# Economic and Social Outlook: *April 2009*

*Our main points here are 1) it appears the world is not about to end; 2) investors are peeking out of their bunkers for the first time in over a year; and consequently, 3) having been priced for Armageddon, stock prices are justifiably rising.*

## Market Overview: Turning?

While the S&P 500 fell 11% during the first quarter, that number doesn't really tell the whole story. At its nadir on March 9 the S&P 500 was down 25% in 2009. From that low point the market staged a powerful rally, climbing 18% from March 9 through March 31, recouping over half the earlier decline.

That strength has surged into the second quarter, making for the best five-week gain since 1933. This puts the S&P up 7% so far in Q2, trimming its loss for 2009 to 4%. So investors are asking themselves: Is this the start of a new bull market or just another bear market rally?

We've been saying since October that bear markets "bottom out" over a period of months and through a series of alternating rallies and declines. This process typically carries the market somewhat lower as it unfolds and that's exactly what we've seen. Along the way you can get powerful "bear market rallies" that run out of gas, followed by steep declines. We saw this late last year as the market rallied 24% from November into early January, only to roll over and fall to new lows in March. We think the current strength in stocks is different.

## Falling Supply or Growing Demand

As with most price gains, stock market rallies result from demand exceeding supply. This can come about various ways. Demand can exceed supply because of sellers' exhaustion—the supply of stocks for sale drops while demand stays constant. Alternatively, buyers' appetite (demand) for stocks can grow as supply stays constant. Or you can have both at once: sellers' exhaustion and buyers' growing appetite.

In bear market rallies you're typically seeing the effects of sellers' exhaustion. This was the case last November and, indeed, ever since last October there has been widespread evidence of sellers being spent.

But that can only get you so far. Without a major resurgence in buying appetite, rallies run out of gas. And that, in part, is what's different this time. Studies done by ISI Research indicate an explosive, indeed historic surge in buying demand over the past month, the likes of which we haven't seen since 1982.

## Economic Overview: "Green Shoots"

What's driving this return of risk appetite? Perhaps a budding belief that the world isn't about to end.

In a recent interview on *Sixty Minutes*, Fed Chairman Ben Bernanke noted that "green shoots" were appearing in the banking system. By this he meant a thawing in the once-frozen credit markets as well as signs of operating profitability returning in some of the major banks. Since that interview, we're seeing many such (very) early signs of spring recovery throughout the economy.

Consumer spending, which fell off a cliff last October, unexpectedly rose in both January and February. Housing sales, similarly in free-fall for months, surprised economists by rising in February. Car sales, a veritable black hole in the retail sector, rose in March. Monthly new jobless claims, though high, have leveled off. And while the economy continued to slow in the first quarter, the contraction is different and encouraging compared to 4Q08.

In the fourth quarter of 2008 the US economy contracted at a dramatic 6.3% pace driven by plummeting consumer spending.

*continues on reverse*

***Major Market Performance 2009***

| | 1st Quarter 2009 % chg. |
|---|---|
| **DJIA** | -12.41 |
| **S&P 500 (large cap)** | -11.01 |
| **S&P 1000 (small/mid cap)** | -11.36 |
| **S&P 1500 (all cap)** | -11.05 |
| **NASDAQ** | -3.07 |
| **Barclays State G.O. Muni Bond** | 3.05 |
| **Barclays Gov/Credit Interm. Bond** | -0.05 |

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In the first quarter of 2009, the economy likely contracted at a still-scary 5% rate, but it did so not because of a further fall-off in consumer spending. Rather, the slowdown resulted from producers slamming the brakes on production to bring down inventories. With consumer spending picking up, however slightly, and inventories down sharply, producers will need to gear-up in order to restock inventories going forward. This in turn should give a boost to overall economic growth as 2009 unfolds.

These green shoots of recovery are the result of several factors. Oil prices falling from $147 to $49 a barrel has lowered prices at the pump and put a vast amount of cash back into consumer pockets. 30-year mortgage rates have fallen to a record-low 4.25%, thanks to the Fed's intervention, spurring a tidal wave of refinancing, which also gives consumers more money to spend elsewhere. Recent income-tax cuts further boost incomes by shrinking Uncle Sam's take. And tax incentives for home and car buyers have helped spur sales by lowering costs.

It's worth noting that these incipient signs of recovery have all registered *before* President Obama's stimulus-spending plan kicks in sometime this quarter, sharply boosting overall spending. In short (and to mix our metaphors), it appears the paddles have been charged and put in place and the patient is being jolted back to life.

## Un-Crunching Credit

As President Obama has said repeatedly, all the stimulus in the world won't revive the economy in a sustainable way unless the credit markets return to more normal functioning. Here the picture is encouraging but still sketchy. Good earnings news out of Citigroup, JPMorgan Chase and Wells Fargo suggests these giants of the banking system may be getting back on their feet. The "stress-testing" of 20 major banks by Treasury officials is nearing completion with better-than-expected results. The Fed's massive interventions in the credit markets—from commercial paper to mortgage-backed debt to money markets—have thawed frozen credit flows a bit.

The major unknown in the credit picture is the effectiveness of Treasury Secretary Geithner's Public Private Investment Plan (PPIP). Geithner's idea is to use Federal guarantees and loans to lure private investors into buying the toxic assets that remain on bank balance sheets. These mortgage-backed securities are the clots in our financial arteries (another metaphor) that must be removed for the flow of credit to resume. While major bond investors like PIMCO's Bill Gross have commented favorably on the plan, the proof will be in the pudding.

## Leading Indicators

Whether the PPIP as currently conceived does the job, one thing is clear: the Feds are pulling out all the stops to get the US economy back on its feet. The best measure of these efforts' success is the fact that money supply in the US is growing at a staggeringly high 15% annual rate. The Feds are flooding the economy with liquidity, which will show up first in financial assets on its way to getting into the real economy. This is why monetary policy (stimulative or restrictive) is a good leading indicator of future economic behavior: It tends to work eventually.

Another leading indicator, our old friend the yield curve, is confirming this view as short-term interest rates are lower than long-term rates, producing a normal, positively sloped yield curve. The yield curve is a good predictor of the economic future and, having turned positive a year ago, is pointing to recovery ahead.

Lastly, the stock market itself serves as a (fallible) leading indicator of the economy. The fact that the market as a whole has stopped falling and begun rising sharply suggests a better economy ahead. Within the market the fact that the consumer-cyclical (retailers) and technology sectors have been doing better than others during this rally is also encouraging. These are "early cycle" sectors that historically respond first to an economic recovery down the road. Conversely, defensive sectors like consumer staples (foods) and healthcare that do well during economic downturns have begun to lag the overall market.

Let me underline that we're by no means ringing the "all clear" bell here. Not by a long shot. Our theme is the more modest "green shoots." As every gardener knows, the first buds of spring often have to weather another freeze or two--sometimes hard ones. So we are far from out of the woods (as the metaphors multiply). Our main points here are only that 1) it appears the world is not about to end; 2) investors are peeking out of their bunkers for the first time in over a year; and consequently, 3) having been priced for Armageddon, stock prices are justifiably rising. Given the horrific market we've suffered through, that would seem to be quite enough.

## What We're Doing

Given this tentatively improving environment, we have been moving portfolios' actual equity exposure, which has been defensive, up from below-target levels towards our official targets, which remain in a neutral posture between stocks and bonds. So we're buyers, if gingerly.

Given these uncharted waters, we'd rather be a bit late than too early in moving to a more aggressive posture in terms of overall stock exposure. That said, we have been rotating our equity exposure into a more offensive, pro-cyclical posture, de-emphasizing defensive names in the staples and healthcare sectors while building up exposure to consumer cyclical and technology shares.

***Farnum Brown***

## Social Advocacy

A coalition of investors including Trillium declared victory in January when Intel Corporation agreed to allow investors to cast advisory votes on CEO pay packages. Intel became the 16th U.S. company to agree to advisory voting known as "Say on pay", perhaps believing, as many do, that Congress is set to extend this as a mandate to all public companies later this year.

'Say on pay' proposals will headline 79 annual meetings (not counting 19 shareholder proposals withdrawn from companies receiving TARP funds, because they became redundant when the bailout legislation required the companies themselves to advance say-on-pay proposals for shareholders to vote on). Shareholders will also get the opportunity to vote on related proposals to eliminate executive "death benefits" and "gross ups" that would pay for execs' taxes on their compensation package.

Shareholders already vote on executive pay in Britain, Australia, Sweden and the Netherlands. These votes are generally nonbinding, but according to a 2007 Yale study of the British system, have proven to create healthier relations between management and shareholders, and focus remuneration on performance.

Trillium convened a dialogue with the restaurant chain Chipotle Mexican Grill to discuss progress toward reducing pesticide use that poses significant risks to soil, water and farm workers' health. The Pesticide Action Network and members of the Investors Environmental Health Network will join us in this conversation. Farm workers and their families exposed to pesticides have a higher risk of poisoning, chronic illness such as asthma, as well as reproductive problems, birth defects, skin disorders, and cancer. Long-term exposure to pesticides has been linked to Parkinson's disease and learning disabilities. Pesticides also pose a risk to neighboring communities, as pesticides drift, even when applied in compliance with existing laws.

Chipotle supports local sourcing programs that are either organic or call for reduced pesticide use on a modest scale. In our ongoing work, we are asking the company to demonstrate strong leadership by providing transparency and accountability to sustainable practices.

***Susan Baker Martin***