

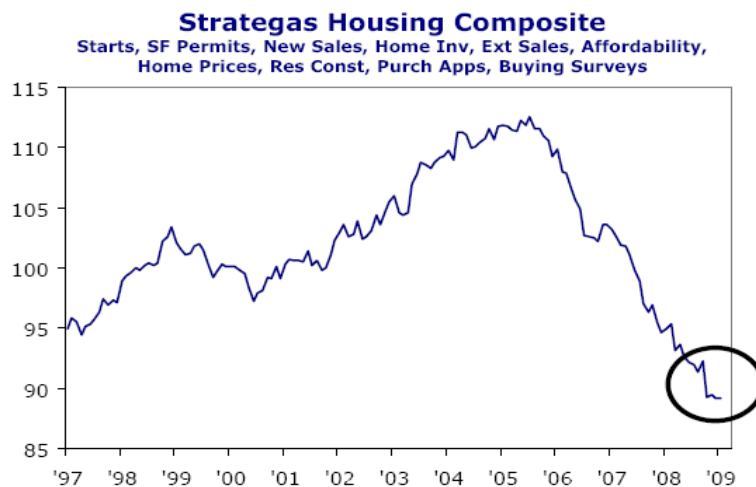
## Quarterly Review and Outlook – First Quarter 2009

The first quarter provided no relief from the stock market declines of 2008. The averages were down across the board with one lone bright spot: emerging markets. The broad equity indices were down 9-15%. Emerging Markets were up 1%. Bonds were up slightly except for high quality municipal bonds which were up 3.5%.

The negative performance during the first quarter was muted by a 20% rally from the March 9<sup>th</sup> low. The rally was a generally hopeful response as further details regarding the Treasury's plan were announced to address the strains in the financial markets with a primary and necessary focus on the banks. The market greeted this news with enthusiasm that continued through the G20 Summit where we saw global leadership coming together and indicating that we need a more comprehensive approach for dealing with global financial crises. Is a reinforced International Monetary Fund the answer? Time will tell. In the meantime, we will be thankful for the rally.

The predominant negative disposition in the market has been due to a continuing deterioration in the U.S. and global economy that has contracted significantly over the past six months. As we write this in early April, the economic environment has shown some signs of stabilization, which has led to a fairly significant rally since bottoming. We believe it is too early to tell if these are early signs of a temporary recovery or signs of something more meaningful.

We have focused on the health, or lack thereof, in the housing sector for signs of recovery since we believe that is the root cause of our current predicament. House prices have shown over the last two years that they can decline as leverage becomes too great and pricing becomes too high. The following Housing Composite chart from Strategas looks at a combination of important housing factors as a barometer for the housing industry:



While there is a slight sign of stabilization, this composite clearly reflects no sign of improvement. The Case-Shiller Home Price index continued to show nationwide price declines in February with the 20 city index down 19% year over year. The continuing decline has had a devastating impact on borrowers and lenders which has led to a tremendous loss in confidence leading further to increased savings, reduced spending and, as a result, declining economic activity around the world. We are experiencing a major global recession.

## **A Normal Recession versus Today**

The US and global economy is experiencing a “balance sheet” recession which contrasts with most past recessions. Richard Koo the Chief Economist from Nomura Securities explains that “a balance sheet recession emerges after the bursting of a nationwide asset price bubble that leaves a large number of private-sector balance sheets with more liabilities than assets.” This is exactly what we have experienced as the collapse in housing prices left banks, consumers and corporations with more liabilities than assets. What makes this recession more severe is that it has touched so many market participants and that it is a global phenomenon.

Balance sheet driven recessions are difficult to fix. By their very nature, when balance sheets become impaired the actions necessary to repair them: reduce leverage, eliminate bad assets, and conserve cash are counter to the typical elixir of increased lending and spending that the economy needs to recover.

Koo reminds us that the “economy will not enter self-sustaining growth until private sector balance sheets are repaired.” Repairing balance sheets takes time and extraordinary efforts. In our view there are four major overhanging issues that have yet to be corrected:

- 1) We are experiencing a massive unwinding of leverage around the world. Consumers are cutting back on spending, paying down debt, and increasing savings to repair their own balance sheet. Companies are also cutting back to improve balance sheets and reorganize their businesses to respond to reduced demand.
- 2) The unwinding of leverage has impaired the credit markets leading to reduced spending by consumers and businesses.
- 3) Housing continues to pressure homeowners and banks. With prices declining and deleveraging the current trend in the market, access to credit remains restricted.
- 4) The employment situation has deteriorated in the last 6 months with no signs of improvement.

All of these things work together in concert and feed on one another forcing a negative spiral. To soften the effects of balance sheet repair, the Fed has embarked on what is known as quantitative easing. In essence, they can no longer reduce rates since they are effectively at zero so in the absence of healthy market participation they have become the buyer and lender of last resort. Most recently, the Fed announced they will buy long dated Treasury bonds in an effort to lower credit spreads. These are necessary but unfortunate actions and will no doubt have unintended consequences that policymakers will have to deal with at a later date. I remain confident that the Fed will ultimately help lead this economy out of a nasty recession but it will take time.

The Obama administration has passed a sizable stimulus package to help the economy get moving and it will be likely that more stimulus will follow. The real focus right now is on the financial sector. Without a functioning financial sector, the economy cannot recover. If banks will not lend, then housing prices will likely continue to decline, employment trends will worsen, and credit will be difficult to obtain. The Treasury and Federal Reserve are working hard to address the many issues in the banking sector. It is taking time and will continue to take time, but there are signs that conditions are beginning to stabilize. We are encouraged, but cautious, due to continued disruptions in the credit markets where credit spreads remain stubbornly high.



## Where are we heading?

My son has been working on a project with his Pre-K class to find letters and numbers out of ordinary things that they see all around them. They are not looking for a letter or number that you would find on a sign but one that is created by using your imagination and thinking how it can be created. The teachers asked me for my comments about the project and this is what I said:

...what I think about it is less important than what our children think of it...[When I asked what my son thought of it], in perfect childhood simplicity he said that he “liked being able to find letters and numbers wherever you are and from many different things”....His comments made me realize that these letters and numbers represent the simple solutions arranged before us as we attempt to answer complex questions. We just need to have the wisdom and experience to open our eyes to find them..... [This project] will be a constant reminder for our children (and their parents) that the simple solutions to life’s questions are before us if we just open our eyes and think.

This project to me is an analogy for what we face as investors because investing in turbulent times can be complex and confusing. Market movements gyrate dramatically without a predictable pattern. It is likely the stock market will begin to reflect better days well before economic indicators signal the all clear. With so many questions about the strength of the economy and markets, this childhood exercise of searching for simplicity is an effective way to navigate today’s markets. We believe a well thought out long-term strategy that focuses on individual risk tolerance, asset allocation and diversification is the best way to deal with investment complexities that arise. This approach attempts to give you the best opportunity for success in your portfolio. Our responsibility is to understand these complexities and direct your investment plan prudently in order to maximize your investment return commensurate with your risk tolerance.

We believe that we are going through an economic and financial crisis with little historical precedence. Deleveraging will likely dominate our investment landscape for some time to come and will have obvious implications on economic growth. While we are certain that the future of our global economy is strong, we are asking ourselves for signs of when that strength will show itself to the markets. We are optimistic and believe that the aggressive efforts that are being pursued will achieve the desired results. We resist the inertia of negativity that surrounds the market but are proceeding with caution within the portfolio as the timing of recovery is uncertain. While this approach is simple, it is not easy as it requires patience and diligence to ensure success.

We will communicate to you the evolution of our thoughts in future letters as well as our meetings and conversations. As you review this report and consider our outlook, please do not hesitate to call us at any time with your concerns or questions.

Best regards,

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