TW Advisors

NEWSLETTER
THIRD QUARTER 2009

IMPRESSIVE MARKET RECOVERY … ECONOMY TO FOLLOW?

Stocks staged an impressive rally in the third quarter building on momentum from its early March lows. The S&P 500 gained 15.61%; most small-cap and mid-cap indices rallied in the high-teens, while emerging markets were generally up by more than 20%. The market rewarded risk in the quarter. From its low the S&P 500 is higher by about 60%, one of the most powerful rallies ever. Although we lagged behind our benchmarks for the quarter, we are mostly ahead on a year-to-date basis, and we are thrilled with our absolute returns. We were fully invested at the bottom and selectively reduced risk by selling or trimming certain securities into the historic rally.

The markets are signaling that the financial panic is over. While the panic is over, after such an historic rally, stocks are no longer broadly undervalued, and thus are more susceptible to corrections. Unfortunately there are many risk factors that could trip up stocks in the short term. The core of the problem is that our economic system is laden with too much debt. On a positive note even after the financial crisis, we are still a wealthy nation. The net worth of US households was $53 billion in June, or about $173,000 per person. However, the cost of servicing our debt as a proportion of income, even with record low rates, is at a 30-year high, as incomes have stagnated and the total level of debt has risen. The finances of our Federal government will become increasingly leveraged. The Congressional Budget Office released sharply higher deficit projections predicting the 10-year deficit would reach $7.1 trillion, some $2.7 trillion more than it had thought in March. Additionally, long-term fiscal problems of an aging population (health care, pension costs) will start to be felt over the next decade. De-leveraging is a painful process and unfortunately it has barely begun.

Employment and its impact on housing are further concerns. Job losses are equal to the net job gains over the previous nine years, making this the only recession since the Great Depression to wipe out all job growth from the previous expansion. The average length of unemployment is higher than it's been since government began tracking the data in 1948. While employment is usually a lagging indicator, this downturn was not usual and continued weakness in employment is a concern, especially if it inhibits a housing recovery from forming. According to the Mortgage Bankers Association more than one in every eight homeowners with a mortgage was behind on home loan payments or in some stage of foreclosure at the end of the second quarter, as mounting unemployment aggravated the housing crisis. Worryingly, the number of prime borrowers behind on mortgage payments rose 13.8% between March and June. Right now, housing remains on government life support. Treasury-backed entities are guaranteeing about 85% of new mortgages, while the Fed buys 80% of the securities into which these taxpayer-backed mortgages are packaged.

There have been several positive developments. Emerging Asian economies have experienced a remarkable rebound with second quarter annualized growth of more than 10%. Analysts now expect emerging Asia to grow by more than 5% this year even though developed countries are expected to decline by 3.5%. Emerging Asia's rebound is mostly because the monetary and fiscal stimuli in the region were bigger and worked faster than in the West. This occurred because emerging Asia's governments, consumers and banks all entered the downturn in better shape than rich countries. Asian spending is an important engine of global growth. Even before the crisis, emerging Asia’s consumer spending contributed slightly more (in absolute dollar terms) to the growth in global demand than did America’s.

Another positive sign is increased merger and acquisition activity. Businesses clearly have the cash. In the first quarter, non-financial companies had some $14.1 trillion in financial assets, according to Federal Reserve data, or 100.1% of gross domestic product, a record high.

We believe there is an important lesson in these trends for long-term investors. Emerging economies are going to be the driver of growth over the next decade. One of the best ways to capture this growth is through well-capitalized, dividend-paying, multi-national, blue chip stocks. You may recall that our strategy began in its infancy under the name: "Blue Chip Plus". Buying exceptional companies when they are attractive in price is still our mantra and in the global marketplace these stocks offer exceptional value, especially in today’s still fragile world economy.

Our message is somewhat mixed. Over the long-term, stocks, in particular the high-quality variety that we favor, should perform well, especially relative to cash and fixed income. However, the economic and financial recovery is fragile and the stock market could easily have a correction in the short-term. Given the market’s extraordinary run now is a particularly good time to **review your risk tolerance.** If adjustments need to be made, please contact us. Thank you for your business and please call us if you have any questions.

Jim Tillar, CFA **Steve Wenstrup**

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