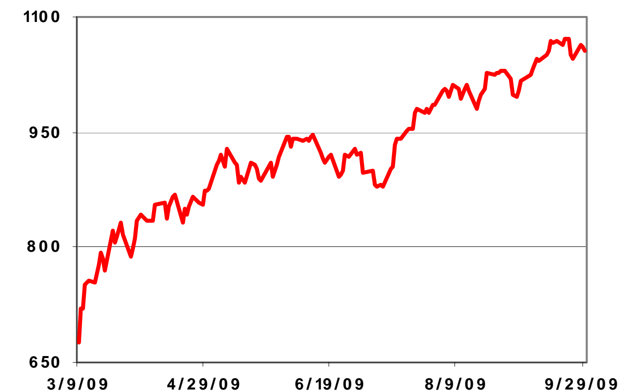
Robshaw & Julian Associates, Inc.
Trusted Investment Advice Since 1979

Investment Matters

For the quarter ended September 30, 2009

Whatever Lola Wants, Lola Gets

The S&P 500 closed the third quarter 56% above its low of March 9th. To put this in perspective, the S&P 500 went up more in the last seven months than it did in any calendar year since the Index was created in 1925; it went up more than it did in the entire decade of the 1960s. For this, the Federal Reserve deserves much of the credit. Like Lola in the popular song of the 1950s, the Fed usually gets what it wants.



THE S&P 500 INDEX IS UP 56% SINCE MARCH 9TH

Created in 1913 to prevent financial panics like the one in 1907, the Fed has an array of tools which give it substantial control over the economy. Although it is best known for setting the level of short term interest rates, the Fed also controls the money supply and is able to provide emergency funding to shore up the financial markets. All of these actions were important to the recent recovery of the financial markets and the ultimate recovery of the economy.

Late last September, after the failure of Lehman Brothers, the Fed realized that the financial system needed extra help. They immediately added unprecedented reserves to the banking system to boost the money supply. Base money, which consists of bank reserves and currency in circulation, was doubled in a matter of weeks, the greatest increase ever. However, in order for bank reserves to become real money, it has to be loaned out. With banks reluctant to lend, even to each other, this was problematic.

Like Lola in the popular song of the 1950s, the Fed usually gets what it wants.

To stimulate lending, the Fed did two more things. Over the next three months they reduced the Fed Funds rate to near zero and pledged to keep it that way for as long as necessary. With a near zero cost of funds, banks had additional incentives to make loans. The spread between the interest they could charge on new loans and their cost of money was very large, large enough to cover losses from bad loans. Though bankers were fearful of making bad loans, they were also very uncomfortable sitting on a mountain of money which was earning nothing for the bank. Within a few months, broader measures of money, which include bank account and money market funds, began to rise. The Fed takes advantage of the age old truth, “money burns a hole in your pocket”.

The Fed also intervened to shore up the short term money markets. These markets have largely replaced banks as a source of working capital for businesses. Corporations need to borrow short term to finance inventories and to provide reasonable payment terms to vendors. Investors provide these funds by buying commercial paper from the corporations. Much of this ends up in money market mutual funds, a popular alternative to savings accounts. By stepping in to buy commercial paper when investors were too fearful to act, the Fed kept the wheels of the economy turning and allowed time for the crisis to dissipate.

With more money in their hands and with less fear of financial collapse, investors began to realize that the economy would eventually recover and that cheaply priced stocks with fat dividends were a better investment than low yielding bank accounts and money market funds. From then on it was off to the races.

Since 1948, the market aphorism, “Sell in May and go away.”, has worked only 35% of the time.

Timeless Wisdom

"Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism but peace, easy taxes, and a tolerable administration of justice: all the rest being brought about by the natural course of things."

Adam Smith, “The Wealth of Nations”,

Great Depression Facts

Although the recent Great Recession (as it is being called) has spurred interest in the Great Depression, there are profound differences, most notably the recent aggressive actions of the Federal Reserve to re-stimulate the economy.

- From the peak in1929, the U.S. gross domestic product (GDP) declined about 17% over the next nine years. The economy did not reach the 1929 high water mark until 1942.
- The Depression was actually two recessions, one from mid-1929 through 1933 which reduced GDP by 45% and the other in 1938, which saw a 4% decline. GDP growth was actually positive from 1934 until 1936. Continuing economic despair marked the entire period.
- Unemployment reached 25% by the end of 1933. It averaged 18% for the remainder of the decade, never dropping below 14%.
- During the 1930s the Consumer Price Index dropped 19%, a condition known as deflation. Prices dropped more than 10% in 1932 alone.
- From its record top in September, 1929, the S&P 500 Index dropped 45% in less than two months. The Index recovered nearly half of this loss by April, 1930. The subsequent decline, which ended in June, 1932, saw it descend to a level 86% below the 1929 peak. From there it went up 275% in the next 13 months. Although the index declined 42% over the entire decade, dividends made up most of the loss and the real return averaged 3.3% per year because of price deflation.
- From top to bottom, world trade declined by 80%. The Smoot Haley tariff which was passed in April, 1930 set off a worldwide “beggar thy neighbor” landslide of protective tariffs. In an open letter, 1,038 economists advised president Hoover to veto the tariff. By the time he signed it, the stock market was again in freefall.
- Falling agricultural commodity prices which had devastated farmers incomes in the 1920s, collapsed in 1930 as world trade declined.
- For the crucial years 1929 through 1932 the U.S. money supply declined by a third. Initially this was a deliberate attempt by the Federal Reserve to curtail stock speculation but mostly it was due to panic hoarding of money (gold) and the failure of the Fed to aggressively counter this effect.
- After buying gold from citizens at $20.67 per ounce in 1934, the government set the price at $35. This was a de-facto devaluation of the dollar.
- The federal government assumed unprecedented regulatory authority over wages, prices, banks, securities markets and labor unions. Much of this was designed to prop up wages and prices.
- From 1929 - 1939, annual federal government spending went from $3.3 billion to $9.1 billion. Much of this was for relief and public works.
- Taxes increased dramatically. In 1932 the lowest income tax rate was raised from ½% to 4% and the top rate went from 25% to 63%. In 1936 The top rate went to 79%. The tax on corporate profits went from a low of 11% in 1929 to 15% in 1936. A 27% surcharge was levied on profits not paid out as dividends. The highest estate tax rate went from 20% to 70%. In 1937 the new Social Security program added a 2% tax on all wages.
- About 40% of U.S. banks had failed by the end of 1932. A national bank holiday was declared in 1933 to prevent a total collapse of the banking system.

Although the U.S. economy is three times the size of China’s, the dollar value of the money supply is about the same in both countries.

The Bottom Line: 9/30/2009

Market Indicator	Current Value	One Year Change
Large company stocks *(S&P 500 Index)*	1,057	-9.2
Small company stocks *(S&P Small Cap Index)*	317	-12.0%
Short term interest rates *(3 Month T-Bill Yield)*	0.1%	From 0.9%
Long term interest rates *(10 Year T-Bond Yield)*	3.3%	From 3.8%
Inflation *(Consumer Price Index)*	215.4	-1.4%
Energy *(West Texas Intermediate Crude Oil)*	$70.61/bbl.	-29.8%
The economy *(Inflation adjusted GDP)*	$14.2trillion	-2.4%

QUOTABLE

“I am more concerned about the return of my money than the return on my money.”

Mark Twain

Robshaw & Julian Associates, Inc.
6255 Sheridan Drive, Suite 400
Williamsville, New York 14221
Tele: (716) 633-6555
E-mail: info@robshawjulian.com
Website: www.robshawjulian.com

This publication is for informational purposes only. It is not to be utilized as investment advice. The facts presented, while generally believed to be correct, are not guaranteed to be accurate.