

## Are We There Yet?

By Mark Luschini, Chief Investment Strategist



A massive fiscal stimulus package is coming...someday. There was a fair amount of chatter last November that then President-elect Obama would have a fiscal stimulus bill to sign the day of his inauguration. While perhaps that was a tad ambitious, it was clear that with the economy slipping deeper into recession little time should pass before Congress belted out something that could be passed. The content of the bill was pitched as a job creation strategy—getting people to work in building out our nation’s infrastructure. By saving jobs and putting the unemployed to work the feedstock for spending would be supplied by wages which, in turn, would help to stimulate the economy and pull us out of this economic funk. But the wrangling began over what size the package should be and of course what was included. Finally, after what seems to be an excruciatingly long time, it appears that we are about to get some form of a new fiscal stimulus. The House of Representatives passed a bill late last month that totaled \$819 billion while the Senate is flirting with their own version that tips the scales at an estimated \$900 billion.

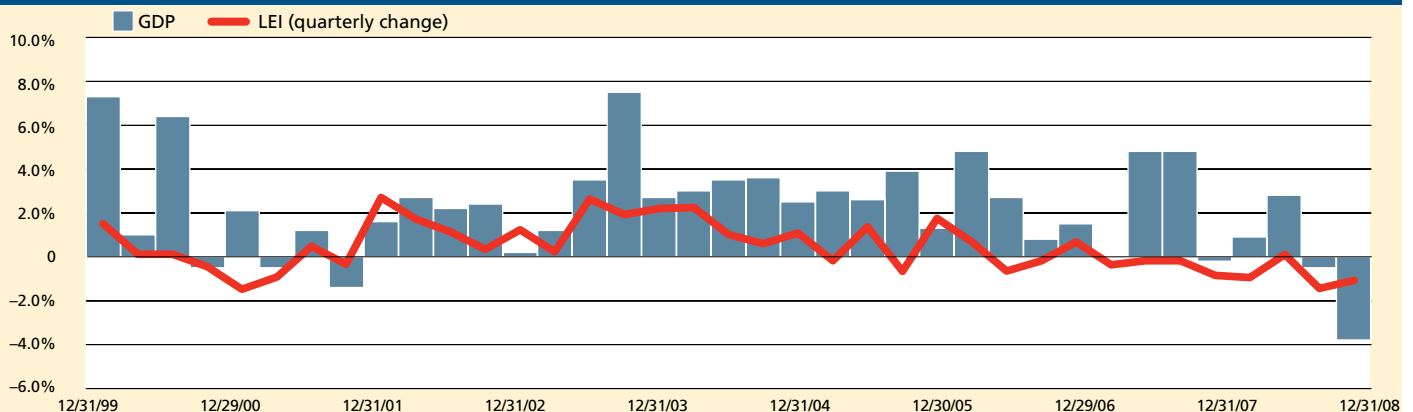
Regardless, the enormity of the package is almost less important than the components of the bill. After all, throwing a lot of money into the economy, like last year’s \$108 billion in rebate checks, had little if any

residual benefit to the economy. The money went to gasoline or savings while a nominal amount was actually spent on clothes, cars, houses, or in restaurants. So a thoughtful, more surgical design is critical. The stimulus needs to be fast acting, not the time capsule approach that is hinted by the packages being discussed today. In addition, the quality of the spending is important. Funding truly shovel-ready projects, giving money to states to forestall cutbacks or tax increases, payroll and other tax cuts, are all means of tapping right into the vein of consumers desperate for some lift in their confidence that the economy is leveling and better economic conditions are ahead.

In the meanwhile, the economy has deteriorated to readings not seen since 1982. Last week’s report on GDP showing a contraction of 3.8% in the final three months of last year is indicative of the erosion in activity by consumers and business. News on the index of Leading Economic Indicators (“LEI”), a forward looking statistic often used as an indicator of economic conditions six months hence, was not encouraging. December’s figure of 0.3% (Chart A) increased mostly because the monetary base is expanding rapidly as the Federal Reserve is plugging the financial system with liquidity. Otherwise, for all of 2008 the LEI had its poorest showing since 1990, suggesting the economy will likely continue to struggle well into the first half of this year.

We are hopeful that the final version of this bill will have the right mass and provisions to kick-start our economy to recovery sooner than a more drawn out process would seem to advocate. Will conditions here in the U.S. improve without it? If you believe in the resilience of our economic system and the fact that our global trading partners have a vested interest in financial viability the answer is yes...eventually. But the shape of that recovery, and the experience of those who will pay the price of it getting worse before it gets better, would be improved by our policy makers getting this one right.

Chart A. GDP and LEI 1999–2008



Source: Parker/Hunter Asset Management



## So Goes the Year

By Gregory M. Drahuschak, Market Strategist

January began with optimism that the market malaise would end. Instead the Dow posted its fifth-straight monthly decline and the tenth down month in the last 13. The month also ended with the S&P 500 posting its worst January on record (Table B).

An old cliché says as January goes so goes the year, which made the loss in January even more poignant. The record of a poor January and how it affects February is mixed. In the 23 years from 1950 through 2008 that the S&P 500 posted a loss in January, the index registered a February loss 14 times (Table C).

Often it makes sense to take a contrarian view to data from some major economic measures like the ISM Index and the Conference Board's Consumer Confidence index. Lows reached in both of these measures frequently coincide with stock market bottoms. Charts D and E on page three, illustrate prior bottoms for the two economic yardsticks.

Clearly there is a corollary between lows in both indexes and turns in the market, but the key question at this time is whether we have reached lows for these measures. If unemployment continues rising, consumer confidence is likely to fall more and with it could come manufacturing, which would affect the ISM Index.

Although the major averages have been in an overall downtrend, as January ended there was some hope that the market was approaching a level that could at least stem the slide if not be a point where stocks could rally.

In our view the relevant levels for the S&P 500 and Dow Jones Industrial Average are roughly 800 and 7950 respectively. Moving below these levels could lead to a test of the respective November lows of approximately 741 and 7400.

A sign that the market's downside may be greatly overdone is that as of February 3 275 of the S&P's 500 stocks were below their 50-day moving averages.

In addition 483 of the 500 stocks are down for the last 12 months, and 286 of them have losses over the last five years. Another 37 stocks have five-year cumulative gains of 10 percent or less.

We continued to be troubled by what feels like a nearly universal belief that the market at least has to launch a short-term recovery rally. This belief is rooted in the fact that many technical indicators are at oversold levels that often presage rallies.

Table B: S&P 500 Worst January on Record

Month Year	Price	Pt. Change	% Change
January 2009	825.88	-77.37	-8.57
January 1970	85.02	-7.04	-7.65
January 1960	55.61	-4.28	-7.15
January 1939	12.3	-0.91	-6.89
January 1990	329.08	-24.32	-6.99
January 1978	89.25	-5.85	-6.15
January 2008	1378.55	-89.81	-6.12
January 2000	1394.46	-74.79	-5.09
January 1977	102.03	-5.43	-5.05
January 1941	10.07	0.51	-4.82

(Source: Janney Montgomery Scott)

Table C: January Losses Since 1950

January Year	S&P 500 result %	February Year	S&P 500 result %
1953	-0.60	1953	-2.30
1955	-0.33	1955	0.11
1956	-2.97	1956	2.98
1957	-3.20	1957	-3.05
1960	-7.18	1960	0.29
1962	-3.79	1962	1.63
1968	-4.38	1968	-3.12
1969	-0.82	1969	-4.74
1970	-7.65	1970	5.27
1973	-1.72	1973	-3.75
1974	-1.00	1974	-0.36
1977	-5.05	1977	-2.17
1978	-6.15	1978	-2.48
1981	-4.57	1981	1.38
1982	-1.75	1982	-5.59
1984	-0.92	1984	-3.89
1990	-6.88	1990	0.85
1992	-1.98	1992	0.96
2000	-5.09	2000	-2.01
2002	-1.56	2002	-2.08
2003	-2.74	2003	-1.70
2005	-2.53	2005	1.89
2008	-6.18	2008	-3.48

(Source: Janney Montgomery Scott)

It should be clear that merely because something happened in the past is no assurance it will happen again or in the same way as it has. Overwhelming belief in any market consensus is a reason to view the consensus skeptically.

Nonetheless, we see the same data others do and easily can see why some people feel a market rally is long overdue. At the same time it is imprudent to suggest aggressively positioning a portfolio for that outcome.

It, however, seems prudent to differentiate between an oversold rally and the start of a new bull market.

The market's willingness early in February to absorb bad news was encouraging. The jump in initial unemployment claims was substantial yet it did not exert selling pressure on stocks. The market likewise took the much-larger-than-expected loss of 598,000 non-farm payrolls in stride. Other poor economic news likewise produced muted market responses or no reaction as the market anticipated the much-debated fiscal stimulus plan and a plan to help the banking system.

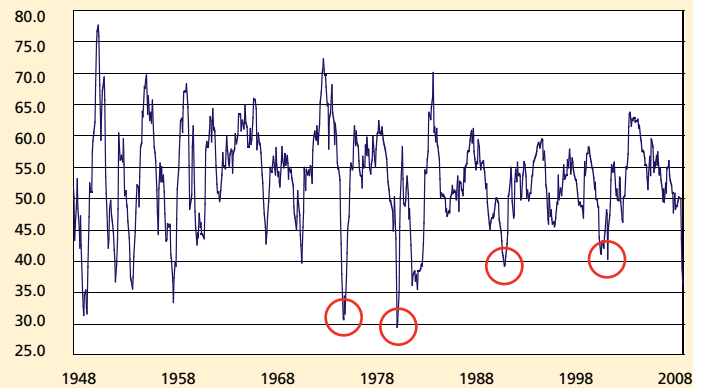
As noted previously, the extent of the market's drop over the last nine months and the market's internal technical condition point to good potential for a market rally. Once a rally starts it could be volatile and reach much higher levels than might seem to be likely. In S&P 500 terms, 1000 is not an unreasonable rally objective.

Aside from the market's near-term potential, we would note that the extent of the economic decline strongly suggests that getting the economy back on long-term solid footing will not be achieved easily or quickly.

Translating this to the market, in our view, means being more willing to take short-term profits when they present themselves. This entails using a good market rally to pare positions in anything where there is less the full confidence about either a firm's finances or long-term business potential.

Looking out beyond the short or intermediate-term, we would suggest considering commodity-related instruments that have as direct a connection to an underlying commodity as possible. Commodities should rise as the economy improves, but they also could provide a good inflation hedge. Early in February there were signs that many commodities were positioned for price increases despite the increasingly widely-held view that the economy is on the edge of deflationary period. Many equity positions might also be well-served holding modest positions in gold.

**Chart D: All-Time ISM Index**



(Source - data from Institute of Supply Management; Janney Montgomery Scott chart)

**Chart E: Consumer Confidence—Conference Board Index**

The year at chart bottom is February of that year.



(Source: data from Conference Board; Janney Montgomery Scott chart)

#### Market Summary

Description	MKTCAP	Daily	MTD	QTD	YTD
S&P 500	7192455	-2.28%	-8.57%	-8.57%	-8.57%
Utilities	331480	-2.39%	-0.83%	-0.83%	-0.83%
Health Care	1146392	-1.19%	-1.30%	-1.30%	-1.30%
Information Technology	1166403	-2.89%	-3.08%	-3.08%	-3.08%
Energy	1014055	-1.24%	-3.16%	-3.16%	-3.16%
Materials	218994	-3.67%	-7.24%	-7.24%	-7.24%
Consumer Staples	924124	-3.22%	-7.67%	-7.67%	-7.67%
Consumer Discretionary	589017	-2.94%	-10.64%	-10.64%	-10.64%
Telecommunications Services	267760	-0.96%	-11.06%	-11.06%	-11.06%
Industrials	763552	-2.48%	-12.66%	-12.66%	-12.66%
Financials	770678	-2.47%	-26.55%	-26.55%	-26.55%

(Source: Standard & Poors)

## New Tools for the Fed

By Guy LeBas, Chief Fixed Income Strategist

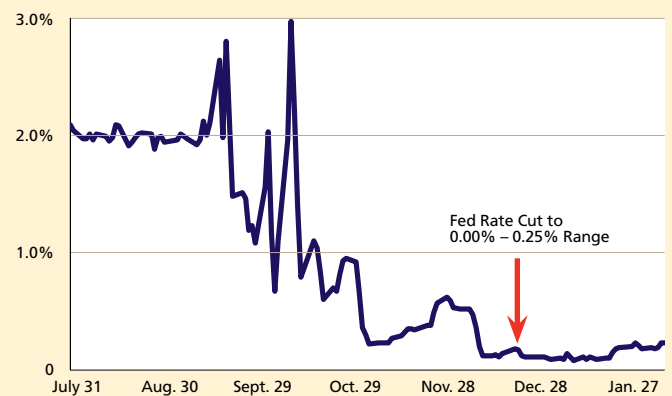


The Federal Reserve Open Market Committee met on January 26 and elected to maintain their target for interest rates stable at a range of 0.00% – 0.25% (Chart: F), a level of monetary policy unusual not only for its extremely ameliorative stance, but also its range rather than a specific level. While the decision was completely as expected, it leaves us wondering when true “Fed watching” (i.e., forecasting the fed funds rate) will return to vogue. With the FOMC committed to leaving short term rates extremely low for an extended period, our traditional skills in handicapping the Fed are largely moot.

In the meantime, the Fed has a limited range of tools open to affect monetary policy, namely lending directly to financial institutions and buying “stuff” (we’re no longer convinced it matters what they’re buying; Kenyan tea futures could well be next). As to the second of these two options, one oft-discussed subset is the potential for the Fed to buy up Treasury notes and bonds, not just the short term bills it typically uses to adjust interest rates. In January’s FOMC statement, the Fed for the first time formally noted that it’s considering this option: “The Committee also is prepared to purchase longer-term Treasury securities if evolving circumstances indicate that such transactions would be particularly effective in improving conditions in private credit markets.” The Fed’s evident interest in the program makes it likely that they will in fact embark on these Treasury purchases, though timing remains uncertain.

The argument behind Treasury purchases centers around two major concepts. First, Treasury rates represent a base upon which other fixed income investments, including mortgages especially, traditionally trade. So by purchasing longer term Treasuries, the Fed would be lowering this base rate and also help to reduce rates in the mortgage, ABS, corporate, and municipal markets, under the theory that the primary alternatives to these sectors, Treasuries, would be less attractive. The second major concept behind a potential Fed Treasury purchase program is the notion that reducing the returns on low credit risk, long term financial investments would stimulate real long term investment and thereby restore some measure of growth to the domestic economy. Take the case of a major pharmaceutical company considering investing in a research product that could take 15 years to yield results. When the alternative to investing in that project, a 15 year Treasury, earns a return of 2.00%, it’s much easier to justify investing in the research than it would be if 15 year yields were closer to, say, 5.00%. So by reducing the returns on financial assets, through a potential Treasury purchase program, the Fed would be attempting not only to ease the flow and cost of credit in other markets, but also to stimulate real, rather than financial, investment.

Chart F: Fed Funds Effective Rate



(Source: Federal Reserve Bank of New York)

We believe that the Fed has too much skin in the game to not pursue some form of Treasury purchase program, though we expect efforts to “talk down” the Treasury markets before implementing. A talk down is essentially a freebie for the Fed—which brings us back, full circle, to January’s FOMC statement. We have a sneaking suspicion that the Fed, but noting explicitly that it’s considering purchasing Treasuries was trying to gauge how deeply expectations of such a plan were priced in to the Treasury markets. A rally on statement release would have suggested that the Treasury markets aren’t pricing in such an eventuality and, as a result, a Treasury purchase plan would be more successful in driving rates lower. Instead, however, the Treasury markets experienced a substantial wave of selling that was re-doubled after Poole’s Thursday morning comment. The sell off sends a bad signal to the Fed: their Treasury purchase program was already largely priced into the markets, meaning that any purchases would have to be larger than the markets anticipate to have a substantial effect in driving interest rates downward. In the coming weeks, we expect Bernanke and other FOMC members to continue “testing the waters” on a Treasury purchase program in speeches and public appearances. Actual implementation of a purchase plan—which, again, is something we anticipate, though not with 100% confidence—would more likely come with the March 17 FOMC meeting. Though there is a potential for an intermeeting announcement on the same timeframe as the Mortgage Purchase Program (MPP), a more controversial decision such as this one will likely take the consent of the entire FOMC.

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