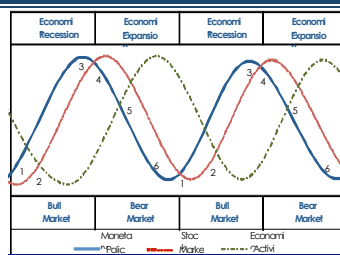


The Financial Commentator

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A GUIDE TO
FEDERAL RESERVE
MONETARY POLICY,
THE ECONOMY, AND
FINANCIAL MARKETS
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ECONOMY

In February I thought the stock market was on the cusp of the largest rally since the bear market began in October 2007, and that it would be ignited by economic statistics showing that the rate of decline in the economy was getting less bad. I thought the optimists would jump to the conclusion that less bad equaled recovery. Despite this expectation, the shift in psychology regarding the economy's prospects has been remarkable. Four months ago, investors felt they were staring into an economic abyss deeper than the cosmic void. When the first series of less bad statistics suggested the economic hole was only as deep as the Grand Canyon, the sense of relief was palpable. Within weeks the phrase 'green shoots' was included in every serious discussion about the economy. Virtually overnight any economist worth their salt had become a gardener. Initially, a few brave economists ventured that the economy might turn up in the first half of 2010. As additional stats in April and May improved from being extraordinarily bad to simply just awful, the notion that the recovery might begin before the end of 2009 took root. And after the *Labor Department* reported that *only* 345,000 jobs were lost in May, confidence that a V-shaped recovery blossomed. By mid June, conviction that a V-shaped recovery was so high the Federal funds futures were pricing a 70% probability that the Federal Reserve would raise rates in November. Green shoots had grown into mighty oaks in a matter of weeks. Who says economists don't know a thing or two about hydroponic gardening?

As discussed in the April and May letters, GDP will likely be positive in the fourth quarter, and maybe in the third quarter. As noted, most of the improvement will be statistical nonsense. In the first quarter, business slashed inventories, which sliced 2.8% from GDP. With sales stabilizing and likely to improve as fiscal stimulus lifts demand, companies will increase production to restock their inventories. This will cause the inventory component within GDP to swing from deeply negative to a slight positive. The wholesale inventory-to-sales ratio jumped from 1.09 months in June 2008 to 1.34 in January. In April, it dipped to 1.31 months, so it is still fairly high, and suggests sales will have to improve more before companies will actually need to increase production. The large decline in exports lowered first quarter GDP by -4%. This drag on GDP will moderate as the global economy helps U.S. export volume to be less bad in coming quarters.

By the end of 2009, the bar chart of GDP will show how the economy plunged from a growth rate of 2.8% in the second quarter of 2008 to a negative 6.1% in the fourth quarter, before reviving into positive territory again. It sure will look like a V-shaped recovery. For those economists who didn't see the deepest recession since the depression coming, or grossly underestimated its depth, the V will

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also mean Vindication. For politicians, the V will be heralded as a Victory of policy. In lieu of a parade, the electorate will endure weeks (months?) of chest thumping and back slapping. A few ingrates will question whether spending trillions of dollars we don't have actually qualifies as 'policy'. But as they say, you can't please everyone, even when you're doling out trillions.

The stock market has rallied smartly since its low in March, as have a number of commodities. The V-shaped recovery crowd has been quick to point out that since markets look ahead six to nine months, the run up in stock prices and oil are telling us a real recovery is afoot. In recent weeks, I've heard at least one expert every day make this statement on *CNBC* or *Bloomberg*. And every day I hope the television anchor will ask the expert a couple of simple questions. "If the stock market is so good at looking forward six to nine months, what was the S&P telling you about the credit crisis in October 2007 as it made an all-time high? When crude oil sold for \$147 a barrel in July 2008, what was it telling you about global demand? And given how wrong the stock market and oil market were, why are you so sure now that they are sending the correct message?" Like Don Quixote, believing markets possess a paranormal clairvoyance adds a bit of mystery, even romanticism to the mundane task of tracking daily fluctuations in prices. The truth is far more straight forward, and absolutely impersonal. At every top and bottom, the market is always wrong.

According to the *International Energy Agency*, there was enough oil in storage at the end of March to satisfy 62.4 days of demand, 14.7% more than a year ago. Last week, the IEA said global inventories in OECD countries jumped 10.4 million barrels in April and another 30.5 million barrels in May. In the first quarter, OECD countries accounted for 55% of global oil demand, while China accounted for 9%. According to *Reuters*, Chinese crude-oil demand rose 3.9% in April over the previous year, but demand was down almost 2% in the OECD countries. Since OECD consumption is 6 times larger than Chinese demand, total global demand is falling. *GaveKal* estimates commercial crude oil inventories are six billion barrels. With oil around \$70 a barrel, that represents more than \$400 billion of working capital tied up in holding onto all that oil. With prices rising, holding inventories is easy. But if prices crack, some of the excess inventory will be sold into a falling market.

Oil prices have risen from \$34 a barrel to \$72 on the growing perception of a V-shaped recovery and the decline in the dollar. When the dollar topped in early March, crude oil was \$45 a barrel. Oil has run up from \$50 to \$72 since late April, as the dollar index fell from 87 to below 79 in early June. After peaking in July last year, crude oil collapsed, as the dollar rallied 25% between July and November. This suggests any decent rally in the dollar will trigger a decline in oil prices that could be fairly sharp since the underpinnings of oil demand are so weak.

In order for the V-shaped recovery in GDP to become a self sustaining economic expansion, private demand will need to be strong enough to carry the economy forward, ***after fiscal stimulus has run its course***. Since the consumer represents 70% of GDP, most of the heavy lifting will be dependent on consumer spending. Obviously, the primary driver behind consumer spending is job growth, which is not going to improve for a long time. The *Labor Department* reported that 345,000 jobs were lost in May, after adding 220,000 jobs based on their Birth/Death adjustment model. In other

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words, the real number of jobs lost in May was near 565,000, or worse. From January through May, the average monthly job losses reported by the Labor Department were 584,000. If the faulty B/D model adjustment is excluded, monthly job losses averaged 652,000. On the surface, the 345,000 figure is 41% below the 584,000 five month reported average, which is a noticeable improvement. However, the improvement is only 13%, if the B/D adjustment is excluded (565,000 vs. 652,000). In May, nearly 25 million (16.4%) Americans were either unemployed, underemployed, or had given up looking for a job. The average work week for those with a job fell to a record low 33.1 hours. In the last year, average weekly earnings rose just 1.2%.

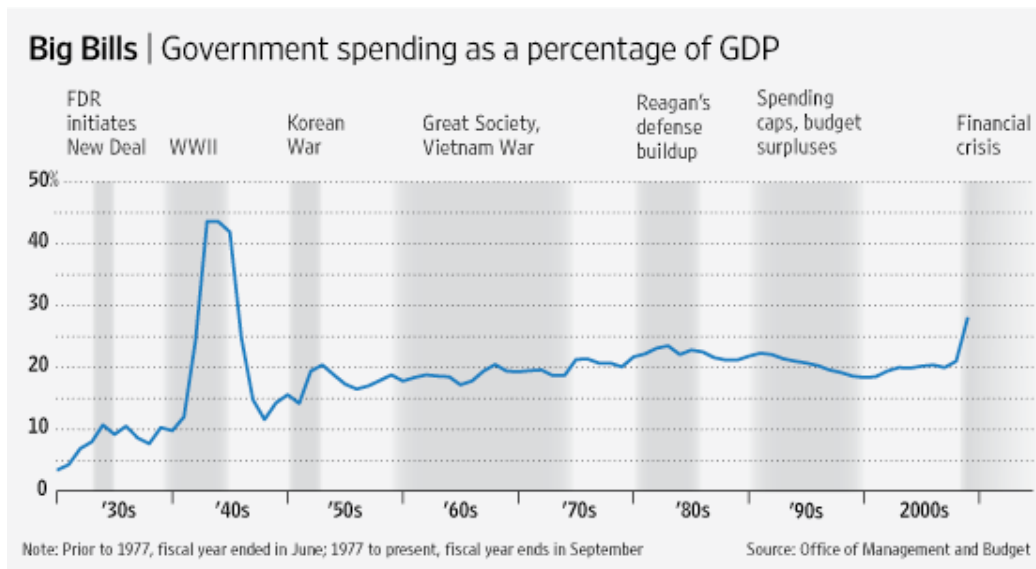
According to *Challenger, Gray, & Christmas*, employers announced 111,182 job cuts in May, down from 132,590 in April and 241,749 in January, and the percent of firms cutting jobs fell to 43% from 56% in January. However, 52.4% of human resource departments surveyed in May said their companies had instituted salary cuts or wage freezes, up from 27.2% in January. This suggests firms are trying to cut costs, why holding on to key staff, while they wait for the V-shaped recovery.

The deterioration in the labor market is slowing, just not as much as most economists realize. Keep in mind that the economy needs to create 125,000 jobs each month *before* some of the 14.5 million unemployed workers will be able to get back to work. Unfortunately, improvement in the labor market during the next ‘recovery’ may make the jobless recovery in 2002-2003 look robust. The NABE said the 2001 recession ended in November. Between December 2001, and August 2003, an additional 1.1 million jobs were lost. According to a recent survey by *Watson Wyatt Worldwide*, 52% of the companies surveyed expect to employ fewer workers in the next 3 to 5 years than they did before this recession began. Of the firms that have cut salaries, 20% plan to make the cuts permanent, and 73% said they expected employees to shoulder more of the cost of health care. All of these factors will keep disposable income growth weak and undercut consumer spending.

According to the *Bureau of Economic Analysis*, the amount of government benefits increased \$209 billion in the first quarter and represented 16.2% of personal income. That’s the highest percentage increase since the government began compiling records in 1929. ***Despite this record assistance to support consumer spending, GDP still fell 5.7% in the first quarter.*** Government benefits – social security, food stamps, unemployment insurance and healthcare – will exceed \$2 trillion in 2009, an average of \$17,000 provided to each U.S. household. This trend continued in April as personal income rose .5%, but was boosted 1.1% by tax rebates, increased jobless benefits and other payments from the stimulus package. According to *Trim Tabs Investment Research*, income tax withholdings are down 5.1% from a year ago based on the Treasury’s daily reports. In the 2001 recession, it only fell 2%. This underscores the severity of this recession, and the immense strain it is placing on the budgets of households, states, and the federal government. The extraordinary level of government assistance has certainly helped stabilize the economy, but this level of assistance is unsustainable. Unless job losses and weak wage growth reverse dramatically by mid 2010, the V-shaped recovery will stall, since consumer demand will be too weak to launch a self sustaining economic expansion.

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There is growing optimism that housing is bottoming. Last week's report on housing starts was accompanied by headlines like "***Home Construction Rebound Solidly From April's Steep Decline***" and "***Housing Starts Jump in May for Third Month***". For those economists and financial analysts who excel at superficial analysis, these headlines are all that's needed to conclude housing is bottoming. Since peaking in January 2006, housing starts collapsed 80.4% to just 357,000 in February 2009. In May, housing starts recovered to 401,000, up 12.3% from February's low, but still down 78% from the peak in January 2006. You buy a stock at \$10.00, it falls to \$1.98, then rebounds to \$2.25. Pretty exciting, huh? But in coming quarters, this solid rebound in housing will add to the illusion of the V-shaped recovery, since the residential component within the GDP report will swing from a negative to a positive.

According to the *National Association of Realtors* about 4,000,000 homes were listed for sale nationwide at the end of April, down 11% from a year ago. The headline for this story read, "***Housing Inventory Drops Again in May***", which suggests the overhang of housing supply is easing, which would be supportive of a bottom in housing. Unfortunately, the NAR statistics only include half of the foreclosed homes banks are preparing to sell. According to *Realty Trac*, a total of 321,480 homes received a foreclosure filing in May, up 18% from last May. Since the moratorium on foreclosures by states and some banks ended in March, notices of foreclosure have exceeded 300,000 for three consecutive months. If the total number of foreclosures were included in the inventories of homes for sale, inventories would have increased, creating an entirely different headline.

According to the *Mortgage Bankers Association*, 5.4 million of the country's 45 million home loans were delinquent or in some stage of the foreclosure process as of March 31. This 12.1% rate is the highest rate ever recorded, and is up from 8.1% a year ago. In the last year, the share of loans in the foreclosure process rose to a record 3.85% from 2.47%, an increase of 56%. As noted in the April letter, the surge in job losses are working their way up the income ladder, with an increasing number of middle income and upper income workers being affected. This is pushing many of those who

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previously were considered prime credit risks over the edge. Prime borrowers comprise 65% of the \$9.5 trillion in first mortgages. According to the *Mortgage Bankers Association*, 6.06% were delinquent at the end of March, up from 5.06% at the end of 2008. For the first time ever, prime mortgages are the largest share of new foreclosures, after the prime foreclosure rate doubled in the last year. In July 2006, the non-profit *Homeownership Preservation Foundation* received 40 calls a day from distressed homeowners. Now, on an average day, they receive more than 6,000 calls. In the first quarter 71% of the callers were seeking help because they had lost overtime pay, taken a salary cut, or one spouse had lost their job. In the next six months, at least another one million workers will lose their jobs.

The first phase of the housing crisis was centered on the lower end of home values because lending standards and down payments were virtually non-existent. Within months, many of these borrowers were unable to make their monthly mortgage, and far more fell behind once the rate adjusted upward. In the next two years there are \$1.5 trillion of Alt-A and Option ARM mortgages resetting. The combination of higher unemployment and underemployment, along with another round of mortgage resets will lead to another wave of foreclosures. This next wave will increasingly impact the mid to upper end of the price range. The availability of Jumbo mortgages is virtually nonexistent, and only at much higher rates. In recent months, foreclosure sales have represented 45% to 50% of total sales. This forced selling has caused home prices to fall 18.7% over the past year, according to the Case-Shiller home price index. As home prices fall below the outstanding mortgage balance by more than 5%, most stressed homeowners are unable to qualify for assistance or relief. In addition, mortgage rates have jumped 75 basis points in recent weeks, hurting refinancing activity and affordability. Although the low end of the housing market is near a bottom, the overall housing market is not. Continued weakness in housing will also undermine consumer spending in coming quarters.

As discussed in April, spending on small business credit cards rose from \$70.4 billion in 2000 to \$296.3 billion in 2008, as the number of cards issued exploded from 5 million to 29 million. According to the *Nilson Report*, the delinquency rate on small business credit cards is 12%, almost 2% higher than the consumer delinquency rate. According to the *National Small Business Association*, in April 59% of small firms relied on credit cards to help finance their day-to-day operations, up from 44% at the end of 2008. The rising default rate is causing card issuers to drastically cut borrower limits for 75% of small businesses. The credit card crackdown and higher lending standards imposed by banks on small businesses represents a serious squeeze on the sector that creates 75% of all new jobs.

After the banking stress test, the Federal Reserve indicated that the banking system had turned the corner. Of course, the Fed wasn't very clear on just how big or rounded the corner might be. The 8,000 banks insured by the FDIC charged off \$37.8 billion of loans in the first quarter. However, the amount of loans at least 90 days past due increased by \$59.2 billion. Banks also set aside \$60.9 billion in loan loss provisions in the first quarter, but the ratio of reserves to non-current loans fell to 66.5% from 74.8% at the end of 2008. According to the FDIC, 7.75% of bank's \$7.7 trillion in loans

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and leases were showing some sign of distress at the end of March, up from 4.1% a year ago. The overall quality of loans is deteriorating at the fastest pace since 1984, when data was first collected.

Earlier this year, the *Federal Accounting Standards Board* was under pressure to change the ‘mark to market’ accounting rules, so banks would have more flexibility (creativity) in pricing assets that trade infrequently. According to the *Wall Street Journal*, 31 financial firms and trade groups spent \$27.6 million in the first quarter lobbying Washington to get the mark to market rules changed. And guess what, FASB modified the mark to market rule. One of the contributing factors to the credit crisis was banks using off balance sheet entities that allowed banks to increase leverage, without being required to set aside reserves on those off balance sheet assets. Shockingly, the Federal Reserve wasn’t even aware of these entities, which shows the thoroughness of the Fed’s oversight. At the end of 2009, banks are required to bring these assets back onto their balance sheets, which will force some banks to raise even more capital. Banks are obviously not thrilled about this prospect, and will express their displeasure by writing and sending more checks to Washington. No matter who is in the White House, or which party is running Congress some things never change. Given the instability of the last two years, it’s a small comfort to know there is at least one thing we can count on.

DOLLAR

I think the Dollar is near an intermediate low, and may very well hold the key to the stock market, gold and oil. In the May letter, I wrote *“With talk of the Dollar being replaced as the world’s reserve currency, sentiment has turned fairly negative. It’s possible that the Dollar is completing the correction from the March peak. Traders can buy the dollar below 79.80 on the cash, using a close below 79.10 as a stop.”* The Dollar did close below 79.10 for one day on June 2, before rebounding on June 3. As I noted in the June 5 Update, *“There is the potential for one more move up in gold, and one more dip in the Dollar. Both may be experiencing a wave 4, up in the dollar and down in gold. If so, wave 5 would likely exceed the recent low in the Dollar and high in gold by a small amount.”* A close above 82.10 in the September Dollar futures would increase the odds that an intermediate bottom is in. Add to Dollar positions in the future, the ETF UUP, or the Direxion Funds 2.5 leveraged bull fund symbol DXDBX. If the Dollar does experience a wave 5 drop below 78.83, it would actually strengthen the technical formation. After a decline below 78.83, wait for a daily reversal to add to positions.

GOLD

August Gold has the potential to drop to \$870.00 - \$885.00 in coming weeks, if the Dollar performs as expected. Lower the stop on August Gold short @ \$960.00 from \$1,002 to \$984.00, and to \$96.60 on the short GLD @ \$94.00. Use a stop of \$19.30 on the long @ \$20.69 2 to 1 short Gold ETF DZZ.

STOCKS

When I was a kid growing up in Chicago, every year I thought the Cubs were going to win the World Series. And they would have in 1969, if they hadn’t run into the Amazing Mets! But every year I was

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able to sustain my expectation of a trip to the World Series, until the Cubs were mathematically eliminated. A similar dynamic is always at work in the financial markets. As expectations of a recovery in 2010 has grown into expectations of a V-shaped recovery, an increasing number of institutional investors stop selling on bad news. This causes a significant shift in the balance between supply and demand to develop. Less selling pressure requires less buying to reverse the price trend from down to up. As more participants see prices begin to trend upward, selling on ‘bad’ news dries up quickly, and buyers step in and shorts are forced to cover, reinforcing and accelerating the up trend. The ‘green shoots’ theme has provided the ideal rationality to justify buying stocks and commodities on awful, but less bad fundamentals.

Since May 8, the rally has been sustained by a lack of selling, rather than demand. As I noted in last month’s letter, *“In recent weeks there has been virtually no selling pressure. This has been a bit surprising, but underscores how convinced institutions are in the second half recovery story.”* Between May 8, and June 11, when the S&P made its recovery high at 956, the 21 day average of up volume contracted from 1.024 billion shares to 712 million shares, a drop of 30%. This suggests that any pick up in selling will easily overwhelm the reduced amount of buying. As I wrote last month, *“The perception of when the economy will recover is ahead of reality. This suggests the market is vulnerable.”* I thought the market had topped on May 8, but allowed that *“the market could spike higher, if the S&P closes above its 200 day average near 940. If it does, selling into that strength would be a good idea.”*

Although the 21 day average of down volume has climbed from 629 million shares to 738 million shares since June 11, selling pressure is still below where it was on May 13, when the 21 day average reached 809 million shares. The S&P should find initial support between 875 and 885. As noted last month, a normal correction would bring the S&P down to 830-850. I still believe that the rally from the March low will take an up, down, up form, which means that the odds still favor a rally above 956 after this correction. However, given the ‘health’ of the economy, I would take nothing for granted. Although the rally from the March low looked impressive in percentage terms, it was not very strong. From the initial surge into March 20, total volume contracted 25.9% by June 11.

BONDS

It is outrageous that financial professionals are concerned about inflation. The 30 year average of capacity utilization is 81%. In May, factory utilization was 65%. The unemployment rate will continue to rise into next year and might exceed 11%. The Federal Reserve has certainly been aggressive, but bank lending was down 8% last month, and consumer credit has fallen the most since the early 1950’s. World wide there is too little demand chasing too many goods, and by definition that is deflationary. Last month, I suggested buying the 10-year Treasury if yields climbed to 3.44%, using 3.62% as a stop. Clearly, I did not anticipate that institutions would embrace the notion of a V-shaped recovery, as yields soared to 4.01%. Buy the 10-year ETF TLT below \$91.00.

E. James Welsh