

Best quarter for stocks in more than 10 years...

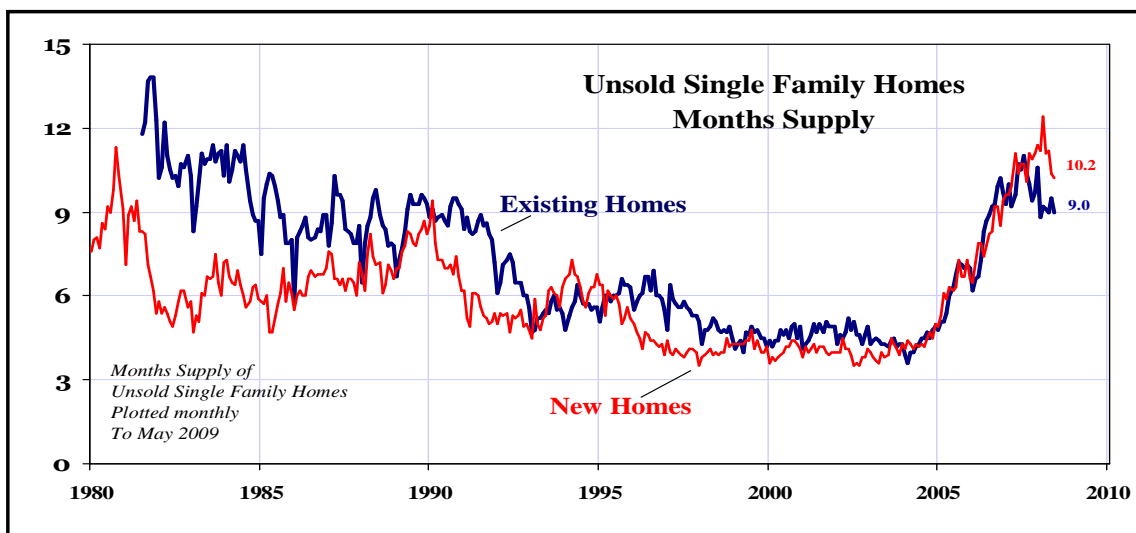
June 29, 2009...On the penultimate day of the second quarter of 2009, stock and bond prices generally rallied in light pre-holiday trading. The Dow advanced 1.1% and the S&P 500 was up 0.9%, while the Nasdaq Composite trailed with a gain of just 0.3%. The quarter is looking like the best for stocks since the fourth quarter of 1998, when the dot-com bubble really started to expand. Market P/E multiples are a far cry from the high levels of 1998; in fact, the S&P 500 forward P/E is almost ten points below the 23-24 levels prevailing when AOL was the market's darling. The risks in today's market pricing have more to do with E (i.e., earnings) than with P/E.

- **Last week brought a mixed set of economic reports and a FOMC meeting that produced few changes in monetary policy.** Home sales were higher, if not especially impressive in May, and wages and salaries are still being held down by layoffs and pay reductions. But durable goods orders were surprisingly good last month, and today's indication from Ford is that June's car sales were the best of the year. This last isn't saying a lot since the auto industry has been in a deep slump, but as with the housing industry the suggestion is that the worst may be past. Last week's rally in bonds continued on Monday, with the 10-year T-note yield dipping below 3.5% today for the first time in a month, down roughly 50 basis points from the 3.95% high three weeks back. The Barclay's U.S. Aggregate bond index indicates that the U.S. bond market returned about 1.8% in Q2, as increases in Treasury yields (30 basis points at the two-year point on the curve; 80 bps at ten years) were offset by declining spreads on corporate bonds and other non-Treasury securities.

INVESTMENT OUTLOOK...Recent economic conditions evoke comparisons with the severe recessions of 1974-75 and 1981-82, and even the 1930s. It may yet be some time before the powerful steps taken by policymakers to turn around the economy and right the financial system begin to produce positive economic growth. While it may strike some as an excessively timid position, we think it is still too early to state that the 2007-09 bear market is over, especially with Treasury yields on the rise recently. Still, one cannot help but be impressed and encouraged by the persistence of the rally that began in March and by the increasing number of signs that the economy is stabilizing and getting ready to grow, if not yet quite growing.

June 24, 2009...In its post-meeting statement today, the Federal Open Market Committee indicated that it sees its policy rates staying low for an extended period, the same language employed in the April 29 Fed statement. The Fed said that oncoming data suggests that "the pace of economic contraction is slowing," a modestly more forceful statement than the one made two months ago ("the pace of contraction appears to be somewhat slower"). Virtually unchanged was its assessment that "the Committee continues to anticipate that policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will contribute to a gradual resumption of sustainable economic growth in a context of price stability."

- As was generally expected, the Fed made no change in the scope of its program of buying Treasury, agency and mortgage securities.** The biggest departure in its language from one meeting to the next was its deletion of the line “the Committee sees some risk that inflation could persist for a time below rates that best foster economic growth and price stability in the longer term.” Instead, it noted that “prices of energy and other commodities have risen of late. However, substantial resource slack is likely to dampen cost pressures, and the Committee expects that inflation will remain subdued for some time.” Ten-year Treasury bonds, which had been trading higher (with a yield down to 3.6%), sold off after the release of the FOMC’s post-meeting statement, pushing its yield back up close to 3.7%. Stocks failed to hang on to this morning’s gain (the Dow even ended slightly lower), but at the close the S&P 500 was just above 900, up 0.7% for the day, and Nasdaq gained 1.6%.



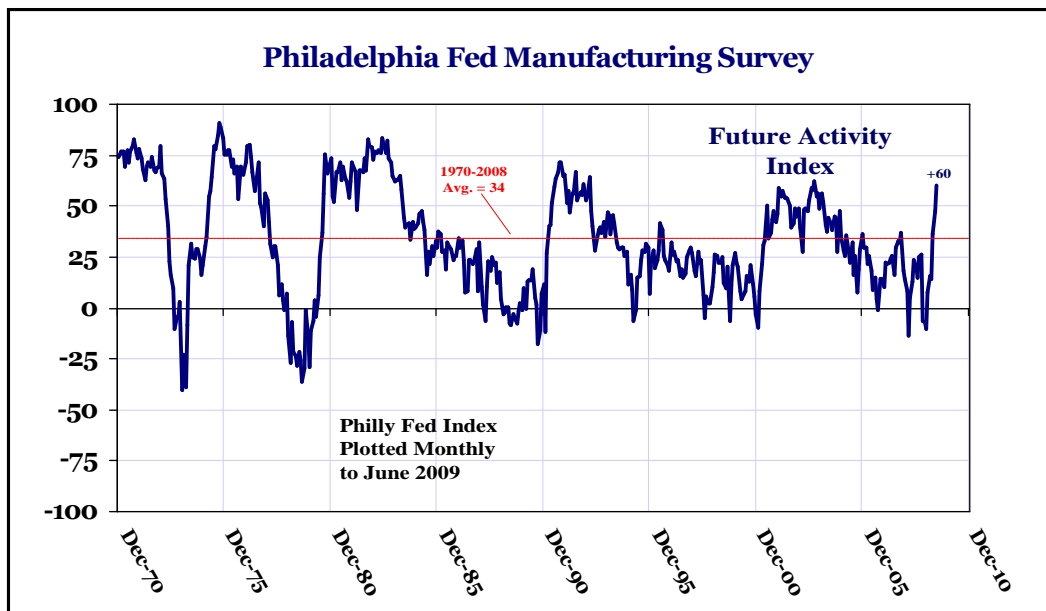
- Wednesday’s new home sales report for May was just slightly below expectations although still indicative of a bottoming, with sales some 4% higher than at January low and the median selling price 3% below the May 2008 level, the first single-digit percentage decline so far this year.** The inventory of unsold new homes stands at 292,000, down nearly 50% from the peak levels three years ago. As with yesterday’s existing home sales report, the months’ supply of homes in inventory is trending lower although still relatively high (see chart). More in the way of legitimate “green shoots” was this morning’s surprise report that durable goods orders increased 1.8% in May (1.1% ex transportation), both numbers well above expectations. Shipments were down 2.1% in May, the tenth straight month of decline, and while shipments of nondefense capital goods were down just nominally, they figure to be off at a 15%-20% annual rate for the second quarter, about half of the Q1 decline. Based on the trend in orders, shipments and the business investment contribution to GDP should be even less of a drag in the second half and may actually start adding to growth sooner than expected.

June 19, 2009...After three down days to start the week, the S&P 500 increased Thursday (0.8%) and Friday (0.3%), trimming the week’s loss by almost one-third to 2.6%. Strength in tech stocks helped boost Nasdaq to a 1.1% increase Friday and a smaller 1.7% loss for the week.

The Dow Jones Industrials lagged for both Friday (down 0.2%) and the week (down 2.9%). The energy and materials sectors of the S&P 500 were the week's biggest laggards, with declines in the 6.4%-6.5% range. Staples (down 1.5%), utilities (down 1.6%) and technology (down 1.3%) had the smallest losses for the week. Gasoline futures prices were off nearly 5% on Friday and crude oil about half that much, as profit taking pushed crude prices back under \$70 a barrel. Treasury bonds rallied Friday and ended the week with yields down from two basis points (for 10-year T-notes) to six bps (for two year T-notes), ahead of next week's big Treasury auctions.

June 18, 2009...On Thursday, stocks managed to get back a portion of what they lost in the first three days of this week. The gains were relatively modest after the recent dip, however, but then again the S&P 500 is still 36% to the good since March 9. The Dow closed with a gain of 0.7% and the S&P 500 added 0.8%. Nasdaq was just about unchanged on Thursday as tech stocks lagged while financial stocks and health care did well. Stocks are about 3% below last Friday's high. As stocks rose, bonds retreated, reacting to some positive economic news and the prospect of more Treasury sales next week. The 10-year T-bond was down a point today, driving its yield up to 3.8%.

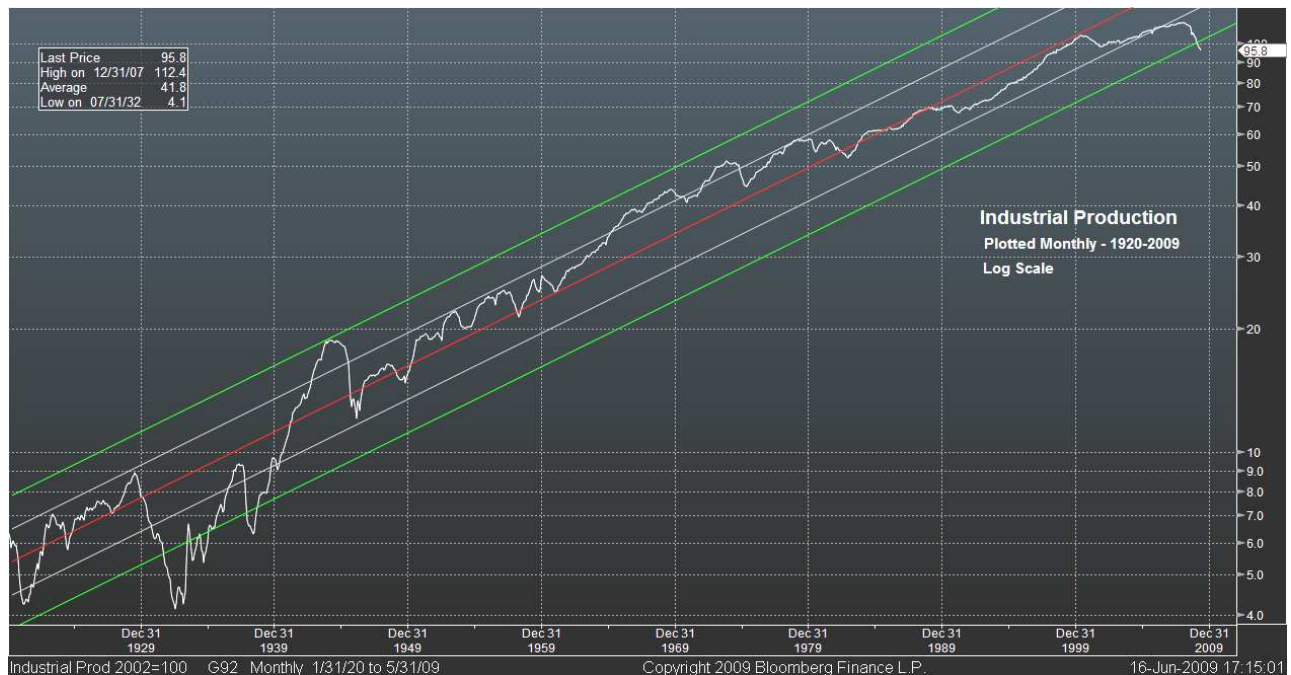
- **Stocks got some support from Thursday's economic reports.** Unemployment claims data continues to hint at some stabilization in the jobs market. Initial claims rose by 3,000 for the week, but the four-week average declined to the lowest level in four months. Continuing claims fell by almost 150,000, the first decline since the first week in January (a decline reported two weeks ago was revised away), but the four-week average continued to move higher. While the claims report was mixed, other data out today was unequivocally positive. The Philadelphia Fed's manufacturing index for June improved more than expected to a nine-month high. New orders jumped significantly, and the future activity index was up for the third month in a row. The Conference Board's index of leading economic indicators also gave a bullish signal, jumping 1.2% in May after a 1.1% rise in April, the best two-month showing since 2001, as the lat recession was ending.



June 16, 2009...Amid mixed indications on the economy, stocks sold off for a second straight day on Tuesday with the S&P 500 declining 1.3%, following Monday's 2.4% drop. From

Friday's seven-month high, the S&P 500 is off almost 4%; the Dow and Nasdaq have corrected a little less (3.25%-3.5%), and the S&P MidCaps and S&P SmallCaps a little more (4.25%-4.5%). And for a second day, stock price pains led to Treasury bond gains, with the 10-year T-note increasing a half point in price Tuesday, nearly matching Monday's gain. The two's/ten's Treasury yield curve, which peaked at a record wide of 276 basis points near the end of May, fell for the sixth day in the last eight sessions. The VIX volatility measure has increased back to the 33% range today, up from last week's low of 27%. It may be merely coincidence, but the lead-up to tomorrow's announcement out of Washington of the Obama administration's plans for regulating financial markets may also have played a role in this week's selling on Wall Street.

- On the positive side for the economy, single-family building permits jumped a surprising 8% in May; on the weak side was the Fed's report that industrial production declined 1.1% last month, the 16th drop in the 17 months since the recession began in December 2007.** The broad decline in the nation's output – which was slightly weaker than Wall Street expectations – brought capacity utilization to the lowest level in at least four decades (68.3%). Also soft was this morning's ICSC tally of same-store sales, which were down 0.6% in the latest week. For May, chain sales were down 4.6% on a same-store basis relative to the 2008 level, and June is expected to be off roughly 5% year to year. The chart below shows the long-term trend in U.S. industrial production; note that the current weakness represents a two standard deviation departure from trend.



Michael Flament (203-783-4360) mflament@wisi.com