Perspectives: April 2009

First Quarter Overview: Good news? Or merely less bad news?

The U.S. financial markets ended the first quarter down 11%. In normal times, such news would herald an economic disaster. In this case, history will likely judge the first quarter as a continuation of a slide that reached -57% from the peak set in October 2007.

By March 6th, the indexes had lost 24% in the first two months of 2009. Then, a number of government and market actions were taken as positive developments, and the markets began to recover from their lows. Since these actions seem to have (at least temporarily) changed market perception, we decided to discuss them more closely in this commentary.

Some economic indicators have begun to show slowing in the rate of decline. Put that data together with the recent government announcements, and this has been viewed as the potential for a positive change in conditions.

It is too early to say "all clear" and we must remain cautious. At the same time, it's important to recognize a couple of things: 1) that a change in the rate of decline could be the beginning of an economic stabilization, 2) a slowing in the rate of decline is still a long way from economic recovery.

Governments Respond to the Crisis

Aggressive policy responses by governments around the world have been broad and deep. These responses have not yet changed economic realities for the world's 6.7 billion people. But at least government actions have assured those who are suffering that they are not doing so on their own.

Time will judge the effectiveness of these policies. And as we have written previously, actions typically have unintended consequences. Instead of worrying about consequences though, it seems far more prudent to prepare to profit from them by allocating resources to the proper investments.

Obama Administration Focuses on Stimulus and Housing

The new administration has passed two centerpiece programs:

- The "American Recovery and Reinvestment Act of 2009" (stimulus program);

- The “Making Homes Affordable” (housing program).

Both of these programs are large-scale efforts to help support the economy, and each has components that are worth highlighting. Let’s examine each in turn.

Stimulus Program includes Tax Cuts and Spending

The $787 billion stimulus program is a combination of tax cuts and federal spending (including assistance to the states). The massive program represents 5.49% of the 2008 total US gross domestic product. Here is a breakdown by category:

1) Highlights of the new tax cuts ($232 billion)

- A $116 billion tax credit for workers; up to $400/individual and $800/couple, phased out for people earning over $75,000/individual or $150,000/couple. The credit will be paid through a reduction in federal payroll tax withholding.
- $70 billion tax cut through extending the AMT “patch” enacted in 2008.
- $46 billion in various tax cuts and credits such as the child tax credit, higher education tax credit, first-time homebuyer incentives, and incentives for alternative vehicles, car buyers, and residential energy efficiency improvements.

Some of the new, more notable tax benefits for individuals that might affect you include:

- Hybrid plug-in vehicle buyers receive a $7,500 tax credit.
- New car purchases (up to $49,500) can deduct state, local, and excess taxes as well as interest on their car loans.
- Energy efficient home improvement, such as new heating/cooling systems and insulation, are eligible for a 30% tax credit through 2010, up to $1,500.
- First-time homebuyers receive a refundable $8,000 tax credit for purchases made in 2009 (before December 1st, 2009).

2) Highlights of the new federal spending and state assistance ($445 billion)

- $180 billion to states, including Medicaid assistance, unemployment and job training, and public education.
- $70 billion alternative energy and “smart-grid” spending, building efficiency improvements, and cleaner fossil fuel energy (clean coal and carbon capture).
- $62 billion healthcare spending, including COBRA subsidies, medical information technology upgrades, medical research spending, and veteran care.
- $48 billion transportation investments, including highway and bridge construction, rail transportation, and public mass transit.
- $46 billion education spending, including Hope scholarship and Pell grant expansions, additional money for schools serving poor children, and early childhood education funding.
- $39 billion in various other programs.

While it remains to be seen whether this massive stimulus program will be effective in turning the economy around, it should at least help to soften the recession.

Housing Program Intends to Help Homeowners and Incentivize Banks
The Obama administration's housing program is intended to help homeowners refinance or modify their mortgages, thus reducing foreclosures. The plan also encourages banks to participate in the programs. Let's examine each.

1) Refinancing
The plan targets homeowners who have been unable to refinance their existing first mortgage because the value of their homes has plunged and they now owe more than 80% of that value. The new plan allows borrowers who qualify to refinance their existing first mortgage balance into new 15- or 30-year mortgages. It is estimated that up to 5 million homeowners may qualify for this program. Requirements include:

- Property must be owner-occupied.
- Mortgages must be owned or backed by Fannie Mae or Freddie Mac (typically referred to as a "conforming" mortgage).
- Owners must have a solid payment history of paying current mortgage, and sufficient income to make the new mortgage payments.
- New mortgage cannot exceed 105% of property's current market value.
- Borrowers cannot get cash out of their refinancing; only transaction costs, such as an appraisal or title report, may be included in the refinanced amount.

2) Modifications
Qualifying borrowers can reduce outstanding mortgage balance if they meet these requirements:

- Property must be owner-occupied.
- Unpaid principal balance must be equal to or less than $729,750.
- Loan must have been originated before January 1, 2009.
- The mortgage payment (including taxes, insurance, and HOA dues) that is more than 31% of your gross (pre-tax) monthly income.
- The mortgage payment is no longer affordable, perhaps because of a significant change in income or expenses.

Homeowners who *apply* for a loan modification have no guarantees that the lenders will agree to modify the loan. But the government is providing substantial incentives to get banks to participate, and most of the large banks such as Wells Fargo, Bank of America, and JP Morgan Chase, have agreed to participate in the loan modification program.

Will the Stimulus and Housing Plans Work?
The national debate surrounding the Obama plans has been heated. Some have argued that the government is spending too much money and is intervening too heavily in private markets, contending that the money could be spent more wisely or that it is

better to let the markets work themselves out. Most economists, however, agree that bold and aggressive action is necessary to stabilize the economy and that inaction or half-measures will serve to deepen the crisis. Bold actions can also have disastrous results if they turn out to be wrong.

Virtually everyone agrees that the economy is in crisis. For investors, the primary question is: *What is the likely impact of the path that we have chosen?*

Markets Address Asset Value

Meanwhile, the financial markets are making changes, too. One of the most important changes came when the Financial Accounting Standards Board (FASB) agreed to relax mark-to-market rules. Marking assets to market is designed to measure the fair value of a company's assets and liabilities. But problems can arise when the measurements don't accurately reflect true value during unfavorable or volatile times. The price of assets in an illiquid market can fall precipitously and can be extremely hard to value. The FASB rules change is an attempt to alleviate those pressures and assign a more normal value. This is a critical issue because it gets at the heart of the downward "domino effect" in the banking sector. In the short-run, this change provides breathing room for the banks to lend and operate normally.

Implications for Investors

We believe that the US dollar will temporarily remain strong relative to other currencies. But when the rest of the world begins to recover, the dollar should begin to weaken from trade balance, deficits, and money supply.

Deflationary forces will also abate and a strong inflationary pressure will push rates higher.

The equity market recovery will not be a smooth, easy road back to the highs of 2007. The recovery will get headline attention because the moves will continue to be 20%+ when they do occur. But the recovery will be marked by large pullbacks of nearly equal size and may take a considerable period of time.

Many businesses have been impaired, their growth prospects diminished, and consumption reduced by high unemployment. This will continue to weigh on the equity markets.

We think it is most likely that the equity markets will be in a wide range-bound environment for the foreseeable future, with corporate earnings keeping the markets from rallying back to old highs and a moderating economic contraction slowing the pace of declines.

We remain convinced that the best investments are in those that would benefit from inflation, weakness in the dollar, higher regulatory standards, and those that have low exposure to recessionary pressures.