



## After the Bounce?

### Equity Review

During 2008, the stock markets here and overseas made history. The Morgan Stanley EAFE index (international) fell 45.1%. Our domestic indices realized the largest percentage drop since 1931 – 77 years ago. Results of the more well known indices are as follows:

Dow Jones Industrials	-33.8%
Standard & Poor's 500 (large cap)	-38.5%
Wilshire 5000 (total market)	-38.7%
Russell 2000 (small cap)	-34.8%
Morgan Stanley EAFE (international)	-45.1%

From October 1929 through 1934 the stock market lost about three quarters of its value. In many ways the recent market crash was actually more destructive. On October 11, 2007 the S&P 500 reached an intra-day high of 1,576. On March 6, 2009, 17 months later, the S&P 500 fell to an intra day low of 666 – a drop of 57.7%. In January and February alone the market indices fell about 20% – the worst performing January-February period in U.S. history! The crash was global and deflated all investment sectors except U.S. Treasury obligations and selected sovereign government obligations overseas.

The recent market recovery of March through September 2009 has been just as dramatic, but positive. The S&P 500 closed out the third quarter at 1,057 recovering 58% from its 666 March low. The other indices have made similar advances. Through the first three quarters of this year the major indices stand as follows:

Dow Jones Industrials	+10.7%
Standard & Poor's 500	+17.0%
Wilshire 5000	+21.0%

Russell 2000	21.0%
Morgan Stanley EAFE	25.5%

For stocks, the third quarter 2009 was the best performer since 1998. The Dow Jones Industrials closed up 15% which was 48.4% above its 12-year low of 6,547 in March; the best third quarter since 1939. Despite this dramatic recovery so far, the Dow Jones Industrials is still down 21.4% from its October 2007 peak.

The S&P 500 at 1,057 finished up a comparable 15% for the quarter; 58% higher than its March low. From its high, this index is still off 32%.

The technology laden NASDAQ (over the counter) index returned 15.7% for the third quarter. It is up 67.3% from its March low – and has advanced for seven straight months<sup>1</sup>.

Internationally, the best markets were in Eastern Europe and Latin America. On a country level, the best quarterly returns are as follows (in U.S. dollars)<sup>2</sup>:

<u>Country</u>	<u>Return</u>	<u>Country</u>	<u>Return</u>
Lithuania	71.0%	Austria	34.7%
Estonia	50.3%	Romania	34.7%
Hungary	39.1%	Turkey	34.0%
Peru	35.6%	Poland	33.8%
Cyprus	35.6%	Argentina	33.7%
Columbia	34.9%	Indonesia	33.6%

Among developed markets, Japan's Nikkei 225 index was a notable laggard with a rise of just 1.8%<sup>3</sup>. A strengthening yen, weaker exports, and an unsettling change in government were factors in Japan's relatively poor performance.

The assets that fell the most in 2008 - real estate, financials and internationals (particularly emerging markets), have had the strongest recovery so far. Defensive stocks such as utilities, along with the more developed economies internationally rose at a more gradual rate.

According to Dow Jones, the best 3<sup>rd</sup> Quarter performers among industry groups were<sup>4</sup>:

Hotel & Lodging REITS	44.7%	Durable Household Products	35.3%
Diamonds & Gemstones	43.5%	Nonferrous Metals	34.0%
Full Line Insurance	36.8%	Paper	33.6%
Residential REITS	36.1%	Airlines	32.3%
Mortgage Finance	31.9%		

### **Debt Review**

The bond market has remained remarkably stable despite the issuance of \$7 trillion in bonds by the U.S. Treasury so far this year. 90-day Treasury bills at quarter-end yielded 0.09%. The 6-month T-bill yielded 0.14% while 2-year T-notes paid 0.87% and the 10-year T-note now yields 3.19% up from its closing low of 2.07% last December<sup>5</sup>.

Debt obligations of intermediate terms (from 2 to 10 years) have recovered from their panic lows of last fall. Prices are rising and yields are falling for lower quality and investment grade debt. During last fall's panic, junk bonds (those with less than BBB rating) yielded as much as 14% but now the numbers are in single digits. AA-rated corporate bonds that yielded up to 8-9% currently pay in the 3.5-3.7% range<sup>6</sup>.

### **Commodity Review**

In tandem with rising stock markets, we are seeing rising commodity values. Crude oil, after touching a low of \$33.87/barrel last year closed at \$70.61/barrel on September 30, 2009. Gold, considered by investors as a hedge for inflation, stocks, and currencies, closed the quarter at \$1,008/troy ounce, up 14.0% year-to-date. Contrary to crude oil, natural gas prices tumbled 55% to their lowest level since 2001 in early September due to over-supply and production. In the weeks following, prices rose 93% and closed the third quarter down 14% year-to-date at \$4.841/million BTUs<sup>7</sup>.

## **Recent Developments**

The forecast for stocks here and abroad remains uncertain and most likely volatile. Consumer confidence has doubled from its record low in February but remains at just half of its historical average and well below the lowest levels of the 2001 recession<sup>8</sup>.

Often we discuss the strong correlation between housing and stocks. Housing starts climbed 1.5% to a seasonally adjusted annual rate of 598,000 in August, on an increase in multi-family home construction. Starts on single-family homes, which comprises 80% of all housing, fell 3% to 479,000<sup>9</sup>.

The ISM manufacturing index fell to 52.6 in September from 52.9 the month before; a disappointing reading on factory activity<sup>10</sup>.

Job losses unexpectedly accelerated in September and the unemployment rate rose to a 26-year high. According to the Labor Department the jobless rate rose 0.1% to 9.8%<sup>11</sup>. The under employment rate, which includes discouraged and involuntary part-time workers, climbed to 17%. Companies have shed approximately 7.2 million jobs since the recession began in December 2007.

The Conference Board's Consumer Confidence Index, which rose for three consecutive months, unexpectedly fell in September. This index, after hitting a historic low in February of 25.3 and rising monthly reaching a 54.5 reading in August, slipped back to 53.1 in September<sup>12</sup>. A reading above 90 means the economy is on stable ground and one above 100 equates to solid growth. Generally a weak showing for September indicates that despite the continuing stock market rally, shoppers are focused on the poor job market and declining wages.

As mentioned in our last quarterly report, our greatest concern going forward is the growing national debt and its effect on economic recovery, weakness of the U.S. dollar, rising prices of raw materials, and potential inflation among many other issues. According to the Congressional Budget Office the federal budget deficit tripled to a record \$1.4 trillion for the fiscal year ending September 30, 2009<sup>13</sup>. Major factors in this deficit include a drop in tax revenues due to the recession, \$245 billion in emergency spending on the Wall Street bailout, and the bailout and takeover of General Motors, Fannie Mae and Freddie Mac. Other significant expenditures include the \$200 billion from the President's economic stimulus bill, as well as increases in welfare programs such as food stamps and unemployment benefits<sup>14</sup>. The 2009 deficit reached nearly 10% of the GDP, a level not seen since World War II. The Treasury Department reports that as of September the national debt was close to \$12 trillion and interest on that debt was \$383 billion for the year<sup>15</sup>.

On a positive note, the most important and recognized indicator that the recession is ending is a positive Gross Domestic Product figure. As reported October 1 by the Commerce Department, the U.S. economy shrank less than expected in the second quarter, down 0.7% after a first quarter drop of -6.4%<sup>16</sup>. Analysts expect a future revision of the second quarter to be positive with the third quarter up 3% or more. Recall that earlier in September Federal Reserve Chairman Ben Bernake said the recession is "very likely over." The economy has contracted for a record four straight quarters – the first time since 1947 that such has occurred. Factors pointing to positive economic growth include less drastic cuts in business spending and a cut in inventories eventually leading to boosting future production to satisfy customer demand as spending increases. After-tax profits of U.S. corporations rose 0.9% in the spring, their second consecutive quarterly gain.

According to the Standard & Poor's/Case Shiller home price index of 20 major cities, home values rose 1.2%, the third month in a row since July. Home sales are also rebounding from their January lows. Sales of newly built homes are up 30% from their lows while sales of previously owned homes are about 14% higher<sup>17</sup>.

The U.S. economy is 70% consumer driven. Retail sales at stores open for at least one year increased 1.1% compared to sales during September 2008<sup>18</sup>. This was the first gain since August 2008 and was a huge surprise to analysts who expected a drop.

Finally, the most recent corporate earnings picture appears to be brighter than expected. As preliminary reports are coming in, S&P 500 third quarter earnings may fall 23.8% year-over-year versus a second quarter drop of 31%<sup>19</sup>. So far, as in most years, Wall Street seems to have understated earnings and it is possible we will see more positive surprises coming forth over the next few weeks. So far Intel, Pepsi, and Marriott reported better than expected third quarter earnings.

### **Our Outlook**

We anticipate continued volatility in both the commodity and equity markets. Rising stock market valuations are ultimately based on rising earnings which we believe will be positive although at a measured pace. Minimal mortgage defaults and stable values for housing are critical for durable business expansion and we anticipate real estate valuations to increase at a slow drawn-out rate. The same holds true for employment and new business start-ups. The pace of economic recovery in other countries may continue to accelerate faster than ours and we have taken advantage of this trend in discretionary portfolios.

For fixed-income investing, diversification is crucial. At some point short-term interest rates will begin to rise as we have seen with intermediate and longer term maturities in recent months. As the economy continues to recover, Federal Reserve policy will shift towards strengthening the U.S. dollar, reducing government spending, and fighting anticipated inflation – the much talked about “exit strategy.” We have read reports that Arab oil producers in the Gulf, along with China, Russia, Japan, and France are in consultations to form an alternative ‘basket’ currency as a global reserve alternative to the declining U.S. dollar – this has created additional downward pressure on the dollar.

We believe the ‘easy money’ has been made and for all the stated concerns (among others) a gradual but volatile ‘work out’ will commence. We at Marathon will be ready and as we have stated in a previous quarterly report – stay calm, stay in, and stay the course. Keep your perspective and recall your long-term goals.

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Footnotes:

1. MSNBC.com, [Stocks Slip](#), 10/1/09
2. [Wall Street Journal](#), Global Stocks Keep the Pedal, 10/1/09, p. C7
3. [ibid.](#)
4. [Wall Street Journal](#), Industry Groups, 10/1/09, p. C7
5. [Wall Street Journal](#), Treasury Buoy Credit, 10/1/09, p. C10
6. [Wall Street Journal](#), Bonds, 10/1/09, p. C16
7. [Wall Street Journal](#), Commodities Sectors Go Their Own Way, 10/1/09, p. C9
8. [Wall Street Journal](#), Confident Consumer to the Rescue?, 9/29/09, p. C1
9. [Wall Street Journal](#), Housing Rebound Proceeds at Slow Pace, 9/18/09, p.A2
10. [Wall Street Journal](#), Weak Factory Data, 10/2/09, p. A1
11. [Investors Business Daily](#), 263,000 Jobs Lost, 10/5/09, p. A1
12. MSNBC.com, Consumer confidence falls, 10/1/09
13. FINANCE: Yahoo.com, CBO: Budget deficit hit record \$1.4T 10/8/09
14. [ibid.](#)
15. [Wall Street Journal](#), Taking Debt Seriously, [online.wsj.com](#), 10/12/09
16. MSNBC.com, Economy shrinks at slower pace in Q2, 10/1/09

17. MSNBC.com, Home prices improve for third straight month, 10/1/09
18. Investors Business Daily, September Retail Sales, 10/9/09, p. A1
19. Investors Business Daily, Q3 Earnings Season Picking Up Steam, 10/12/09, p. A1