H. M. Payson & Co.

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PERSPECTIVES

Riding the Baby Bull

Bull markets are born on pessimism,
grow on skepticism, mature on optimism,
and die on euphoria.
- John Templeton

Legendary investor, the late John Templeton, was fond of saying the best time to buy stocks was at the moment of "maximum pessimism" – when new "bull markets are born". Certainly in modern market history there was seldom, if ever, a more verdant pasture of pessimism upon which a new baby bull market could graze! As illustrated by the NDR Crowd Sentiment Poll chart on the next page, we witnessed investor sentiment bounce off extreme negative levels during the last quarter right around the time of the recent market low on March 9th.

Not in a very long time had the market put investors through such a long, torturous period - in fact, never in the lives of most market participants today. Without much pause after the disastrous and nerve-wracking fourth quarter of 2008, this year through March 9th the S&P 500 continued its waterfall decline another 25% confounding the likes of Warren Buffett and other notable, though rare, market bulls who publicly proclaimed that stocks had become very attractive even as early as last fall. Indeed, the S&P 500's decline in the six months leading up to the March low was the steepest *since 1932!*; and the decline in *inflation-adjusted* market value from the high, way back in 2000, was exceeded only three times in history - the last being 1929-1932[1] ...talk about a virtual water-boarding of investor psyche - it's no wonder market sentiment reached levels of sheer despair! Not withstanding a spirited 18% recovery from the March low, the S&P 500 finished down 11% for the quarter - its sixth quarterly decline in a row. The startling improvement in market sentiment late in the quarter belied a continuing steady stream of bad (though in certain ways somewhat more hopeful) economic data.

There's no denying global economic activity "fell off a cliff" in the fourth quarter of 2008. However, it's ridiculous to compare current economic conditions with the Great Depression - for no other reason than policymakers this time, among them our Fed Chairman Bernanke, a student of the Depression, understand the need for the massive (if unnerving) liquidity creation now underway. Still, much of the headline economic data suggests we may be in the most serious recession since the 1930s: *in the fourth quarter profits suffered their biggest decline in 55 years; fourth-quarter GDP contracted by an annualized -6.3%, its biggest decline since the first quarter of 1982; gross domestic income fell the most since 1980 and jobless claims are on the rise.* This period may well turn out to be what some have dubbed "The Great *Recession"* - entering its 15th month, about two months shorter so far than the longest previous postwar recessions of 1973-1975 and 1981-1982[2].

[1] The Economist – March 12th

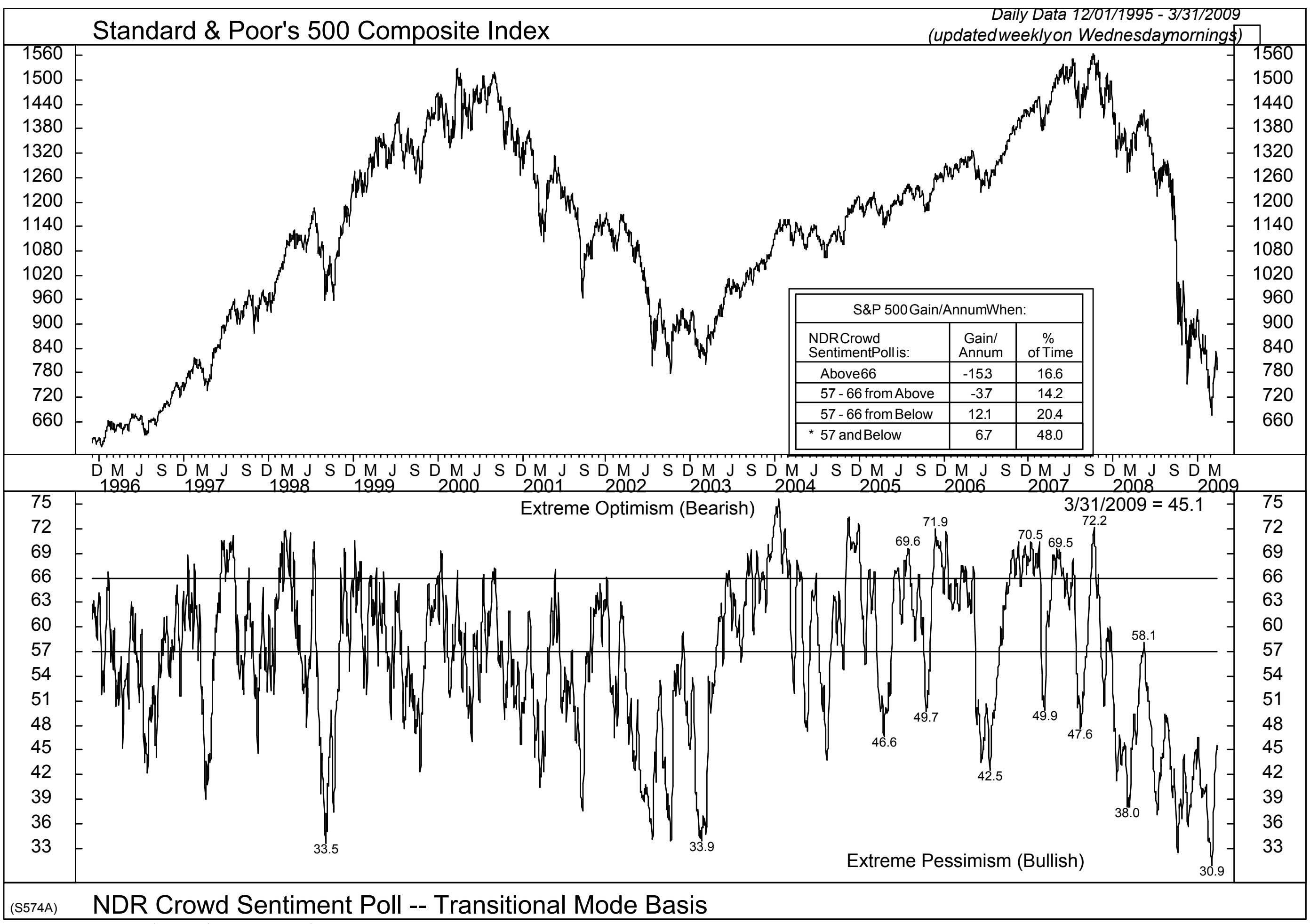
[2] Ned Davis Research

Comparisons to the recession of 1981-1982 seem more apt to us; for even in the face of skyrocketing unemployment in 1982, the S&P 500 gained over 50% from August of that year through December of 1983, the month in which the unemployment rate finally peaked at 10.1%. Today, the stock market is starting to look ahead, shaking off the extreme pessimism engendered by cascading market declines and some of the scariest headline economic data we've seen in a long time. To be sure, the bad economic news will continue to flow; and unemployment (a lagging economic indicator) may not peak for 6-9 months. However, as Warren Buffet says, “The future is never clear; you pay a very high price in the stock market for a cheery consensus”.

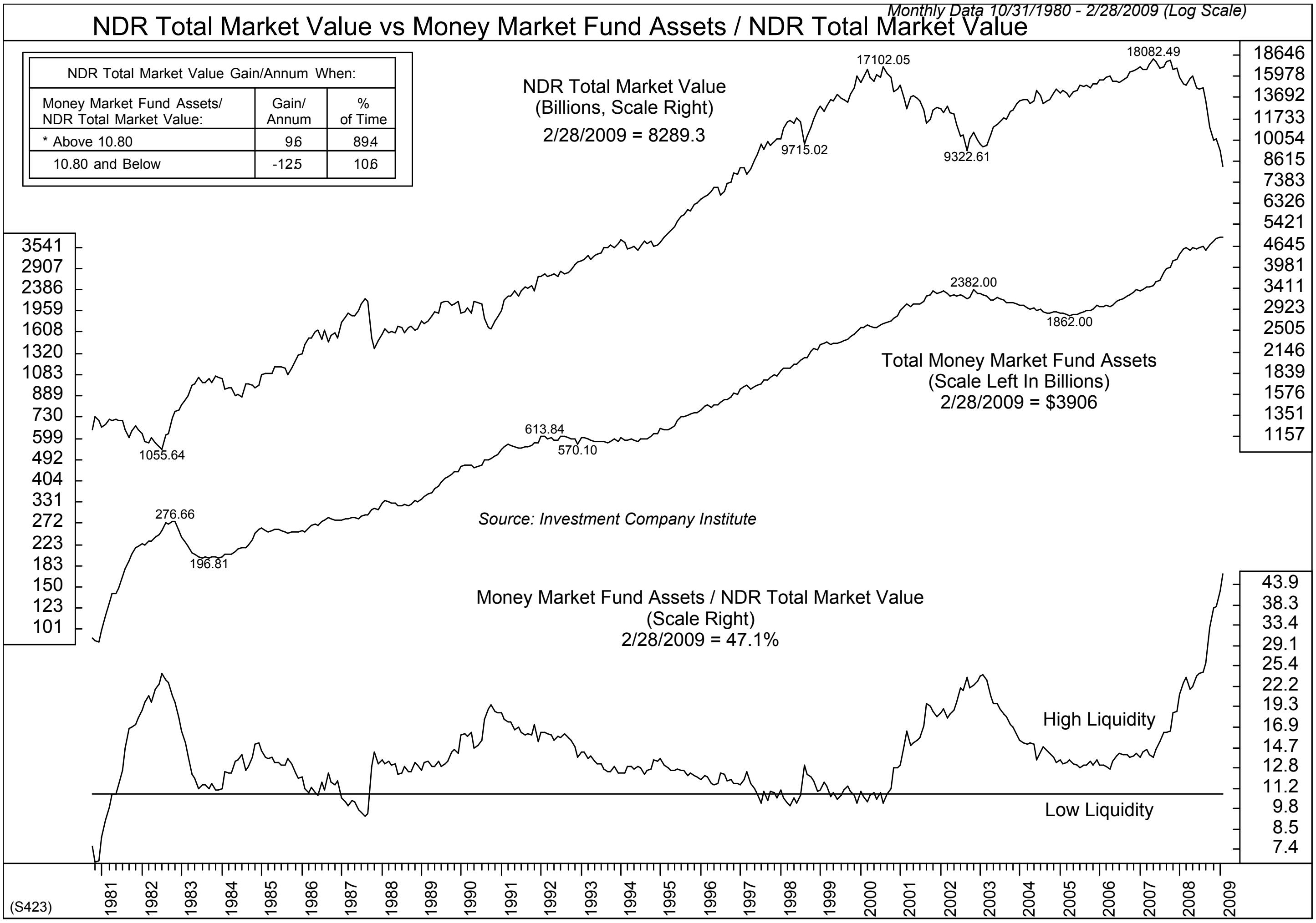
Recent strength in some commodity prices, the PPI and CPI, as well as generally higher yields in the Treasury market indicates to us we may be nearing a bottoming process in inventories and industrial demand. Gold and Emerging Markets joined commodities in leading returns for the last quarter. The unsustainably low production of everything from steel to automobiles over the last two quarters could be setting the stage for a typical, post-recession, leveraged rebound in economic activity.

Our confidence in the vitality of the stock market rally which began last month is bolstered by the fact that through March 23, the S&P 500 posted its largest 10-day gain since 1938 - accompanied by historically and convincingly wide market breadth (meaning most stocks participated in this rally). Together, we take these admittedly technical market observations as strong evidence that the near-term market downside risk is low. Fundamentally, too, there is ample liquidity in money markets to support stock prices should investor sentiment continue to improve (as shown on the graph to the right).

In the meantime, however, reported corporate earnings will remain on the ropes for at least several more quarters. We expect corporate managements



Source: Ned Davis Research



Source: Ned Davis Research

to throw every form of non-cash charge and balance sheet write-off into upcoming corporate reports, exacerbating the free fall in reported earnings, but clearing the way for robust future earnings comparisons when business improves. Stock prices should remain buoyant relative to earnings, anticipating the inevitable profits recovery - which would lead to higher price/earnings multiples. However, against other valuation metrics we employ, such as price/cash flow and price/book value, stocks look reasonably if not attractively valued, despite recent gains.

There is still little evidence that much liquidity has been worked into the economy from the government stimulus efforts, which we see reflected in low monetary velocity. However, current scattered evidence of a slowly improving economy and better consumer confidence suggests to us it's likely much of the stimulus effort will take effect *after* it is most needed (as in stimulus efforts during previous recessions) providing a strong tailwind into the next upwards earnings cycle.

Accordingly, we have continued to shift our portfolio emphasis towards "real economy" stocks - a strategy that is working well very early in this quarter. Encouragingly, the strong relative performance of basic material stocks is consistent with the passing of other bear market lows. Additionally, in our portfolios we see no reason to abandon the extremely high-quality, stable franchises - the Johnson & Johnson's of the world - which continue to trade at attractive valuations. Therefore, we think the best portfolio strategy is to invest in securities of both defensive *and* cyclical companies, which combines the best attributes of their stable cash flows and earnings leverage, respectively. We continue to emphasize exceptional balance sheet strength in our portfolios since strong companies typically emerge from tough economic times even stronger than their competition.

In considering our asset allocation we view today's market landscape as a "good news / bad news" situation. The "bad news" is that over the past painful year-and-a-half bear market, diversification failed to afford much portfolio protection as most asset classes performed miserably together. The only two true bastions of safe diversification were cash and U.S. Treasury securities. As a result, both of these asset classes are extremely expensive - reflecting the market's willingness to accept negligible or even negative real returns to avoid market risks of any kind. On the other hand, as the market declined, higher "risk" was reflected in the prices of most corporate securities - both stocks and bonds - whose valuations now present opportunities to earn outsized long-term returns across both asset classes.

This has important implications for investors who may be interested in realizing higher income from their portfolio, or who would feel more comfortable reducing their direct exposure to stock market risk after suffering through the recent turbulence. Today the "good news" in terms of the asset allocation decision is that corporate bonds, at current levels, present an effective way to earn a higher current income return *and* the opportunity for some capital appreciation as bond prices rise with improving prospects for corporate profits.

Certainly there are times when maintaining a long-term market view can become psychologically challenging; today is one of those times for investors, including many of our clients. Therefore, we are urging our clients to take advantage of the recent market strength to re-calibrate their "psychological threshold" (a term we borrow from a friend and client going through just such an exercise), and to weigh the utility of sleeping well against the value of future portfolio returns in the context of high market volatility. Our portfolio managers can assist clients in making any necessary adjustments to market exposures and liquidity levels after reviewing each client's situation with them.

We believe the economic and market tide is turning for the better; though we expect the *markets* will perform far better than the *economy* in the near term. We are certain the markets will experience plenty of continuing volatility along the way, recognizing the myriad systemic and unquantifiable risks embedded in the balance sheets of our banks, corporations and even, or especially, our Federal Reserve and the Treasury.

If, as they say, markets like to "climb a wall of worry", then the markets should find plenty to like about our current economic circumstance. In the meantime, we are working hard to understand the implications of political and policy developments as they unfold and what they might mean to the markets and our clients' portfolios.

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