Special Market Commentary

Gardening and the Less-Bad News

June 2009

My family dug potatoes in our garden Sunday night after supper. Yukon Gold and Pontiac Red were plentiful just beneath the surface of the soil; we probably dug up sixty pounds of potatoes. For the children it was like an Easter egg hunt; they were barefoot and filthy, crouching in the cool soil, jostling each other to grab the next potato that turned up. "I get the next one, Frances! There's a huge one, Daddy! Dig over here! Look Ben, a worm! We need another bucket, Mama!" It seems like just the other day when I was barefoot and filthy, sifting through the dirt on our farm just south of Charlotte at my dad's knee as he barked at us. "Watch your fingers, John! Let Phillips get one, Benton! Katie, we're not going fishing, we're digging potatoes; put the worm back!" That was thirty years ago, but the experience Sunday evening was almost identical to my experience as a child. And it was a great experience; probably more so as a parent. As the older children pulled little Charlie's Radio Flyer wagon to the house loaded with potatoes, squash and cucumbers, I noticed that the tomatoes were coming on strong; another month and we will be enjoying tomato sandwich season. Slice 'em thick, slather on the mayo and wolf it down. Hard to beat!

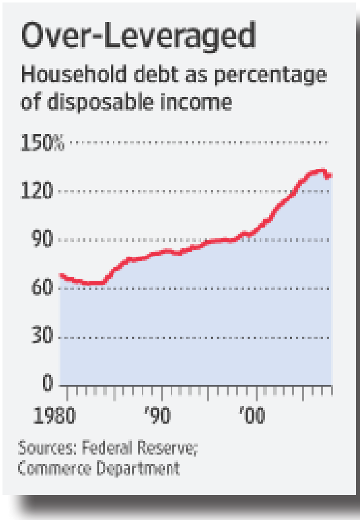
In my few years of gardening, it is my observation that planting a garden is a bit easier than building an investment portfolio. If you prepare the soil, plant at the right time and hoe out the weeds, Mother Earth will produce what you expect, pretty much when you expect it. Now some may argue this point; my father would quickly point out that my garden would be an embarrassment without his advice and counsel. He'll try to take credit for the labor too and in the interest of full disclosure, I'll admit that he did plant those potatoes. I think I was out of town that weekend? It takes a village? I've already placed a bushel on his porch.

The portfolio is a different matter. Plant any number of seeds, diversify your holdings, tend to your rebalancing and you may still get a decade like we have just endured with minimal yield. The last nine months alone have been equivalent to a hundred-year flood. There is simply much less certainty about the future when it comes to the economy and investment returns.

By early March of this year, it was looking like full-time gardening might be in all of our futures. When the market bottomed on March 9th, the S&P was down 57% from the peak of October of 2007 and the news was bleak. Since those gloomy sky-is-falling days, investors have slowly regained their appetite for risk. We have enjoyed a substantial rally in stocks. The S&P is up 37% from its low and foreign markets are up even more. The shares of many banks and other financial companies have doubled or more after teetering on the brink of worthlessness back in February. The Treasury department completed its stress tests on the banks and the weaker banks appear to be successfully raising the capital needed to remain solvent. Some of the banks are paying back government-provided TARP funds ahead of schedule. Consumer confidence as measured by the Conference Board rose to a reading of 55 in May after reaching an all-time low of 25 back in February. The May reading of 55 was still weak but a marked improvement from a long string of dismal numbers. Home prices are still falling but sales are finally picking up. Home construction has dropped so much that the huge inventory of unsold homes has finally started to decline. While the unemployment rate rose to 9.4% in May, the 353,000 jobs lost for the month was a significant improvement over the average monthly loss of 600,000 over the last seven months. Including the downward revision for April it is clear that the rate of decline in jobs is subsiding.

So while the news is still bad, it is at least less bad than it has been. Does this mean things are back to normal? Can we project forward the stock market gains of the last two months? Will the market continue its recent march right back up to 14,000 on the Dow? We would suggest not. If "normal" means full employment, easy credit, a healthy real estate market, fat corporate profits, low inflation, low taxes, GDP growth of 3-4%, robust global trade and consumers who never say no, then we are a long way from normal.

Simply put, we have some imbalances in the economy that will serve as a headwind to a so-called "V-shaped" recovery. The battered consumer is at the top of the list. Obviously the six million people who have lost their jobs since the recession started in December of 2007 have sharply curtailed their spending. They have been joined by nearly all of us. In the twelve months ending in March of 2009, the Federal Reserve reported that US household net worth declined by almost 20%. The impact of this massive loss in wealth has been and will continue to be profound. Consumers have reverted from spenders to savers. According to the Bureau of Economic Analysis (BEA), Americans saved 5.7% of their disposable income in April, up from a negative savings rate over the last two years. While any financial planner would say this is a positive trend for the future of the average American, it is certainly bad news for the economy. As the chart below from the Federal Reserve shows, consumers may be saving more but they have made little progress in reducing the debt burden built up over the last decade. The Fed also estimates that as a result of excessive borrowing and the recent unprecedented decline in home prices, home equity value now stands at 47%, the lowest reading ever. For the first time, the bank now owns more of our real estate than we do. This imbalance will be corrected but it will take time.



Consumer spending will also be constrained by tighter lending standards. This phenomenon will also limit investment by businesses looking to expand. Despite the progress that has been made with the financial system, the banks have become much more stringent with their lending standards. I am experiencing this first hand as I am in the process of refinancing my mortgage. Last time I did this, the lender said, "just sign here." This time they want my first-born son. While this has been a hassle, it is as it should be. We're going to see more regulations on financial companies that are designed to limit overall leverage and risk to the system. Again, while this should be good for the long-term health of our economy, it will be a headwind in the face of a speedy recovery.

The rest of the world is struggling too. GDP Declines at annual rates for the first quarter of 2009 were 14% for Germany, 15% for Japan, 7.4% for the UK, 9.8% for the Europe as a whole and 21.5% for Mexico. All of these numbers were much worse than the 5.7% decline in the US. While the seeds of this crisis were planted in the US housing market, the fallout has been widespread. Global trade has fallen significantly; according to the BEA, our imports are off 32% from their peak in early 2008 and our exports are off 25%. As our imports have declined more than our exports, this has been good for our trade deficit. However our trading partners are suffering and this ultimately lessens our ability to finance our deficit spending.

Finally there is government spending. We are in uncharted waters here. It is no secret that the federal government is planning to run a deficit of $1.5 trillion in 2009, a deficit equal to 12% of GDP and larger than any since World War II. And the spending doesn't stop there. According to the non-partisan Congressional Budget Office, the nation would borrow an additional $9.3 trillion over the next decade, leaving us with total debt equal to over 100% of GDP, double the level of last year. And this ignores the $40 trillion off-balance sheet, unfunded liability for Medicare, Medicaid and Social Security. You can certainly make the case that the alternative to this massive intervention by the government was for our Great Recession to become another Great Depression. Had the government not stepped in to backstop the financial system, things would have deteriorated quickly. But now we are in a pickle. The UK just had its debt rating put on watch by Standard & Poors. This matters. Investors (China, Japan) will stop buying the debt of any country that spends irresponsibly for fear that the debt will be monetized (we simply print money to pay them back) resulting in a massive devaluation of the currency. Who wants to hold a dollar that has lost half its value? Our spending is not sustainable and fortunately officials at Treasury and the Federal Reserve know this. Hopefully the politicians will follow their lead and choose a path that doesn't jeopardize our children's future.

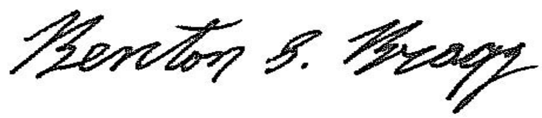
What kind of portfolio do we own in an environment that is anything but "normal"? Back in March we wrote about our approach to portfolio construction in this environment. This approach has not changed. Go to our website www.braggfinancial.com and click on the March 2009 Investment Report for the full read. The short version is as follows. As always, our emphasis is on diversification and a balanced view toward the future. We first focus on liquidity and sustainability, making sure there are adequate funds in cash equivalents and bonds to provide the income needed for up to ten years worth of spending. With the longer-term capital, we diversify among stocks and bonds. Within the stock portion of the portfolio, we diversify by asset class, style and sector. Within the bond portion of the portfolio, we diversify by issuer, maturity and tax treatment. Finally, we consider the implications of inflation throughout the portfolio.

We have talked a good bit today about the imbalances in today's economy that stand in the way of a rapid recovery. Importantly, we are the first to say that we don't know what the market or the economy will do in the short term and we do not advocate extreme positioning of the portfolio in anticipation of either a continuation of the recent rally or a sharp pullback resulting from some of the headwinds we have described today. Something we have written about a lot and that we constantly talk about in the office is that things take time, markets take time, cycles take time. We remind ourselves that we do not have a crystal ball and we should never load up the portfolio based on a short-term view. My grandfather (Dad's dad) was born in 1898 and he lived to be 101. He had no formal education but a lot of common sense. He used to tell us to beware of anyone who had all the answers, especially about religion or politics. We would add economics and investing to the list. Only in hindsight can we see that we could have made a fortune shorting oil at $143 per barrel last April before it fell to $38 by November. Only in hindsight can we see that we should have backed up the truck and loaded up on stocks on March 9, 2009. When the sky was falling in February and March, we heard more than one shrill cry, "Don't just sit there, do something!" Today we can see that the best advice for us all at that point would have been, "Don't do anything, just sit there!" Two years from now we'll have 20/20 hindsight that tells us exactly what we should be piling into today. We'll never lose sight of this and we think that will serve you well in the coming years.

We've settled into our new offices at 1031 South Caldwell Street and we look forward to your next visit. Miraculously, the phones, copiers, fax machines and computers all came on when we flipped the switch. You never know with technology...a bit less certain than growing potatoes.

Thank you for letting us help you with your planning and investing. Please let us know when you would like to review.

Sincerely,



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