"Irrational Pessimism"

Market Commentary – April 2009

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The final reading of Gross Domestic Product (GDP) shows that the value of goods and services produced in the U.S. fell by 6.3% in the fourth quarter of 2008. The Organization for Economic Cooperation and Development (OECD) recently forecasted that the world economy will shrink by 2.75% in 2009. The OECD expects the following economic contractions this year: U.S. 4%, euro-zone 4.1%, and Japan 6.6%. Federal Reserve Chairman Ben Bernanke recently commented to the Council on Foreign Relations that "the world is suffering through the worst financial crisis since the 1930s, a crisis that has precipitated a sharp downturn in the global economy." He added that if the financial system stabilizes, the recession will persist until "later this year".

According to Bloomberg, the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), and Treasury have committed to spend, lend, or guarantee up to a limit of $12.5 trillion. To put this number in perspective, U.S. GDP for all of 2008 totaled $14.2 trillion. Bloomberg provided a useful summary of how this $12.5 trillion is earmarked:

- <u>Federal Reserve – $7.8 trillion committed:</u> commercial paper funding ($1.8 trillion), Government Sponsored Entity mortgage-backed securities ($1 trillion), Term Auction Facility ($900 billion), Term Asset-Backed Loan Facility ($900 billion), currency swaps ($606 billion), Government Sponsored Entity debt purchases ($600 billion), Money Market Investor Funding Facility ($540 billion), commitment to buy Treasuries ($300 billion), Term Securities Lending ($250 billion), Citigroup bailout ($220 billion), asset-backed commercial paper liquidity ($152 billion), primary dealer trading ($147 billion), AIG bailout ($113 billion), primary credit discount ($111 billion), Bank of America bailout ($87 billion), Bear Stearns bailout ($30 billion). Of this $7.8 trillion committed, $1.7 trillion has been used.
- <u>FDIC – $2.0 trillion committed:</u> FDIC liquidity guarantees ($1.4 trillion), Public-Private Investment purchase of toxic assets ($500 billion), General Electric debt guarantee ($126 billion), Citigroup bailout ($10 billion), Bank of America bailout ($3 billion). Of this $2.0 trillion committed, $0.4 trillion has been used.
- <u>Treasury – $2.7 trillion committed:</u> Obama stimulus package ($787 billion), Troubled Asset Relief Program ($700 billion), line of credit for FDIC ($500 billion), support for Fannie Mae and Freddie Mac ($400 billion), Bush stimulus package ($168 billion), student loan purchases ($60 billion), Treasury Exchange Stabilization Fund ($50 billion), tax break for banks ($29 billion). Of this $2.7 trillion committed, $1.8 trillion has been used.

Technical factors of the market are mildly bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. Stock prices are driven over time by earnings power. First quarter earnings, to be announced in April and May, will likely be unfavorable on an absolute level. Any glimmer of hope that earnings are not as bad as expected, however, would ignite a sharp rally.

Irrational pessimism has market participants in a trance, coaxing investors to get rid of their stocks at rock-bottom prices. The S&P 500 broke support at 752 before finally bottoming at 676, about 10% lower. The decline from 2009's closing high of 934 has occurred with a degree of ferocity representative of panic and capitulation. Since hitting the bottom, the S&P 500 has bounced back to 797. While volume on the decline was high (indicative of capitulation), it has been even higher on the bounce. As well, market breadth has improved such that our indicator went into positive territory on March 25 (for the first time since January 20). These factors tilt the scale in favor of a change in psychology, from "sell the rally" to "buy the dip". For risk tolerance reasons, some investors will still prefer to lighten up on stocks into a rally. For someone more comfortable with the long-term risk-and-reward characteristics of the stock market, this is an outstanding time to buy high-quality stocks that are on sale.