



## “Green Shoots” or “Black Stumps?”

While the economy remains mired in the worst global recession since the end of World War II, the business media has lately been abuzz with references to “green shoots” in the economy. Interestingly enough, this increasingly clichéd term was used by Fed Chairman Ben Bernanke to describe the economy in a March 2009 *60 Minutes* interview:

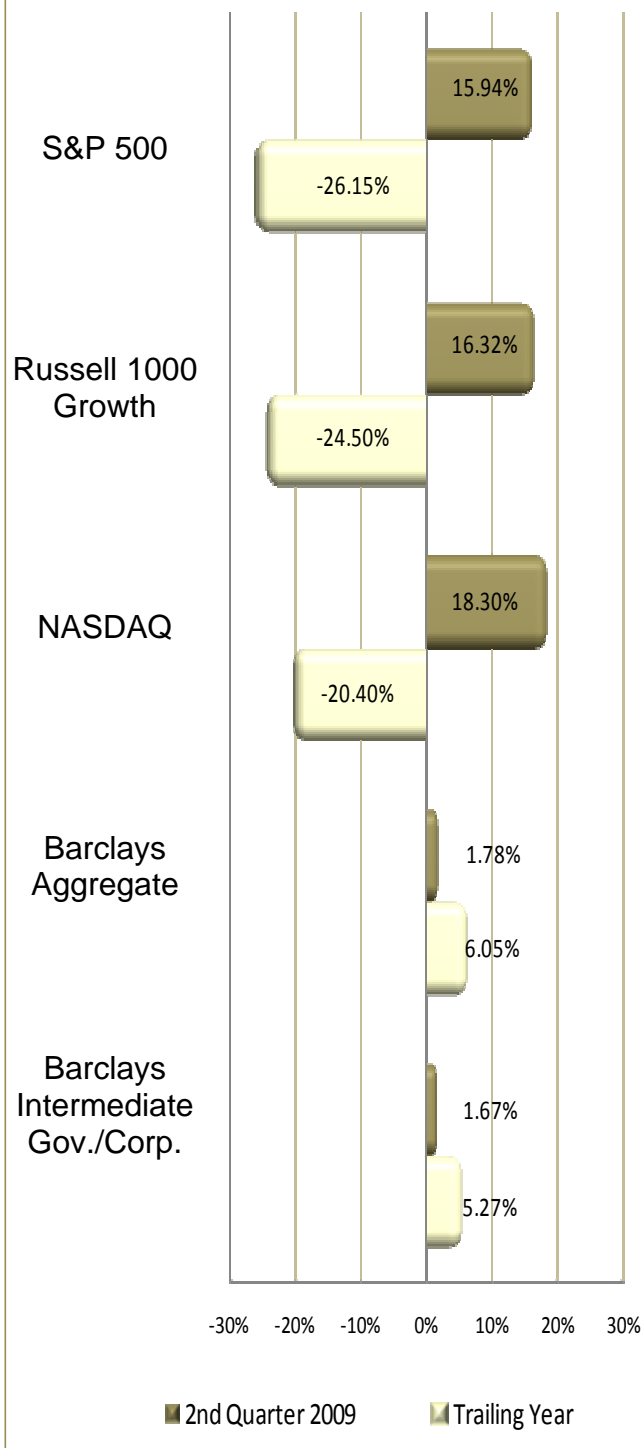
*“...I do see green shoots. And not everywhere, but certainly in some of the markets that we’ve been functioning in. And we’ve seen some improvement in the banks, as well, certainly in some key cases.”*

In the four months since Mr. Bernanke expressed this tentative optimism on the economy, some positive developments have come to pass:

- **TARP Payback**  
In June, the government received a payback of \$68 billion in bailout funds from 10 financial firms. This repayment came much sooner than expected, and represents a “win” for the taxpayer.
- **Real Estate Bottom?**  
In hindsight, the collapse in real estate prices was one of the major causes of the current economic downturn. But the real estate landscape is showing signs of improvement. As of June 2009, median home prices appear to be ticking upward, and home affordability is at a 40-year high. Home prices have declined by an average of 24% since 2006, but these low prices may (finally) be attracting marginal buyers.
- **Credit Market Thaw**  
Last fall, following the meltdown of Lehman Brothers, yields on investment grade corporate bonds relative to Treasuries (yield spreads) reached all-time highs. At the time, we discussed the importance of the credit markets to the economy and the equity markets. We postulated that equities would be hard-pressed to generate a strong rally until and unless credit markets improved. Credit market conditions improved dramatically during the 1st and 2nd quarters of this year, bringing yield spreads back

*(Continued on reverse)*

## Market Index Update



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## **“Green Shoots” or “Black Stumps?” (continued)**

to levels last seen in September 2008. Other measures of credit market health, including LIBOR (the rate at which banks borrow unsecured funds from other banks in the London wholesale market) and the TED Spread (the difference between the rates on the three-month Treasury bill and the three-month LIBOR) have also shown signs of dramatic improvement over the past six months.

### ▪ **Stock Market Rally**

After posting an intraday low of 666 in early March, the S&P 500 rallied to 892 as of 6/30/09. This represented a welcome 34% move off the bottom, and was probably spurred by low valuations and a growing recognition of a better credit market backdrop. And since the stock market is considered to be a “leading indicator” of future economic activity, the recent rally could be seen as discounting a gradual improvement in the economy later this year.

For all of these tentative signs of life in the economy and the markets, numerous areas of pervasive weakness remain. Rather than “green shoots,” these trouble areas might be better described as “black stumps:”

### ▪ **Continued Job Losses**

New jobless claims continue to rise as companies scramble to shed overhead. The unemployment rate is currently 9.5%, and it almost certainly will exceed 10% by year-end. Furthermore, the Fed’s measure of *under-employed* workers (“U-6,” in Fed-speak) has risen to more than 16%, which is a generational high. Given the fact that over 70.5% of U.S. Gross Domestic Product is comprised of Consumption, this is a problem. Consumers cannot “consume” if they don’t have a job.

### ▪ **Personal Savings Spike**

As we discussed last year, this crisis was caused by too many people taking on too much debt to buy too much stuff. Well, it appears that the recession has finally caused consumers to repent from their formerly spendthrift ways. The personal savings rate has increased significantly since 2007 (from 0.57% to a current rate of 6.9%).

While higher savings are probably a good thing for our economy in the long run, in the shorter term it can have a negative impact on the economy. A dollar saved is, obviously, *not* a dollar spent or consumed.

### ▪ **California IOU’s**

California, the world’s 8th-largest economy on a stand-alone basis, is facing severe financial difficulties. The state’s \$24 billion budget shortfall is eye-opening, as is Governor Schwarzenegger’s recent decision to issue IOU’s to pay vendors and contractors. Given the fact that California represents 12% of U.S. Gross Domestic Product, a prolonged downturn in their economy could have national and global implications.

We expect the back half of 2009 to be a battleground between the “green shoots” and “black stumps” in the economy. Global equity markets will remain volatile as investors try to discount coming economic developments. In our opinion, the economy will trough sometime in the second half of 2009, probably during the 4th quarter. This economic bottom will mark the end of the recession, and it will be followed by a slower-than-normal economic recovery in 2010 and beyond. We do not expect the economy to roar back to a normal growth pattern anytime soon.

Considering all of the evidence at hand, we do not expect a “smooth ride” for equities in the coming months, but we think the odds favor moderately-higher stock prices by year-end 2009. As we discussed in detail in our 1st quarter 2009 Commentary, equity valuations are attractive, and investor sentiment is signaling that an upturn may be coming. Furthermore, we think the economy’s “green shoots” should begin to win the battle over the “black stumps” later this year. And we should not forget the fact that there is currently almost \$4 trillion in money market assets sitting on the sidelines. These trillions of dollars are earning almost no return, and we can expect zero returns to become extremely unappetizing over the next couple of years—especially if inflation begins to tick up. As the economic picture stabilizes and ultimately lurches upward, we think that a good proportion of those cash balances will find their way back into quality stocks, with an attendant rise in the overall market.

In fixed-income, we favor investment-grade corporate bonds over Treasuries, as we believe that the credit markets will continue to improve. However, given our concern over a potential rise in interest rates and inflation sometime within the next 12-18 months, we are focusing on short- and intermediate-term maturities to minimize interest rate risk.