests that the stock market has continued to move upward during Phase 3, but at a considerably less subdued pace than during Phase 2. While admittedly a small sample size, since 1975 there have been five recessions and the average S&P 500 stock market index return six months after the recession has been 4.3% (the average has been 8.4% twelve months later). The batting average, four positive gains after five past recessions is good, if not perfect (the 2002 decline after the 2001 recession was the notable exception).

At this point it is worth reiterating the importance of reading the "It Feels Like 1974" column. But until you get to that, let me at least point out a couple risks, caveats, concerns....During that June 15, 2009 column we said that we expect a 6% correction in the S&P 500. By absolute, complete, and sheer luck we then got a 5.2% correction (at least so far, as of the writing of this report). Not that blind luck in timing should lend much credibility to any other forecast (it is impossible to be both consistent and accurate in forecasting), but we did note then and still expect a 2.5 month correction of 10-15% starting in August or September of this year.

We don't expect any pullbacks to be a sign to get out of the market; rather we would view them as an opportunity to build equity positions. Not that we are Pollyanas – after all we were quick to sell equity positions well before the stock market crash of 2008 (**we're not buy-and-hold investors for the sake of just owing stocks; we manage both risk as well as reward**). Although we are turning more positive, we are not blind optimists. There are certain signs that we will be looking for that could convince us that we need to, once again, adhere to a more defensive strategy. For instance,

1. A substantial downturn in market breadth could turn us more negative.
2. A "blow-off" sign of optimism (measured by either a spike in stock prices or surveys) would warrant caution.
3. Significant rises in interest rates (corporate as well as Treasuries) across the yield curve would be a warning.

As much as we do not enjoy 10-15% corrections, a decline of that magnitude without accompanying technical or fundamental deterioration, should be considered less as an early indication of pending trouble and more as an opportunity to buy on weakness. Investing is a blend of art and statistics which manifest itself in the form of probability. While risks remain, the probabilities favor more reward for the stock market over the next twelve months. The market's problems could reappear some time in late 2010, or 2011

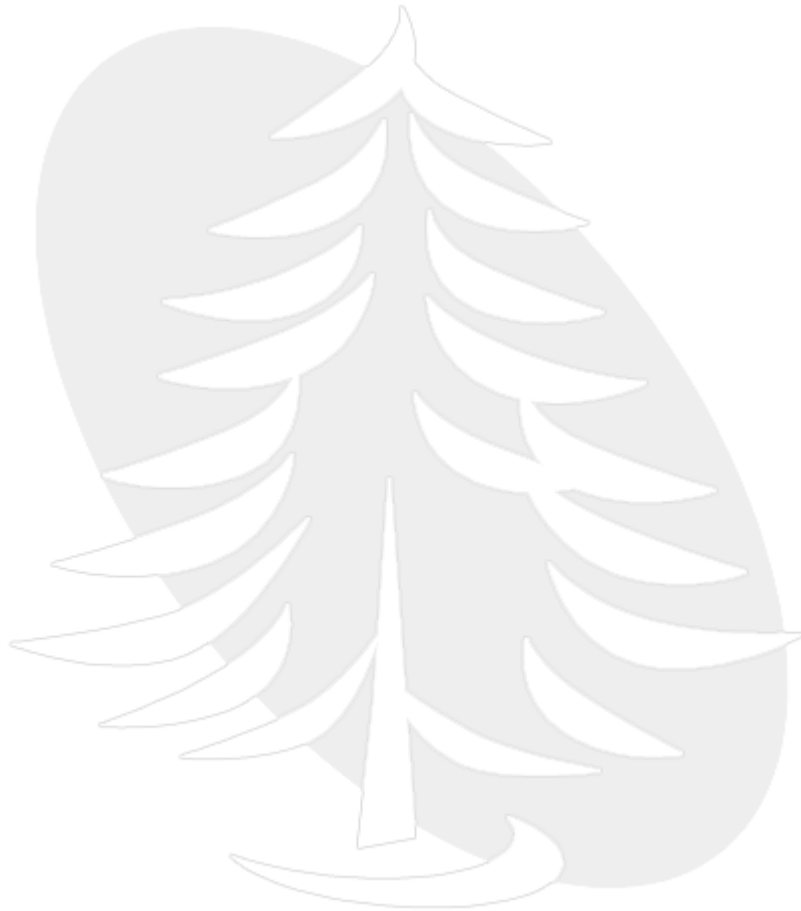


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Another interesting chart is the “Four Bad Bear Markets” chart (courtesy of Doug Short from DShort.com). This chart is different than the Waterfall Decline chart in that instead of charting a composite, it tracks the 2008-2009 crash against three other bear markets, each line starting at its peak.



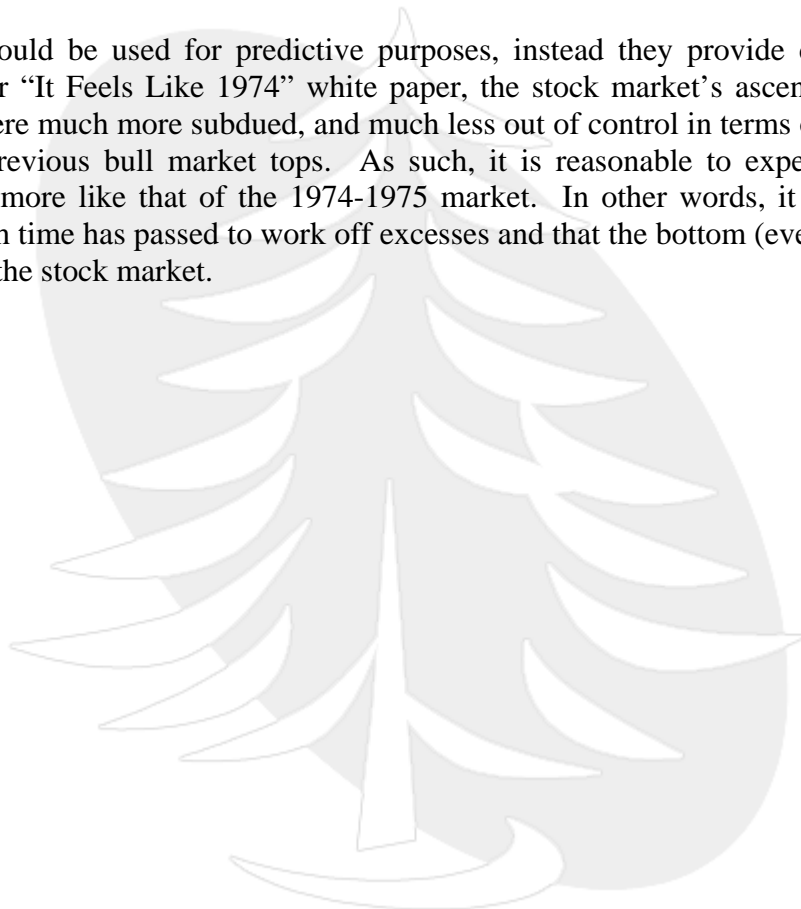




The 2008-2009 experience did not feel good, but it wasn't entirely unfamiliar. Nor has the follow through been unfamiliar. The follow through may not be perfectly repeating the charts of the past, but it certainly has thus far rhymed.

Going back to the idea of investing being about probabilities, we do not feel as if the move from the March 2009 is just a "tradable rally" – we believe that this is a move you can buy-and-hold for over a year. **Remember, you don't have to buy-and-hold forever. If you rode the stock market down and are feeling timid about getting back it, keep in mind that you can make any trade you want so long as you have an exit plan to limit your losses.**

Neither charts should be used for predictive purposes, instead they provide context. As we pointed out in our "It Feels Like 1974" white paper, the stock market's ascent to its peaks in 1973 and 2007 were much more subdued, and much less out of control in terms of hyper-inflated stock prices of previous bull market tops. As such, it is reasonable to expect the length of adjustment to be more like that of the 1974-1975 market. In other words, it is reasonable to expect that enough time has passed to work off excesses and that the bottom (even if the lows are retested) is in for the stock market.





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May/2008

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