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INSIGHTS & ACTIONS

SUMMER - 2009

QUARTERLY FINANCIAL INFORMATION FROM FINANCIAL COUNSELORS, INC.

Spend Now — Save Later

By Bill Courtney

Bill Courtney

Historically, recessions have been good entry points for buying equities…

It appears the economic depression trade has been taken off the table and replaced by a recession. The trend of better than expected economic reports, a solid earnings quarter and forward earnings guidance by companies has helped the equity markets stage a nice rally. Historically, recessions have been good entry points for buying equities and we are going to find out quickly if these recent buyers of equities are owners or renters. If they are owners, we should see more buying power on a price pullback and worst case a sideways market. If they are renters, we will see selling power on any decent pullback and a possible correction. The massive government spending and financing, code name "Red Bull", is not a permanent solution and the baton will have to pass to the American consumer. We don't think company profit margins are going to jump back to record highs any time soon because the consumer will not be able to lever up and spend more than they make, but spending everything they earn should be enough to provide for a low growth economy.

Scarcity breeds opportunity. While equity growth opportunities will be lower in numbers, this should increase the value of investing in them. Revenue growth, operating margins, and free cash flow will continue to be key fundamental metrics of assessing the health of the companies we chose to own. We do not believe a secular bull market has begun due to the following headwinds:

- Higher future interest rates, taxes, and unemployment
- Increased government regulations
- De-globalization or "soft protectionism"
- Continued de-leveraging of the American consumer

These headwinds are why growth will be scarce and we will need to harvest profits when we can get them.

So far, Things are Just "Less Worse", Not "More Better"

By David Anderson

David Anderson

First quarter corporate profits (with 70% of the S&P 500 firms having reported) are slightly better than analysts' had expected. However, the pundits weren't really looking for much, as year-to-year results have shown a decline of nearly 33% and dividend cuts have exceeded any previous period since the Great Depression. The S&P 500 has rebounded more than 30% from its March 6th low of 666, helping investors to "feel more better" about having recovered approximately $2.5 trillion of wealth that had dissipated since late last year. Investors seem to be anxiously looking across the valley at perhaps more promising fundamental prospects ahead.

Of the reporting public companies, 66% have beaten estimates, which is slightly more than the pattern of the past two years. Furthermore, results have averaged about 10% better than consensus projections, instead of 10% below, as had been the recent pattern. Earnings per share this quarter fell at a reduced rate, vs. the final three months of 2008 and, even though analysts are still cutting estimates, they are doing so at a reduced pace and to a lesser degree. In fact, individual company estimate increases are more prevalent than they were just 30 days ago.

Currently, our greatest concern is that legal insiders are showing a greater propensity to use post earnings trading windows to sell, as buyers are showing very little conviction. In fact, market-wide "insider sentiment" has fallen to its worst level since early 2007. We should hasten to note that heavy pick-ups of insider selling activity haven't always correlated with market tops, but in our opinion it offers a good reason to exercise some "near-term" constraint.

Historically, stock buying opportunities are often best even as the economy deteriorates and counter intuitively the worst time to buy is when economic conditions seem wonderful. The fact that Government bond rates have been nudging higher since mid-April is of modest concern, but rarely does the S&P 500 yield more than a 10-year Treasury, as is currently the case.

Early cycle, high beta leading sectors, such as technology and consumer cyclicals have begun to show signs of market leadership, as well. However, despite many early signs of fundamental improvement, analysts remain cautiously hopeful (note-continuing skepticism is an encouraging sign of worry to contrarian value investors). And, we must keep in mind that 2009 and 2010 expectations are still being reduced, albeit to a lessening degree. Soon investors will need more promising growth prospects to justify that a true long-term bottom has been seen. The current pattern of earnings revisions is still negative (i.e. more down than up) and that is certainly not enough to continue to propel stock prices higher if conditions just continue to get "less worse". Ultimately, earnings need to actually get "more better".

Out of the Woods Yet?

By Val Schaff, CFA

Val Schaff

Recession, recession, recession. We have been hearing about the economy being in a recession for over a year now. With the economic numbers out for the first quarter, GDP has now declined for three straight quarters which is the longest period of decline since 1974–75. In addition, the last six months has been the weakest period since 1957–58. The question now in the minds of most people is when will it end and when will growth resume?

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Out of the Woods Yet?

In contrast to previous downturns, this recession has been a reaction to the excesses in the financial system. These excesses have not been in manufacturing, but in housing and in the credit markets. Since housing and banking are so key to our way of life, correcting these excesses has necessitated a level of "pain" not felt in decades. First the Bush administration and now the Obama administration have attempted to utilize various parts of the government to provide the liquidity, the guarantees and the money to get the economy back on track.

So where does the economy stand at this point? The manufacturing sector continues to decline, but there are indications the decline is moderating. The Institute for Supply Management manufacturing index has now increased for four months in a row even though the index remains in contractionary territory. The confidence of the consumer in the future health of the economy is improving even though the attitude toward the current situation remains negative. These two areas are an indication that the worst of the downturn may be behind us.

Perhaps more important is the condition of the financial system. While there may be the need for additional capital in some of the largest banks, the dire predictions about the results of the bank stress tests appear to be unfounded. In addition, the recent decline in mortgage rates has provided welcome relief to the housing market and has helped stabilize, to a degree, home prices in many markets.

While some of the economic numbers will most likely continue to look bad, especially ones related to the labor market, the rate of decline has moderated. The improvement in consumer confidence should also go a long way toward providing a degree of stability and even some positives. Is the economy "out of the woods" yet? Not totally, but it is a lot easier to see the edge of the forest today than it was a short time ago when we were in the deepest and darkest depths of that same forest.

Fixed Income

By Gary Cloud, CFA

Gary Cloud

Credit conditions in the high grade bond market have improved noticeably since the beginning of the year. Benchmark short-term rates like 3-month libor and the TED spread have dropped down to levels that prevailed prior to the bankruptcy of Lehman Brothers last September. Investment Grade bond issuance has been very strong and the annualized amount has approached record levels. Credit spreads in the high grade corporate space have tightened about 2.50% since 12/31/08 and high yield spreads have narrowed by 12.50% over this same timeframe.

Corporations who had no access to credit and a dire need to refinance near term debt maturities suddenly found the window open to them, albeit at historically wide spread levels to Treasuries. But that sure beats defaulting on your debt! As more and more companies were able to issue debt with better financing terms, the flood gates opened and prospective buyers battled one another for a piece of each new deal. The net effect of all this activity was to jump start the credit markets and allow investors to start focusing on the recovery of the business cycle instead of fretting over its ultimate demise.

Markets, by their very nature, are discounting mechanisms, trying to anticipate and price-in today, what might happen in the future. You never know how much of the "bad" or "good" economic news has been factored into security prices. Clearly, the credit markets are looking ahead and like what they see, unless they decide otherwise, later! Time will tell. We have been overweight corporate bonds for the last six months and added even more during the first quarter. Our Treasury and Agency positions have been trimmed to make room for an increased corporate bond allocation. We expect that Treasury rates will trend higher later this year and are confident that the riskier parts of the investment grade bond market should be the best performers.

Asset Allocation

By Brian Perott, CFA

Brian Perott

As the risk of a global credit crisis meltdown subsided and the threat of total nationalization of the U.S. banking systems declined, both the fixed income and equity markets breathed a sigh of relief and rallied nicely off the lows in early March. Additional drivers of the recent rally, first quarter corporate earnings and economic reports, have also been better than expected. On an absolute basis the reports continue to be weak, but the markets tend to trade positively off of "better than dire" expectations and anticipation of even more improvement in the near future.

While we continue to look for evidence that the "risk-taking" environment is improving, we are making calculated asset allocation recommendations to take advantage of opportunities that the massive monetary and fiscal policy stimulus has provided. We believe that these efforts have reduced the risk of deflation and further economic crisis.

What does this mean for our asset allocation targets? We continue to favor incremental additions to asset classes such as corporate bonds, high yield securities, emerging markets, small cap stocks and some hard commodities which we initially outlined in our Spring Strategy letter. Although these asset classes have performed very well over the last few months and, therefore, the relative attractiveness has declined somewhat, we believe this outperformance should continue. One slight change from our previous report was to reduce cash/ money market balances as much as possible and overweight short investment grade corporate bonds. This could greatly improve the yield characteristic of the overall portfolio.

As we continue to assess the ever changing market and economic environments, we'll evaluate whether our slight underweight of equities continues to be warranted.

Tactical Asset Allocation (Weighting relative to strategic allocation targets)

	UNDERWEIGHT	NEUTRAL	OVERWEIGHT		UNDERWEIGHT	NEUTRAL	OVERWEIGHT
EQUITIES	●			FIXED INCOME			●
GROWTH			●	SHORT-TERM INVESTMENT GRADE			●
VALUE	●			INTERMEDIATE-TERM INVESTMENT GRADE		●	
LARGE CAP			●	LONG-TERM INVESTMENT GRADE	●		
MID CAP	●			CASH	●		
SMALL CAP		●		COMMODITIES		●	
INTERNATIONAL		●		HI-YIELD		●	
EMERGING MARKETS		●		REITS	●		

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