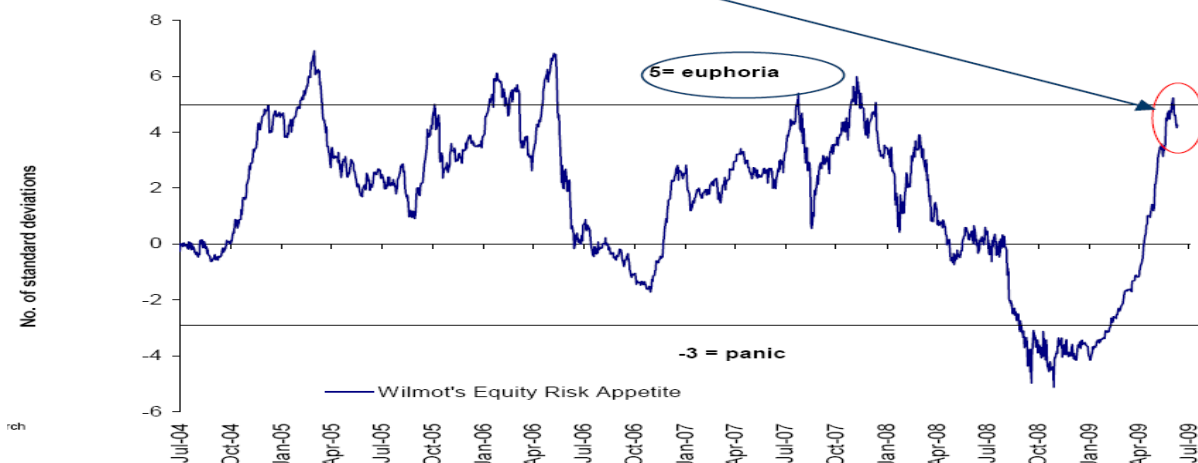


## **2<sup>nd</sup> Quarter 2009 Market Commentary and Outlook**

The 2<sup>nd</sup> quarter was characterized by a dramatic emotional swing from the “despair and panic” present at the beginning of the period to the “euphoria” of late June (see the Credit Suisse graph below). While the world “did not end” in March, the market was off more than 50% from its October 2007 high. With the market now up more than 30% from the March 9, 2009 bottom, there are obvious questions. Are things really okay? Are we on a sustainable path to economic recovery? Is the U.S. bear market over and have we started a new bull market cycle? We think the simple answer to these questions is “no”, and we will take you through our rationale and tell you how we plan to manage your assets through what we continue to see as a volatile and risk-filled investing environment.



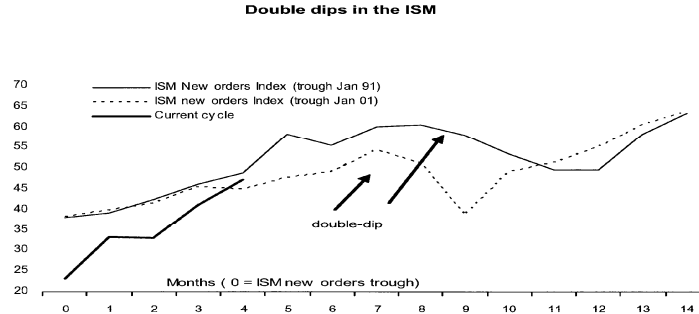
**LESS BAD NEWS** - The positive, or in this case “less bad”, earnings results that companies reported in the first quarter of 2009 was mainly derived from dramatic cost cutting efforts on lower than expected revenues. In addition, corporations delivered better than expected cash flows due to a temporary yet dramatic inventory destocking. We question the quality, sustainability and the signal sent to the market by these results. Delivering better than expected earnings on dramatically reduced expectations brings to mind the old saying “you can’t cut your way to prosperity”. Obviously, the tough decision that investors face at this point is to decide if this is a market that is poised for a multi-year rally (i.e. the start of a new bull market) or just a pause in which the bear market will return and send stock prices lower. Heading into the second quarter reporting period, investors are braced to determine if it is simply too early to tell whether the March 9<sup>th</sup> lows signaled a market bottom. Comments by corporations looking into the second half of 2009 will indicate how durable the economic and hence market recovery will be. If the following comments from bell weathers (Federal Express and Best Buy) are any indication, we do not hold much hope for an “all clear” signal.

*“Manufacturing activity is expected to be substantially negative year over year through the summer and last year’s first quarter results benefited from stronger economic activity, making earnings comparisons difficult. At this time we do not have enough visibility into the economic recovery and jet fuel prices to provide meaningful annual earnings forecast.” - Alan B. Graf, Jr., FedEx Corp. executive vice president and chief financial officer.*

*“Given the limited visibility to consumer spending in the back half of the year, along with the fact that a majority of the company’s earnings are derived from the holiday selling season, it’s prudent to maintain our original guidance at this point.” - Jim Muehlbauer, Best Buy’s executive vice president of finance and chief financial officer.*

## THE PSYCHOLOGY OF THE INVENTORY CYCLE

**5 to 8 months into a normal recovery ISM double dips, after the inventory build**



CREDIT SUISSE

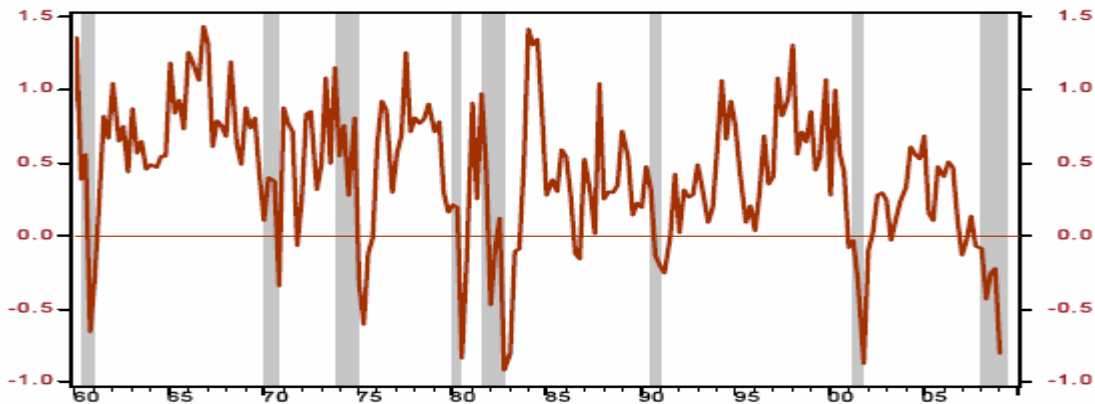
Source: © Datastream International Limited ALL RIGHTS RESERVED. Credit Suisse research

12

As noted above, first quarter corporate earnings results and recent macroeconomic indicators can only be described in terms of “less bad news”. Corporations slashed costs and inventory in the fourth quarter of 2008 and into the first quarter of 2009 as the ISM Purchasing Managers Index hit a multi-year low of 23.1 (50 is the level required to indicate an expanding economy). During their first quarter conference calls, several companies reported that they and their customers literally stopped ordering product to generate cash as the credit markets locked down and corporations scrambled to reduce outstanding commercial paper balances for year end (see chart below). As a result, we are concerned that much of what we are seeing right now in the form of “green shoots” is simply a mini inventory restocking cycle. As can be seen from the ISM data above, in past recoveries, the initial inventory restocking is often followed by a pause 5-8 months later. Unfortunately, that pause may fall squarely in the middle of the third quarter. This is the period when corporations will attempt to forecast their demand outlooks during their second quarter earnings release conference calls. In these highly volatile markets, investors will not wait to sell if they sense any reversal in the trend toward “less bad news”.

### **Inventory Investment**

**% Real GDP**



### **WILD SWINGS IN THE ECONOMIC, SOCIAL AND POLITICAL LANDSCAPE TO CONTINUE**

In our last quarterly letter, we stated that uncertainty and volatility would continue to dominate the economic, political and social landscape. That prediction continues to be very much the case. We also noted that we are in a “trading market” and the volatility and risk inherent in the market will continue. As one can see from the chart below, we are still very much in a market that continues to

swing wildly. As a result of this volatility, we remain in a defensive posture and continue to position portfolios to be opportunistic, trying to take advantage of these wild emotional swings when opportunities present themselves.



**THE MARKET NEVER REALLY GOT CHEAP – VALUATIONS BACK TO NORMAL**

As mentioned in previous quarterly letters, we believe the secular bear market began in 2001 (i.e. a long period of flat or declining stock values, running on average 13 to 16 years). Other analysts, including Tim Hayes, Chief Investment Strategist from Ned Davis Research, agree with this view. Importantly, within secular bear markets, shorter cyclical bull markets do develop. Typically, these cyclical bull markets have an average increase of 64% and last a year and a half. This means the current rally could have more than a year to run. The rise in stocks from the March 9<sup>th</sup> lows does qualify as a bull market (using the traditional definition of a 20% move off the bottom), however,

**P/E on trend earnings is in line with average**



we do not see the March lows as marking a transition into a new secular bull rally. That is, in part, because the market did not fall far enough during the sell-off. The market fell to a P/E ratio of roughly 12 times in early March and recently ran back up to 16 times, nearly equaling the 40 year median of 16.5 times earnings. This compares to the 1970's when P/E's got down to 10 and stayed there until 1982. Hayes states that the current secular bear market "is mature but it can go on for another several years". He also notes that it is possible that the current cyclical bull market could continue into next year but then get derailed by rising interest rates and inflation. Significantly higher inflation would boost nominal earnings but likely depress stock prices, sending P/E's down to the kind of levels that might mark the beginning of a new secular bull market. We agree with much of Hayes' thinking which supports our near term caution regarding chasing equities. We feel that there will continue to

be rallies in this bear market, much like the one that we have experienced in the second quarter and like those seen for three years after the 1929 crash (see table below). However, we believe that the potential for P/E multiple compression or loss of value on a real basis will continue to be a significant, upside limiting factor for equities.

### Bear market rallies during the Great depression

**Bear market rallies in the Dow Jones (1929-1933)**

Start	End	Duration (MM)	%
Nov-29	Apr-30	5	49%
Jun-30	Sep-30	3	16%
Dec-30	Feb-31	2	25%
Jun-31	Jul-31	1	29%
Oct-31	Nov-31	1	35%
Jan-32	Mar-32	2	25%
<b>Average</b>		<b>2</b>	<b>30%</b>

*Trough was in Jul. 1932 at 41*

### THE BROKEN U.S. CONSUMER

U.S. consumer spending (~70% of U.S. GDP) is getting squeezed from all sides. The consumer has too much debt, is facing an unemployment rate of 9.5%, and has experienced trillions of dollars in decline in net worth due to the drop in their home and equity values. With this reality, the U.S. consumer is trying to rebuild their balance sheet (see RDQ Economics chart below, which indicates that the U.S. consumer will need to build their savings rate to 7% alone just to compensate for the loss in net worth). In addition, the specter of an additional (federal and state) tax burden will again force the consumer to save more and reduce consumption. These are not the catalysts for a rapid and robust economic recovery. The world will need to look to a new buyer of last resort to drive demand leadership. The deleveraging process that has begun in the household sector of developed economies,



including the U.S., makes it unlikely that the consumer sectors in these economies will drive a global growth recovery. Foreign countries are restructuring their economies to emphasize domestic consumption thereby offsetting the structural reduction of U.S. demand for their exports. Many Asian economies have begun this shift. The middle classes, particularly in Asia, represent a source of demand that has barely begun to be tapped. These regions are where demand, and hence, opportunities to invest in consumer goods, services, and distribution are likely to be the most rewarding. In past letters, we have highlighted this theme and talked about global consumer goods

companies that are well positioned to take advantage of this secular transition (including Abbott Labs, Colgate Palmolive, Diageo, Johnson & Johnson, and Kimberly Clark).

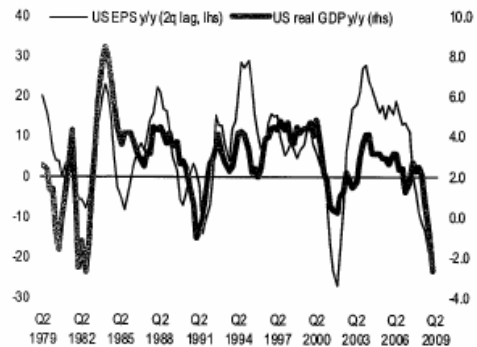
**LIMITED ECONOMIC AND EARNINGS GROWTH – CAPS MARKET UPSIDE**

While we have seen a turnaround in two key leading indicators (ISM New Orders and the Michigan Consumer Confidence Survey), an analysis done by Credit Suisse (see charts below at left) would indicate that, while the trend in the leading indicators is heading in the right direction, the level of these indicators would only predict a GDP growth rate of 1.3%. Obviously, this is better than a declining GDP, hence the term “less bad news”. However, as one can see from the chart at the right below, the *economy needs to be growing at least 2% on a real basis before corporate earnings begin to expand*. Recently, the Organization for Economic Cooperation and Development (OECD) revised its assessment of the world’s economy and said that the “worst may be over in the current slowdown”. The OECD forecast for its 30 member countries is for a 4.1% contraction this year and a .7% expansion in 2010. That compares with its March forecast that GDP would shrink 4.3% this year and .1% in 2010. As outlined above, it is hard to classify .7% growth as anything other than “less bad news”.

US lead indicator points to GDP growth of c1.3%

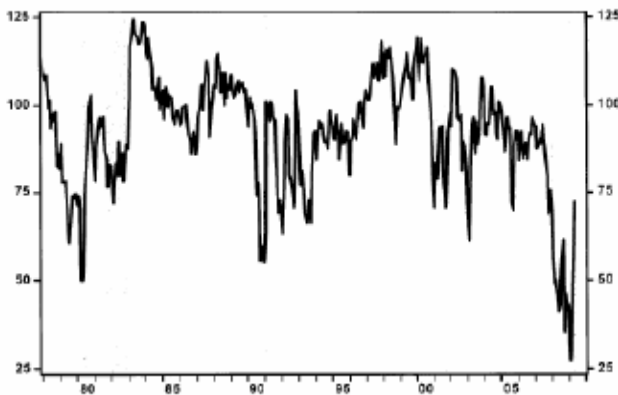


US corporate earnings typically rise when real GDP growth is above 2%



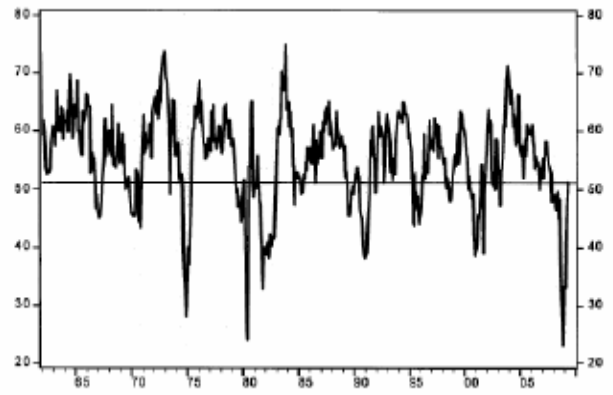
Consumer Confidence: Expectations

SA, 1985=100



ISM Mfg: New Orders Index

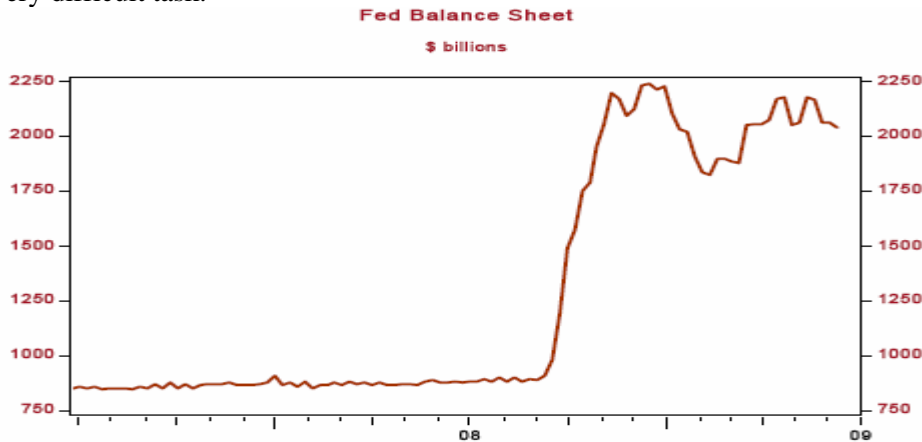
SA, 50+ = Econ Expand



**WHAT HAPPENS WHEN THE FED PULLS THE “PUNCH BOWL” AWAY?**

The mind numbing expansion of the Federal Reserve’s balance sheet (RDQ Economics chart below) over the course of the last six months was obviously the correct medicine for the financial crisis. The massive amount of liquidity injected into the system globally stopped the destructive psychological spiral of deleveraging, which had started to feed on itself. That is the good news. The bad news is, at some point, these actions will need to be reversed. Already, with the passing of the most intense emotional fears of the financial crisis, public opinion combined with “bond vigilantes” (*we refer to the global investors once known as the bond vigilantes, who demanded higher Treasury bond yields from the late 1970s through the 1990s whenever inflation fears popped up*), are starting to second guess the

size and need for the multiple actions taken across the board on both the fiscal and monetary front. The actions of the Federal Reserve and Treasury, should they remain too long, may result in significant inflation and higher interest rates, a major negative for equity market values. We believe the prospect of getting the timing right on managing the fiscal and monetary stimulus will be at best a very difficult task.



## Summary

For most client portfolios, the significant cash and short-term bond levels that we have maintained through the first half have helped to dampen the dramatic volatility experienced in the market. The S&P 500 finished the first half up 3%, however, at its March 9<sup>th</sup> lows it was down almost 25%. Most of our clients experienced significantly less volatility.

The ongoing challenge for 2009 will continue to be to remember that, while the market is a discounting mechanism, this is still a “trading market”. We must avoid becoming caught in the dramatic emotional swings from fear to greed and back again. Near to longer term, we will continue to assess the economic ripple effects beyond the initial phase of the financial crisis. We continue to feel that the implementation of major, untested fiscal, monetary and political policies has injected significant unseen and hard to quantify risks into the financial markets. While we believe this is the eighth year of a secular bear market, we have found many opportunities to generate returns during this period. Beaumont remains convinced that there will be select attractive opportunities within sectors of the market such as a soon to be released government backed Public Private Investment Program or PPIP, which may offer a limited risk vehicle, allowing investors to participate in the troubled loan and securities markets. In addition, despite the recent recovery in emerging markets, we still believe there are attractive investments in these markets and we are monitoring values closely. We remain enthusiastic about the prospects for gold and precious metals over the next few years as well as energy. We will continue to utilize exchange traded funds (ETFs) to take advantage of short-term trading opportunities as well as to hedge some of our equity exposure within client portfolios.

As we have outlined above, we do not feel that we are out of the woods yet and see significant secular headwinds facing the equity and fixed income markets. With this view, we will continue to overweight the Safety and Income allocations within most client portfolios. While we know that significant challenges lie ahead, we look forward to guiding you through these difficult times, and, as always, we thank you for your trust and confidence. Please contact your Relationship Manager if you would like to review your long term risk and return objectives.

If you have any questions or comments, please contact us at 781-237-7170 or E-mail me at [mstack@bfpartners.com](mailto:mstack@bfpartners.com)

Michael P Stack CFA