Advocate Asset Management, LLC

MARKET COMMENTARY **SECOND QUARTER 2009**

This quarter, we find ourselves asking more questions than providing answers. At the top of this list is the question of what will drive a recovery. Not *when* a recovery will emerge, as so many are hypothesizing, but from *where*. What segments of the economy will drive a recovery? If the only major force for recovery is government spending, the response may be weak and the economic malaise more stubborn to reverse.

The world gorged on a diet heavy on debt for several decades that is now causing massive indigestion. The level of insolvencies may reach record levels before this downturn reverses. This process of shrinkage will keep unemployment very high as profit making companies attempt to navigate through a period of systemically lowered sales and revenues.

The past six months have been a tug of war between conflicting signals of economic strength and weakness. The most troubling aspect of the massive amount of data available to all investors is that there is really very little useful information in the data. Much of the seemingly improving data is statistically insignificant and subject to significant revisions. The phrase *du jour* was the oft-repeated metaphor of less negative economic statistics linked to the early spring emergence of "green shoots." Some of the analysts and economic pundits stretched to justify a more positive stance. When an economic statistic was down, from 100 to 70 in one period and it 'only' declined to 60 in a more recent period, this was taken as a point of optimism. This must be the new math in a faltering economy.

The biggest change in our thinking has been about the risk of emergent inflation. All the worry about inflation is running up against the facts.

While earlier in the year we focused on the shorter-term risk of inflation, we now believe that this risk will be delayed beyond this year, probably into 2011 at the earliest and likely into 2012. With worldwide industrial excess capacity at record levels and with muted growth prospects, deflation is the predominant theme for the moment. There is no broad excess demand in the real economy which is a strong pre-requisite for inflation. In some industry groups, capacity utilization is very weak, leading to ferocious price competition; this is deflationary. Of course, there will be some inflationary aspects to short-term oil prices and U.S. dollar movements, but these will be transitory. Higher commodity prices are not, in isolation, inflationary and may actually be deflationary (by drawing spending away from other economic areas). But watch out later in this market cycle for resurgent inflation! There are estimates that the world's economies need to raise $5 trillion in new government-funded debt to supply the necessary funds to extricate us from this debt-induced collapse. That could be highly inflationary.

How will the world's central banks maneuver their nationalistic entities through this morass without escalating into protectionist policies? No

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matter how favorable and optimistic the sound bites resonate from the industrialized country meetings, the problems are incredibly severe and the solutions should not include creating false expectations. Why? Because to do so only exacerbates the situation longer term and ultimately tricks households into thinking that the turn is just around the corner.

As stated by economist James K. Galbraith (Levy Economics Institute), we are not in a temporary economic lull — an ordinary recession — from which we will emerge to return to business as usual. Rather, we are at the beginning of a long, painful, profound, and irreversible process of change — and we need to start thinking and acting accordingly. Galbraith calls for a number of measures that are needed including "realistic economic forecasts, more honest bank auditing, effective financial regulation, measures to forestall home evictions and keep people in their homes, and increased public retirement benefits." Unfortunately, human nature is predictable; the likelihood of all this happening is nil.

Outlook

The mountain of debt needs to be reduced but that is unlikely using conventional approaches. The overall U.S. debt (government, private and household) is about 350% of GDP. Household debt as a percentage of disposable personal income has declined fractionally from 133% at year-end 2007 to 128% at the end of the first quarter of 2009. Think about that statistic; the average household owes more than its disposable income by a large amount. Additional job losses or reductions in wages from working less hours (furloughs, mandatory time off, etc.) tips over precarious household finances into potentially calamitous conditions.

During the past three decades, the consumer part of the economy grew from about 65% to 72% of GDP. During the past few years, this growth had been augmented by homeowners drawing down the equity in their homes to the extent of about 3% of GDP per year — about $400 billion per year. This supplemental cash flow was viewed as income and used to augment profligate spending. This borrowing added to the enormous burden of debt that households now struggle to pay back. Currently, this technique has passed its peak and is reversing with a vengeance. There are few banks offering lines of credit backed by residential real estate. We are highly confident that increasing household savings rates foretell a smaller portion of GDP dominated by the consumer.

There is only one sector that can begin to replace this shortfall in GDP activity. Not surprisingly, this is the U.S. government. This is not healthy for the longer-term prospects of the economy. As the government makes decisions as to where to allocate resources, it is usually misdirected and late. Getting people retrained and back into gainful, full-time employment is just not going to proceed rapidly. The administration's promise of creating or saving several million jobs is a fantasy. It is impossible to measure and is the type of declaration that sounds sweet but has a bitter aftertaste.

In our opinion, employment is the critical element in this cycle. Without stabilizing household cash flow, the programs from the Fed and the Treasury will have limited impact because households will continue to default on their debt commitments. Reversing the unemployment picture is the key to stabilizing household cash flow. Once unemployment stops rising and finally begins to decline, then we may see home prices begin to stabilize, the real estate market begin to absorb the excess inventory, and turn upward. However, we would not forecast a vigorous bounce back in residential real estate prices. The unfolding disaster still to come in the commercial real estate markets will be a reminder that real estate development (residential and commercial) is done on high leverage and leads to excessive booms and tragic busts.

The question is whether new job losses will overwhelm the benefits of the government's stimulus spending. Reduced or lost wages combined with continued declines in real estate prices could put millions of more Americans in arrears on their mortgages and other debt obligations. This could force banks to realize additional losses and prompt them to tighten credit again (contrary to what the government is attempting to accomplish). That might blunt a recovery and exacerbate joblessness. The next several quarters should clarify whether the Obama administration's stimulus initiatives are enough to avert that. We doubt that the stated goal (of four to six million new or saved jobs) will be accomplished.

The jump in unemployment in June confounded most economists. They were surprised by the reversal in the newly developing positive trend. (Of course, the time frame for a trend has been foolishly compressed into two months now — essentially, two data points are viewed as making a new trend.) For those who are aware of how unemployment is actually calculated, this was no surprise. The various states administer their own rules on how long the unemployed may receive benefits. When the number of those beginning to receive benefits no longer surpasses the number of participants going off benefits, it *appears* that the employment situation is improving. This is referred to as the "absorption rate." One might assume that the reason that one stops receiving benefits is that they have found a job. *In the past that was usually the case*. Today, it appears that more and more unemployed have not found jobs but have run out of benefits so they drop out of the statistical calculation. This is interpreted as a sign of a rebounding economy, although it should not be. Household income obviously suffers from unemployment and this distress works its way throughout the economy.

In this downturn, corporate profits may remain positive (but at substantially lower levels than during the economic expansion) due to draconian expense controls (including labor reductions). However, it should be clear that companies are not anxious to rehire. They are planning to operate with a lower head count and muddle along at some level of operating profits. This means that the so-called recovery, although sluggish, must anchor itself on a jobless recovery. Corporations may "recover" but the labor market will struggle to improve. Lower employment means reduced income-tax deductions, smaller payments into the Social Security and Medicare systems, and so forth. These have a large impact on the federal deficit and an enormous impact on state and local finances. Ultimately, perhaps sooner rather than later, one should expect to see new tax legislation in an attempt to reduce these enormous deficits. Unfortunately, raising taxes has never been an engine of economic growth. In high-tax states such as New York and California, estimates are that effective tax rates may rise from about 45% currently to over 60% — a 33% increase. So, strategies to reduce the huge deficits that are coming this year (and for the foreseeable future) will counteract the stimulus programs and act as a brake on attempts at recovery.

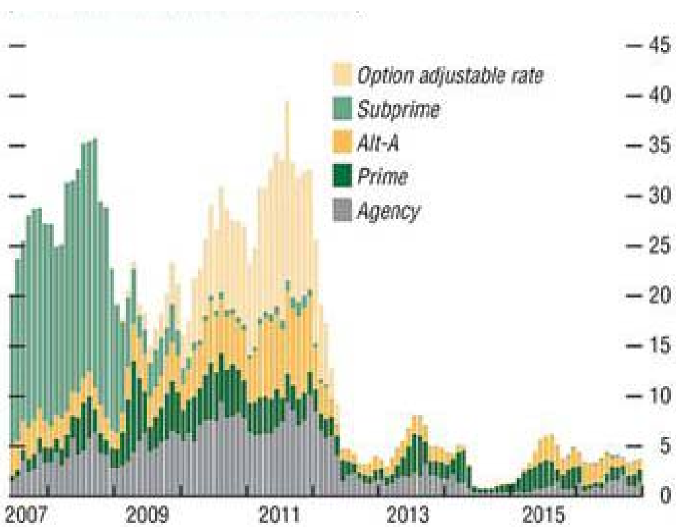
The one sector that most baffles us is the Financials. The relaxation of the mark-to-market rule in early April may continue to provide for positive year-over-year comparisons for bank earnings. However, we view these earnings with suspicion. The less-than-reasonable valuation of assets on bank balance sheets remain a continued cause for concern — especially in the future when sluggish economic growth makes it more difficult for banks to grow out of their problems. This is not solved by ignoring it and hoping that time will work miracles.

The banks have raised substantial additional capital in the bond and stock markets (as demanded by the bank regulators) during the past few months. The most positive development is the record yield spread between Treasury note and bond yields (the positive yield curve). Also constructive is the low level of the federal funds rate that governs interbank lending. Historically this positive spread has been a big booster of net interest income for banks.

Another major positive is the narrowing of credit-quality spreads in the bond markets that have taken place between December 2008 and June 2009. As a cautionary note, we think that as the economic situation takes longer to improve or even worsens, these credit-quality yield spreads will reverse and widen into the winter of 2010 as more companies default on their loans. We see this coming as a freight train moving slowly down the track.

The bad news is that rising mortgage interest rates are depressing mortgage refinancing activity. This (along with one-time business unit sales) was a major source of bank earnings during the first quarter.

Monthly Mortgage Resets in Billions US$ (source: Credit Suisse)



Attempts at reducing foreclosures in order to keep people in their homes appear to have stalled. The different parties are having difficulty agreeing which of the parties need to step up and how much of a hit they should absorb. Many homeowners are underwater and cannot get out from their enormous mountain of debt.

As we look into the future of prime housing mortgages and collateralized commercial mortgage obligations that reset or mature in 2010 and 2011, the picture is ominous (see chart at left). Residential and commercial mortgages are likely to generate more bad loans over the rest of this year and during the next several years. If interest rates rise (due to crowding out by government financing of private needs for capital and the utter massive amounts of government funding), then the spill-over effect in the mortgage market will be horrendous.

We have identified other factors to consider. The rise in the price of oil during the quarter (due to U.S. dollar weakness rather than underlying demand growth for petroleum) is impeding consumer spending, already restricted by high unemployment. This is a growing negative and serves as a *de facto* tax on consumers. Recent price moves down have been helpful in this regard.

The capital markets are a mixed bag of positive and negative news and data. Let’s highlight just a few of these to illustrate how malleable the interpretations may be.

- Sentiment – consumer expectations were turning more positive as the stock market rose but recently, the problems with the again-increasing unemployment are dampening hopes for the future. This is a highly volatile measure that is almost wholly dependent upon very recent consumer experiences. This is not particularly indicative of the real economy, but is often cited by the media.
- Jobless claims – continue to increase but at a smaller pace. The economy cannot recover with increasing unemployment. The distinction between 650,000 and 575,000 jobs lost is not material, although the media seems to forecast minor reductions month-to-month as extreme positives.
- Housing inventory – remains at historical peaks and will not come down until the foreclosed housing inventory (on the sidelines as banks are loath to flood the market) is removed.

Declining prices are causing more homeowners to sink underwater with their homes. Sales appear to have increased, but this data is statistically insignificant.

- Personal savings rates – this is positive for the U.S. economy longer term but is adding to a reduction of consumer activity in the near term. Households are frightened.
- Corporate estimate revisions – seem to be improving as corporate America is adjusting to lower levels of economic activity and cutting costs. Earnings, while positive, will not support rehiring during lean business operations.
- Insider share sales are at record high levels. Corporate managements and directors are evaluating the recent rally as a time to unload their 'insider' holdings. There may be valuable information content in that negative trend. Near ultimate market bottoms, insiders see the order book improving before it translates to revenue increases and earning growth. That appears to be <u>not</u> what they are seeing, hence their wave of selling into this rally.

We acknowledge that while the easing of Armageddon worries is positive, the current situation says nothing about the economy regaining vigor. The crisis may have merely given way to something more ordinary, yet still miserable for tens of millions of people; a continued slog through recession, with demand for goods and services weak and jobs hard to find.

So, while equity prices are within a broad range of normal (or at least out of the range of Armageddon), we are still not willing to commit to normal equity allocations because of the downside risks (in our view, substantial). Because of our cautious stance, we are invested below the lower boundary of equity exposure, but moving towards minimum equity exposure in defensive sectors. We have difficulty believing that with all the economic problems facing us, this is the start of a new Bull Market. We are waiting patiently for reality to set in for those with short memories and excessive risk appetites.

Client Portfolios

After increasing equity exposure in February and March, we sold off all equity exposure (which was already low) during the first two weeks in April. We felt that the strong equity market rally was based on an anticipation of economic recovery that was premature and a weak U.S. dollar-led rise in commodity prices.

In our view, the real economy is on a path to stagnant growth for the next several years. So, we want to focus on sectors that will perform well in this environment. On the equity side, in this time of volatility and uncertainty, we favor sectors with greater earnings transparency. This leads us to focus on relatively defensive sectors such as Healthcare and Utilities as well as a growth area, Technology. In addition, we are pursuing a non-domestic investment in the country of Chile, which is heavily based in Utilities and has a responsible economic model that is a beacon to good governmental management.

In May, we started investing in Healthcare (other than government, the only area adding jobs) and Utilities. In June, we added to positions in Healthcare and Utilities and initiated a position in Technology. In early July, we also initiated a position in Oil and Gas Equipment/Services, although this is more of a tactical investment given that the projection for oil demand is stagnant to decreasing during the next several years.

On the bond side, corporate access to credit is stable, so we have already re-allocated assets away from government bonds to investment-grade corporate bonds; we are still shying away from junk bonds because of the likelihood of massive defaults.

In asset classes other than equities and bonds, we have targets to initiate positions in convertible securities and long U.S. dollar versus a basket of developed-market currencies. We have observed that dollar weakness correlates highly with rising stock prices, so our ‘long’ dollar position is a hedge. Our only sell target is for Gold in the $970/troy ounce range.

Market Highlights
Securities prices rose across a broad front starting in the second week of March. U.S. equities led the advance. International equities rebounded while the emerging markets went on a tear. The BRICs (Brazil, Russia, India, and China) all advanced significantly.

Most amazing to us was the explosive rally in high-yield bond market that rose 40% since early March. Moody's is forecasting the default rate among high-yield companies globally to soar to about 15 percent by year-end from 8.3 percent in April 2009. This is predicated on the fact that in the period leading up to the credit crisis, over-leveraged companies financed a record amount of high-risk, high-yield debt. They will now struggle to refinance maturing debt. Even though the credit markets have eased up a bit and recent junk bond offerings have sold well, this forecast of record defaults is a major deterrent to the intermediate-term prospects for this market.

U.S. Treasuries lost ground (prices declined as yields rose) as the recovering stock markets pulled some cash from the sidelines where it was largely parked in Treasury securities. The sell-off in Treasuries was offset by rallying corporate bonds.

Much of the talk from Washington was intended to prop up markets. Exuding an air of vocal determination, the administration took steps to stem the pessimism that had built during the prior six months. Congressional testimony about the extent and focus of the stimulus packages also added a luster of credibility to the proposition that the financial markets were regaining stability. The first quarter was a free fall (as was the fourth quarter of last year) while the speed of descent moderated during the second quarter. It was if the first quarter was a person falling from an airplane, gaining speed as he fell. The second quarter was the parachute opening. The rate of descent slowed considerably, however the underlying trajectory was still downward.

Perhaps the most anticipated data this past quarter was the bank stress tests produced by the Treasury Department (in consultation with the banks) in May. Commenting on the stress tests, Nobel Prize laureate in economics, Joseph Stiglitz, commented that "The stress test that was not much of a stress.   How we went from near-insolvency four months ago to a mere $75 billion in capital needed (to restore the banking system) remains a mystery to us, especially considering how deep the GDP, employment and home-price declines have been in the past couple of quarters… not to mention how far off these loss estimates — about $60 billion according to the Fed — are compared to other private-sector estimates and those from the IMF.” So much for bank’s significant earnings recovery. This, in the extreme, is analogous to a house with a dreadful termite problem. However, the wallpaper looks fresh and cheerful. Markets may ‘look good’ but the underlying structure of the recovery is on a shaky foundation and may have little capacity to withstand unexpected (and additional) stresses.

Concluding Thoughts
We have two straightforward rules as stewards of client capital. Rule #1, try not to loose money. Rule #2, try to earn a reasonable rate of return. This capital preservation bias means that we always remain cautious and focused on the risks of capital loss. We thank you for your support and confidence in Advocate. Please contact us at 312-578-8300 or via email if you have any questions or would like to discuss our outlook.

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