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Investment Matters

For the quarter ended March 31, 2009

Little Rays of Sunshine

Besieged by the incessant blaring of bad economic news, people often fail to notice the little rays of economic sunshine which precede an eventual recovery. Even now, in the depths of recession's despair, there are a few hopeful signs that the decline may be reaching a nadir. Here are some reminders that economic cycles have two directions:

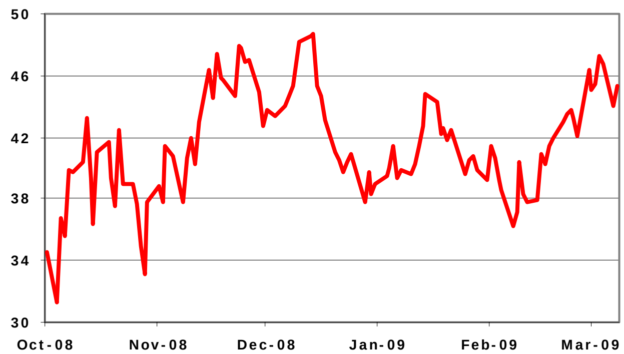
Commodity prices are rising around the world. The prices of oil, copper, recycled paper and other basic materials reached major lows late last year and have recovered dramatically in 2009.

Leading indicators of economic activity are up in Japan and the Pacific Rim countries.

The Chinese stock market is up almost 50% from its low last Fall.

The Baltic Freight Rate is going up again. Shipping rates on the Baltic Sea in northern Europe are notoriously sensitive to developing economic conditions in the world. Although the rate fell in 2008, it is up sharply this year.

The housing market is showing early signs of bottoming. Over the last two weeks housing starts, homebuilder surveys,



The Chinese Stock Market is up Almost 50% from Its Low Last Fall

existing home sales, mortgage applications and new home sales have been better than expected. Similar reports are coming from the depressed housing market in England.

With average new home prices down 29% from the peak and with the average interest rate for a 30 year mortgage now at 4.8%, homes are more affordable now than at any time in the last 20 years. Some forecasters are predicting a bottom in home prices before year end.

The Conference Board's Index of Consumer Confidence ticked up in March.

Money in circulation, the grease for the wheels of the economic engine, is rising fast. M2, a broad measure of money in circulation, is up $100 billion in just the last three weeks and is growing at an 18% annual rate. Globally, the money supply is growing at over 10%

A recent survey of bank lending to consumers showed its first improvement since the recession began in December, 2007.

As of March 31st, the S&P 500 Index was up nearly 20% from its early March low.

Information Technology stocks are up 4% this year, much better than the overall market. Tech stocks are known for being early harbingers of a better economy.

Four Reasons to be Bullish on Stocks for the Long Term:

Regression to the mean. The mean annual real return (i.e. after inflation) from investing in U.S. stocks has been 6.8% since 1925, a period which included numerous recessions, the Great Depression and a number of wars. In order for real stock returns to catch up to the long term average, future returns from this point must be above average. This may take some time, but it is a high percentage opportunity.

Tobin's Q ratio. In 1969 finance professor James Tobin started tracking the ratio between stock prices and the cost to replace all the assets of the underlying companies. Although not at a major low, the ratio is currently somewhat below average. A similar picture is presented by other long term value measures such as the Schiller 10 year Price Earnings ratio. Stocks may go lower if serious deflation or inflation develops but they are currently cheap enough to promise good long term returns even with additional economic problems.

Helicopter Ben. Fed Chairman Ben Bernanke got his unwanted nickname by once referring to the idea of curing deflation by a "helicopter drop" of money. A student of the Great Depression, when an anemic money supply exacerbated a deflationary spiral, Mr. Bernanke is willing to risk some inflation to stop

Continued on page 2.

Reasons: continued

deflation in its tracks. The Federal reserve is pouring money into the economy at an unprecedented rate. Although difficult to implement, this strategy is the best hope we have to return to a normal economic environment.

Blood in the streets. Baron Rothschild, an 18th century British nobleman and member of the Rothschild banking family, is credited with saying that, "The time to buy is when there's blood in the streets." Many famous investors made their reputations by buying stocks when others were in a panic. Recent surveys indicate a level of investor pessimism not seen since the 1982 recession bottom .

Go figure. While people vented their rage about AIG's retention bonuses, its stock price went from a low of 33 cents to an intra-day high of $2.00, a 600% increase in just 10 days.

Fire & Ice

"Some say the world will end in fire, some say in ice..."
Robert Frost

Inflation and deflation are much on the mind of investors today but the jury is out on which one is more likely to cause further damage to our already battered economy.

Most people understand the scourge of inflation. Many lived through the 1970s, a decade in which consumer prices more than doubled. Retired people living on fixed incomes were devastated. Many struggled between buying food and paying their heating bills. Unemployment remained high. Hard assets like gold were hoarded. Dollar bills quickly became worth 95 cents and then less. Stock and bond investors saw the value of their holdings plunge. Businesses struggled to stay profitable and plan for an uncertain future. The national mood became morose.

A less well understood fact about inflation is that some people benefited. Borrowers were able to pay their debts with cheaper dollars. Politicians also benefited. Since inflation raised tax receipts much faster than the economy grew, they didn't have to vote for unpopular tax increases to get the money they wanted to expand government programs.

The dangers of deflation are not appreciated today. The last major deflation in America took place more than 70 years ago. Debtors, including farmers, businesses and homeowners were crushed as the value of their property plummeted while the purchasing power of the dollars they were paying in interest went up. Banks, unable to collect on their loans, closed their doors. Consumers stopped buying, perpetually waiting for prices to fall further. Businesses failed. The unemployment rate went as high as 25%. Tax receipts dried up and the government was forced to raise rates. Money was in short supply, hoarded by frightened citizens. Treasury bond holders did well, but only because the government did not default. The deflationary malaise was finally ended by World War II, which like all wars, boosted prices of nearly everything.

Once established, inflation or deflation become stubbornly entrenched and are difficult to dislodge. In 1979-80 it took a courageous Federal Reserve Chairman, Paul Volker, to defy politicians and raise interest rates to unprecedented levels, thereby causing a deep recession, but also breaking the back of inflation. Once inflation was defeated it was relatively easy to lower rates and re-start a healthy economy.

In 2009, Fed Chairman Ben Bernanke is trying to stop deflation before it catches on. By flooding the economy with dollars he is trying to make them so plentiful that they cannot rise in value and will not be hoarded. In theory this should stave off deflation. The problem is that it's never been tried before on this scale and we don't know all the pitfalls. So far, we know the cost is high, a lasting burden on our children and grandchildren. We also know it will take extreme courage by the Fed Chairman to reverse the flow of dollars once deflation is stopped, since this will surely cause the economy to slow again, if only for awhile. If, under immense political pressure, he hesitates too long, the U.S. economy will have avoided the deflationary ice only to be consumed by an inflationary fire.

The Bottom Line: 3/31/2009

Market Indicator	**Current Value**	**One Year Change**
Large company stocks *(S&P 500 Index)*	798	-38.1
Small company stocks *(S&P Small Cap Index)*	222	-38.1%
Short term interest rates *(3 Month T-Bill Yield)*	0.2%	From 1.3%
Long term interest rates *(10 Year T-Bond Yield)*	2.7%	From 3.5%
Inflation *(Consumer Price Index)*	213.0	+0.1%
Energy *(West Texas Intermediate Crude Oil)*	$49.66bbl.	-51%
The economy *(Inflation adjusted GDP)*	14.2 trillion	-0.8%

QUOTABLE

"When you run in debt you give another power over your liberty."

Benjamin Franklin

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