The Economy Stinks… Buy Stocks!

The *"Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."*

"Buy when there is blood on the streets"

"To buy when others are despondently selling and to sell when others are greedily buying requires the greatest fortitude and pays the greatest reward"

-Sir John Templeton

Let's be frank: we are in a deep recession that could get worse especially if there are policy mistakes. In the fourth quarter of 2008, gross domestic product shrank at an annualized rate of 20.8% in South Korea, 12.7% in Japan, 8.2% in Germany, 5.9% in the UK and 6.2% in the US. Alarmingly, declines in industrial production in these countries were even worse. The first quarter of 2009 will not be any better.

However, the fact is the correlation between current economic conditions and future stock returns is highly variable, and paradoxically, a poor economy usually presents investors with a buying opportunity as suggested by the eloquent quotes above of famed investor Sir John Templeton. According to the International Monetary Fund world economic growth achieved one of its highest readings in 2007 at slightly above 5%. The world economy was rocking but that turned out to be a lousy time to invest in stocks as the landscape changed quickly and the world de-levered. As we know now stock prices were high and the economy was artificially inflated. Chances are the opposite is true today: prices are low and the economy is artificially deflated. Just as stocks should have been avoided in 2007 perhaps they should be embraced today.

In a recent research report, Citi strategist, Tobias M. Levkovich, writes about the unsustainable decline in output and the potential opportunity for investors:

"The intensity of inventory reduction is stunning, as management teams are moving at high speed to generate cash. Under-producing final demand is not a new condition when recessions hit, but the depressed level of production relative to final sales argues that there is real potential for production levels to lift in 2H09. Since production trends and earnings changes are inexorably linked, given inherent business operating leverage, investors may be pleasantly surprised later in the year."

We know from the lessons of behavioral economics that investors tend to extrapolate the most recent past into the future. As noted above, the economy has been in a free fall, and current stock prices suggest investors believe the economy is far from bottoming. However, if this pessimism turns out to be overdone stocks could rally meaningfully.

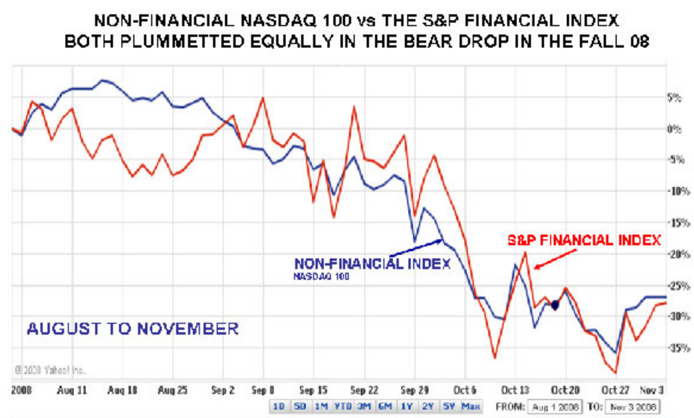
The basis for any optimism today has to come from the belief that current prices more than reflect the obvious lousy fundamentals. Much of the data we survey support this assertion. Importantly, the breadth of the market is much improved. During the initial sell-off in October/November 2008 when the S&P 500 made its initial lows around 740 about 80% of individual stocks were making new lows. Even though the S&P 500 is lower now only about 30% of stocks are making new lows. More surprising is that about 40% of stocks are actually higher than they were at the November 2008 lows. As pictured in the charts below, both financial and non-financial companies declined about equally in the first wave drop into November. Since November there has been a dramatic divergence in the performance of financial and non-financial stocks from November to early March. So while most stocks fell, financial stocks most related to the deleveraging taking place in the market, bore the brunt of the damage.

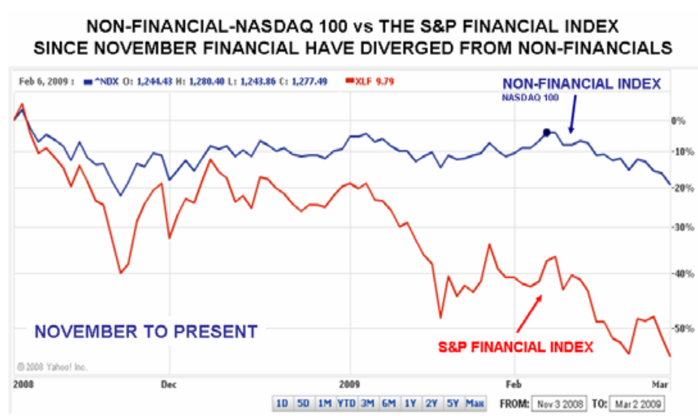
The S&P 500 lost -3.4% annualized for the ten year period ending February 2009, marking one of the worst performances in its history. In the past, investors have been rewarded for buying after a decade of significant negative performance. While there can be valid disagreements on the valuation level of the market, our analysis suggests stocks are cheap trading around 10 to 12 times normalized earnings, especially since interest rates are low. Finally, along with record bearishness (a positive) there is a ton of cash sitting on the sidelines earning next to nothing that could provide the fuel for higher prices once confidence returns.

Given the pain the stock market has inflicted over the past year many investors' attitude is to go to cash and wait for the worst to pass before getting back into the stock market because there will still be plenty upside left for them to capture. While this strategy sounds logical in theory it is almost impossible to carry out successfully. The reasons are the future is never clear, there will always be good arguments to wait, and volatility will scare people away.

So while pessimism is rampant and Blood is running in the street, investors have been despondently selling. It doesn't feel good to own stocks and anything can happen in the short-term, but these are the types of gloomy conditions that have produced excellent long-term buying opportunities in the past.

DIVERGENCE:
The NASDAQ 100 Index is a Non-Financial Index
The S&P Financial Index Holds Financial Service Companies





Thanks for working with us.

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