

## SOME GREEN SPROUTS, AND SOME WEEDS

The economy and the financial markets continue to dominate the headlines. With so much information out there it's a good time to sort through the data and discuss the implications to our portfolios.

### The Positives

- Corporate executives are feeling as confident as they have in 3 years, according to a Business Council quarterly survey, which surged to 50 in April, its highest since early '06 and double January's reading. The NFIB's small business optimism index also jumped in April, by a record 5.8 to 86.8%. It's good to know big and small businesses are feeling better because their optimism is highly correlated with hiring. How high unemployment goes will say a lot about the strength of the recovery and market advance.
- Manufacturing's decline is slowing, with March industrial production and capacity use slightly better than expected, and April's regional index of activity in New York surprisingly on the upside, reaching its highest level since last August.
- Business inventories shrank 1% in March, the 7<sup>th</sup> straight decline, and retail inventories fell a strong 0.7%. Inventory shrinkage is necessary for future restocking and manufacturing, activity.
- The European Commission's economic sentiment index jumped in April by the most since November, 2003. Meanwhile, fresh reports on manufacturing and retail sales in the U.K. and home sales in Spain were better than expected.
- Crude oil prices hit \$60, up 75% from February lows. This sign of an improving economy lessens prospects for deflation. Gas prices are following crude, up 25 cents in 4 weeks, to a 6-month high, just in time for summer vacation. It may not matter: Only 42% of Americans plan to travel, vs. 49% last year.
- University of Michigan Consumer Sentimental Index. The final reading in April surged to a stronger-than-expected 65.1, its biggest gain in more than two years, compared with 57.3 in March and a three-decade low of 55.3 in November.
- ISM Manufacturing. April enjoyed a larger-than-expected gain to 40.1, versus 36.3 in March and 32.9 in December.
- Consumer Confidence. Much larger-than-forecast surge to 39.2 in April, its largest increase since 2005, compared with 26.9 in March and a record low of 25.3 in February.
- Chicago Purchasing Manager's Index. Better-than-expected 40.1 in April versus 31.4 in March. We also saw similar sharp improvements in the Dallas, Richmond and Milwaukee regional Fed

manufacturing indices this week, confirming the strong gains we saw in the Philly Fed and Empire indices the prior week.

- Case Schiller Home Price Index. Down 18.6% year-over-year for the 20 largest home markets in the U.S. in February, compared with a record 19.0% decline in January. This marked the first time since 2007 that the pace of decline in home prices had actually slowed sequentially.

### *The Not So Positives*

- April's retail sales came in much worse than expected, falling 0.4% on top of March's downwardly revised 1.3% decline, throwing cold water on hopes that consumer spending would start to heat up. It was particularly troubling because April's slide came despite Easter sales that had been pushed into the month and tax refunds that were 15% fatter than a year ago.
- Weekly jobless insurance claims, which had been trending down from their late March high, rose more than expected. And Bank of America observes that gross jobless claims have never peaked without confirmation from continuing jobless claims, which set another record high in the latest week. Since '48, the maximum monthly job loss typically has been followed by a turn in the economy within 2 months. Payroll losses peaked in January. We're starting to see Wall Street analysts wonder if we already are in a recovery.
- Chinese exports plummeted 22.6% year-over-year in April, close to February's record plunge of 25.7%, while U.S. non-petroleum exports plunged at a 45% annualized rate in the 1<sup>st</sup> quarter. Elsewhere, industrial production in export-oriented India fell 2.3% in March, the most in 16 years. History shows that any sustainable global recovery must be accompanied by a pickup in trade.
- First-quarter defaults impacted \$531 billion of corporate debt, the largest quarterly amount since records started in 2000, S&P says. If the pace continues, it predicts defaults could total 248 this year, the most since records began in '81.
- With money hard to find, businesses and governments are grabbing it wherever they can. American and US Airways led airlines in charging a record \$1.1 billion in baggage fees in '08. In New York, cabbies say city police have been uncharacteristically quick to hit them with \$120 fines when they are "trapped in the box" - stuck in intersections when the signals change. And for the first time since '75, Social Security recipients can expect to go without COLA increases the next 2 years.

### *Implications/Outlook*

The market as measured by the S&P 500 Index is up over 35% from its March low, marking its best two month stretch since 1933. The issue in the near term is what will move it next? The jobless situation merits a very close watch. There is a tremendous amount of attention focused on weekly initial jobless claims, and of course, the monthly non-farm payroll numbers. If numbers begin to flow positively, that could help the markets sustain their momentum, on the other hand, a breach of 10% unemployment could

ultimately stall the next leg up. There is wide spread acceptance that the economy will begin to grow again by year's end fueled by the unprecedented monetary and fiscal stimulus but will this initial boost be enough to fuel a longer term expansion? The markets will recover. And looking ahead to that day, my biggest concern is how investors position their portfolios and future investment plans in anticipation of this recovery, and in light of what has occurred over the past 18 months.

In the field of behavioral finance, the "recency effect" describes how investors formulate their expectations and base their decisions by placing the highest weight on what they've recently experienced. In today's environment, with nearly all individuals – my concern is that this recency effect will lead investors in two very different directions that both can spell trouble. One direction is to hunker down and hold a portfolio consisting only of very low risk-return investments. The other direction is to conclude the only way to catch up from recent declines is to shift their portfolios to substantial weights in much higher risk-return securities. Now more than ever, a broadly diversified portfolio may be the best approach for achieving a solid risk-adjusted return over the long term. Saying this, a portfolio must be first designed with the goals of each investor at the forefront.

The recent economic turmoil may have impacted these goals for a number of families. Over the past eighteen months, I have had a numerous discussions and meetings with clients across all demographics. The door here remains open to continue these discussions, and I hope to hear from all any time that best fits your hectic lives. I remain confident that the best years of the global economy remain in front of us and the quality of life will continue to improve. Hope to hear from you soon.

Sincerely,

Gary J. Najarian

