Beacon Pointe Research

Clearing Skies, Choppy Waters

April 2009

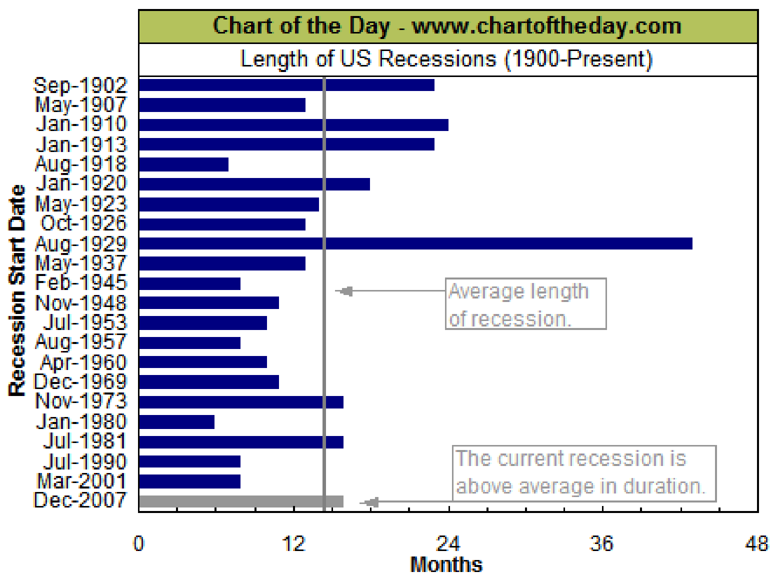
Confidential – Proprietary

500 Newport Center Drive, Suite 125, Newport Beach, CA 92660
TEL 949.718.1600 FAX 949.718.0601 www.bpadvisors.com

Clearing Skies, Choppy Waters

At the close of Wednesday, April 29th, U.S. equities were on a strong (almost) eight-week run, which has propelled the S&P 500 Index 30% higher than the March 9th lows. But has this run been merely a "spring break" from an on-going bear market or the beginning of a new bull market? In the words of Winston Churchill "The future is unknowable, but the past should give us hope". Beacon Pointe is guardedly optimistic in its outlook for financial markets and an eventual trough in economic activity. We caution that markets are still very fragile and volatile price action will likely persist for some time. Further disappointing economic news should not come as a surprise and another retest of the recent lows is possible. However, tentative signs of stabilization in some, although not all, indicators are present and the stock market's discounting mechanism seems to be accounting for this subtle change in our economic realities.

At 16 months and counting, the current recession is already getting long by historical standards. As the chart below illustrates, the average length, based on the 21 recessions that occurred between 1900 and 2007, was 14 months. The two longest recessions in the post-Great Depression era – 1973 and 1981 – both lasted 16 months. How much longer will the U.S. economy continue to contract? As a reminder, NBER (the National Bureau of Economic Research) is the official judge when it comes to dating recessions. Its pronouncements, however, often come with a substantial lag.



Source: Chart of the Day

After a relentless string of grim economic news during the first two months of the year, March brought in some "less bad" readings that surprised on the upside. To be sure, none of the key indicators are painting an *improving* picture. But what is somewhat encouraging is that for many data series, the rate of deterioration is slowing down and some are stabilizing around potentially trough levels. We heard one investment professional describe the latest situation as "clearing skies, choppy waters". Beacon Pointe would also stress that the waters remain choppy and caution is still very much required. 1Q09 will likely bring in another big drop in real GDP, unemployment (a lagging indicator) is likely to continue its ascent into 2010, consumer spending remains constrained, and the financial system is still under pressure. Nevertheless, we have seen some tentative signs of clearing skies in the distance.

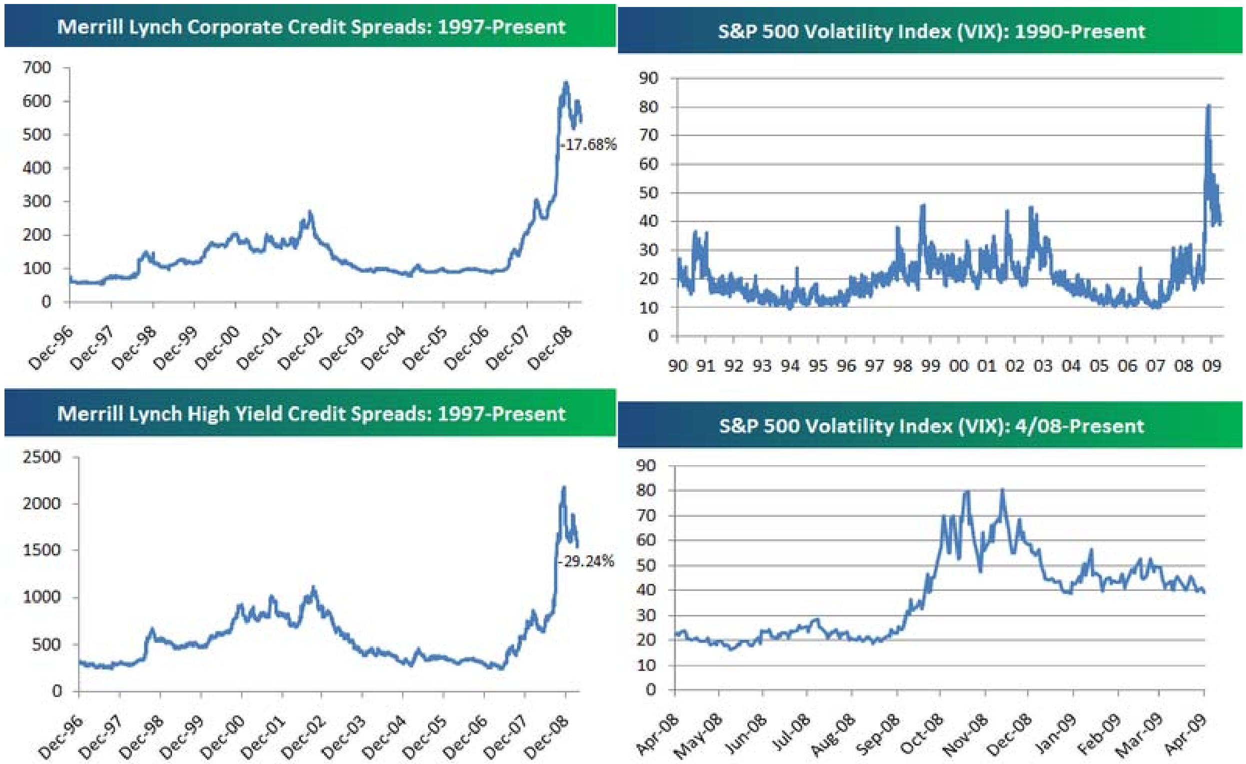
For example, a number of economic indicators ticked up in March, as the following chart shows. Personal spending, existing home sales, durable good orders, and consumer sentiment all signaled slight improvements that often mark recessions' bottoms. Only time will tell if these positive developments are short-lived or sustainable. Yet they helped fuel the rally that started on March 10th – Mr. Market seems to have found a reason to cheer!

Source: Investment Postcards from Cape Town

Furthermore, the housing market decline may soon reach the point of exhaustion. With substantially lower mortgage rates (chart below, right), materially reduced new housing starts, and much improved housing affordability (chart below, left), the conditions are set for a gradual absorption of home inventories and price stabilization. This, in turn, would greatly benefit battered financial institutions' balance sheets, consumer confidence, and ultimately GDP growth.

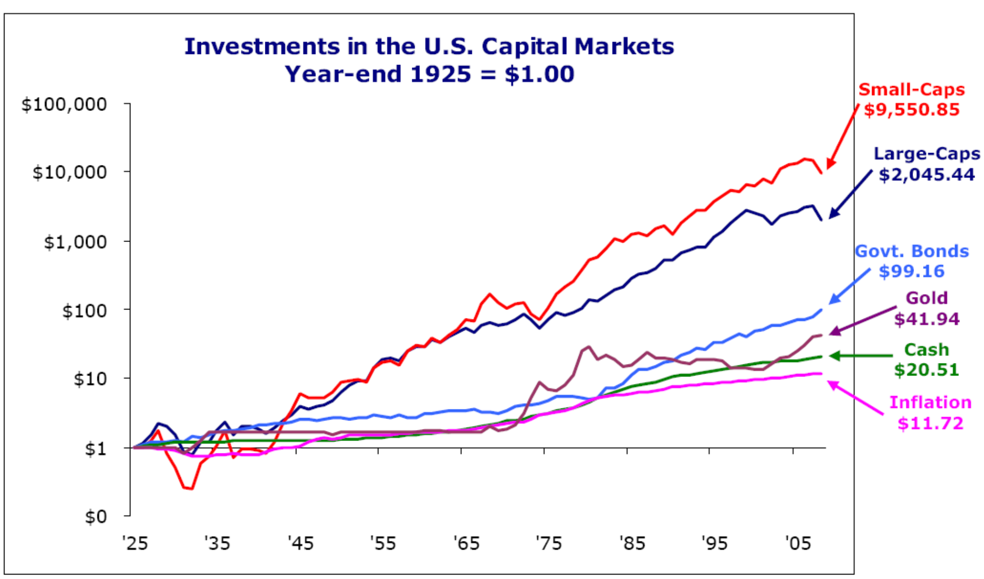
Source: Investment Postcards from Cape Town

Meanwhile, financial markets are also showing signs of stabilization. On the credit side, spreads have come down from recent highs, although they remain elevated relative to historical norm. According to Bespoke Research (charts below, left), investment grade corporate spreads have fallen over 17% from the peak, while high yield spreads have fallen 29% from the peak. On the equity side, volatility has moderated somewhat, as measured by the CBOE Volatility Index (VIX). After hitting a record level of 80 twice last year, VIX has retreated back to around 40. This "fear gauge" is suggesting that fear is subsiding from panic levels.



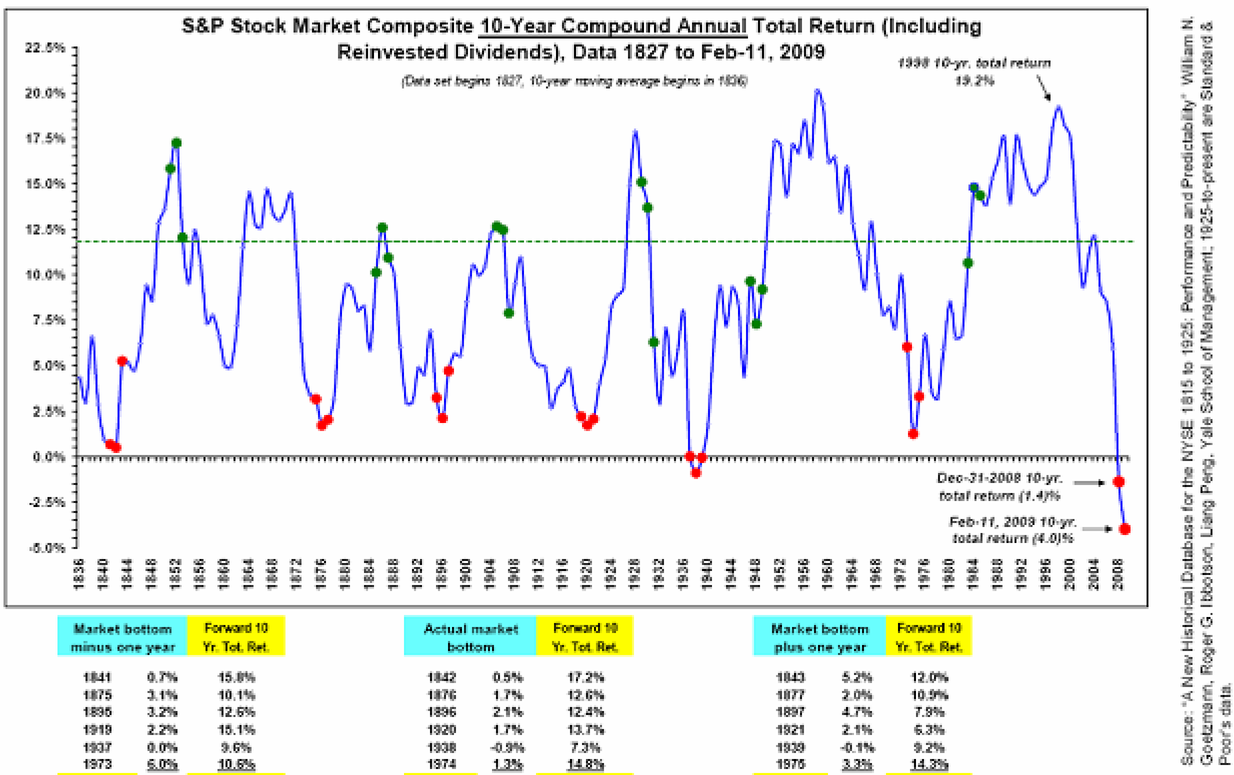
Source: Bespoke Research

Thus, while it is too soon to project smooth sailing from here on out, we remain cognizant of the changing dynamics in our economic and market seascape. As always, a long-term perspective guides us in our investment decisions and recommendations. The following graph plots the long-term performance of various asset classes since 1925. Despite stocks' poor showing in 2008, they are still the best performing asset classes with small caps leading the pack, followed by large cap equities. Government bonds came in a distant third, yet managed to outperform inflation handily. Gold has a somewhat more volatile track record, but has pulled into fourth place over the past decade. Cash and inflation bring up the rear.



Source: Strategas Research

Of course, the right asset allocation differs for each client, depending on his or her risk tolerance, return objectives, and other circumstances. The point we are trying to make is that equities and, to a lesser extent, bonds are still the best investment vehicles to preserve and grow wealth. Notwithstanding equities' record losses over the last 10 years, we do believe that they offer good values at the present time. The chart below, courtesy of Dreman Value Management, plots the trailing 10-year compound annual rate of return (including dividends) of the S&P 500 Index, using data going back to 1827. As of mid-February 2009, large cap equities were at the lowest point ever in the history of this data series.



Market bottom minus one year		Forward 10 Yr. Tot. Ret.
1841	0.7%	15.8%
1875	3.1%	10.1%
1895	3.2%	12.6%
1919	2.2%	15.1%
1937	0.0%	9.6%
1973	6.0%	10.6%
Avg.	2.5%	12.3%
St. Dev.	2.1%	2.7%

Actual market bottom		Forward 10 Yr. Tot. Ret.
1842	0.5%	17.2%
1876	1.7%	12.6%
1896	2.1%	12.4%
1920	1.7%	13.7%
1938	-0.9%	7.3%
1974	1.3%	14.8%
Avg.	1.1%	13.0%
St. Dev.	1.1%	3.3%

Market bottom plus one year		Forward 10 Yr. Tot. Ret.
1843	5.2%	12.0%
1877	2.0%	10.9%
1897	4.7%	7.8%
1921	2.1%	6.3%
1939	-0.1%	9.2%
1975	3.3%	14.3%
Avg.	2.8%	10.1%
St. Dev.	2.0%	2.9%

Source: Dreman Value Management

In addition to putting the performance of large cap stocks over the latest 10-year period in historical perspective, the graph highlights another important implication for equity investors. According to Dreman: "Buying the S&P one year before, after, or right at the bottom for the rolling 10-year total return (price + reinvested dividends) has historically produced a double-digit return ranging from 10% to 13% with a standard deviation of 2.7% to 3.3% in the forward 10-year period. Few investors are thinking about 10-year forward returns, and therein lies the opportunity, in our opinion." Beacon Pointe agrees with this assessment. We will continue to exercise caution given the choppy waters, but we do see signs of clearing skies on the horizon and believe that our clients are well positioned for what lies ahead.

Please feel free to call Beacon Pointe at 949-718-1600 should you need additional information or have any questions.