

Whatever it Takes

By Mark Luschini, Chief Investment Strategist



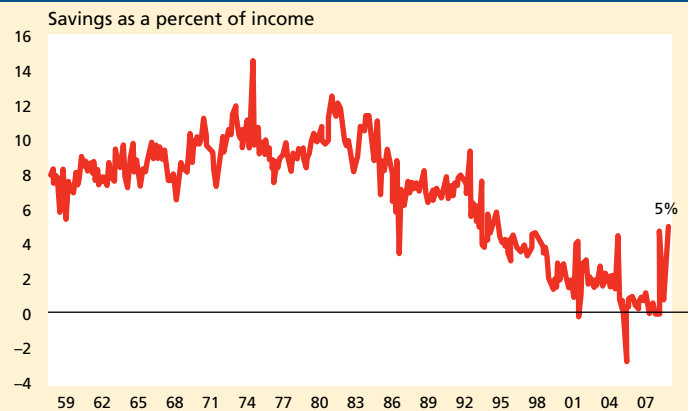
The Federal Reserve was very sensitive to the risks that might emanate from the inevitable bust of the technology bubble that developed in the late 1990s. A paper published in mid-2002 noting the threat of deflation, stated "stimulus, both monetary and fiscal, should go beyond the levels conventionally implied by baseline forecasts of future inflation and economic activity."

Fast forward to today and we find on the monetary front the Fed seems to be operating right out of that playbook. By pushing down interest rates and expanding its balance sheet it has indicated that it will do whatever it takes to restore functionality to the credit markets. Unfortunately, the Fed's efforts have had a limited impact, so far. Banks, which have been the recipient of the Fed's liquidity injections, have been holding cash rather than boosting their lending. Meanwhile, the Term Asset-Backed Lending Facility (TALF) announced by the Fed last November has yet to get started although hopes are that it brings much needed liquidity to the market by circumventing the banks. Some worry that the Fed is taking huge inflation risks in pursuing its massive monetary intervention. While true that it may be a problem down the road, the more immediate concern is the threat of deflation, inviting the Fed to error on the side of too much rather than too little.

Monetary stimulus is being matched in effort by the Obama administration's willingness to reflate the system by throwing billions of dollars in to programs such as the \$700 billion Troubled Asset Relief Program (TARP), the \$787 billion stimulus package, the \$275 billion housing rescue plan, and money to shore up banks and other financial institutions through the trillion-dollar-plus Financial Stability Plan. Some of this money will be invested in such a way that the taxpayers may actually see a return on their investment as conditions improve. However, the cash still needs to be spent up front meaning borrowing through huge amounts of Treasury bond issuance are in order. The alternative, including declining asset values—be they stock market or home prices, and further deterioration of economic activity, which has already burned on for 15 months at this juncture—is far worse.

In order to stave off at least some of the effect lower asset values have had on household net worth, private savings have begun to rise as consumers retrench (Chart A). Unfortunately, this paradox of thrift is problematic for the economy at the moment.

Chart A: Personal Savings as a Percent of Disposable Personal Income



(Source: Bespoke Investment Group)

The more people try to save, the less they spend—further weakening the economy—which undermines incomes as jobs continue to be lost. Perhaps somewhat perversely, efforts by consumers to repair their personal balance sheets create a negative feedback loop that works counter to what is needed to resuscitate the economy—spending. Thus the government has substituted for the consumer in taking extraordinary measures to stimulate economic activity. The government will pay whatever interest rates the markets require in order to fund its borrowing needs. Likely, the ability to draw investors to purchase our debt will require overseas buyers to expand their appetite making the U.S. vulnerable to the varying interests of counter parties.

Economic activity is far below potential and may remain so for years, implying there is little risk of inflation anytime soon. In fact, the near-term threat is deflation, not inflation. However, the longer-run is another story. Eventually demand will recover putting upward pressure on interest rates. Inflation could also escalate if the Fed is slow to unwind the recent build out of its balance sheet. For policymakers, it appears that the risk of an imbalance ensuing due to a monetary or fiscal overshoot is less of a threat than a painful, if healthy, washing out of the excesses.



Sent for a Loop

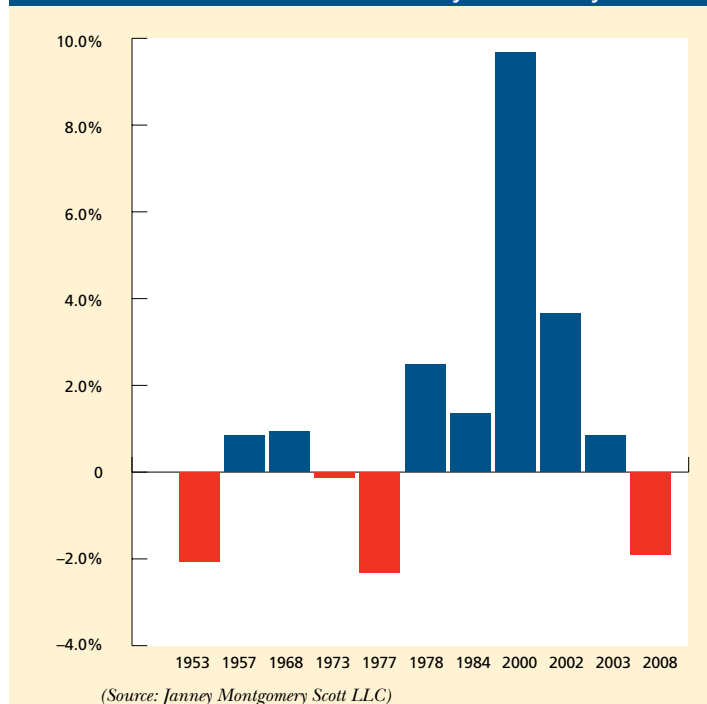
By Gregory M. Drahuschak, Market Strategist

Prior to 2009 the S&P 500 had posted back-to-back losses in January and February only eleven times since 1950. In seven of those years the S&P rebounded in March (Chart B). Hopefully this will be the eighth year that March produces a rebound following losses in the two opening months of this year.

February's S&P 500 loss this year (down 10.99 percent—the worst for the month in the last 59 years) followed an 8.57 percent loss in January, which was the worst loss for that month since 1950.

In the eleven prior years that the S&P fell in both January and February, the index managed to post a gain for the entire year only four times 1968, 1978, 1984 and 2003.

Chart B. March S&P 500 Results after January and February Declines



Most investors do not need to be reminded of how devastating the market decline has been, but the extent of the decline has a positive side.

As of March 3, slightly more than 20 percent of the S&P 500 were 80 percent or below their five-year highs. Seventy-four percent were down 50 or more percent. Approximately 42 ½ percent of the S&P 500 was only ten percent or less above their five-year lows. At present there is enough money market cash on hand to buy 46% of the entire S&P 500. More than 20% of the S&P stocks trade in single digits. Forty-seven are below \$5 a share and six are below \$1.00. Forty (40) percent of the S&P 500 today would not qualify to be added to the index.

A five-year period may not be sufficiently long enough to provide a fool-proof gauge to determine if the market decline has been overdone, but based on anecdotal evidence as well as technical factors the market early this month was as oversold as we have seen in decades. The extent of the losses suggests that once we get a rally started it could be extremely strong even if all the market did was to bring the extent of losses back to an average level for many of the bear markets experienced over the last 30 years.

As interesting as historical market patterns may be, we acknowledge that their usefulness has declined significantly in recent years. Economic data analysis also has fallen on hard times and reminded investors why the study of economics has been dubbed the dismal science.

Instead of traditional data analysis, many people are beginning to recognize that the relatively new study of behavioral economics might be the best way to determine what will happen in the economy.

Behavioral economics in a very general sense has been around for more than half a century. Essentially it attempts to apply psychological principles to the economy.

Nonetheless, as traditional economic measures fail to offer solid guidance, some general principles of behavioral economics could be helpful. An overly simplistic but still fair characterization of behavioral economics is to suggest that we do as we feel. If we have a good feeling about our individual fiscal positions we are likely to be more willing to spend and invest. Conversely, if we are ill at ease we tend to pull back.

The concept of a negative feedback loop is in place now. If a business person who feels good about their position hears that the economy is poor that person in time is likely to cut spending or expansion plans. This in turn will add to weakening economic stats, which then will prompt more concern for the person that initially felt good about business prospects.

This also works in reverse—a positive feedback loop—but clearly these days the negative loop is the prevalent condition.

Feedback loops are not easily altered. They tend instead to take on a life of their own that clearly lasts at least for months and can exist for years. A negative feedback loop applied to stocks suggests that emotion-driven selling in many cases might be the primary motive for many investors, but a very understandable one considering the news environment that almost daily reinforces the negative feedback loop.

At this time the dangers of being caught up in a negative feedback loop creates the risk of making terribly wrong decisions.

Washington is awash in an alphabet soup of plans aimed at stemming credit market problems. The failure has been that no one seems to appreciate that a constant barrage of negativism and the lack of clarity adds to the negative feedback loop, which is counterproductive. Perhaps, however, there is an appreciation of the impact of reinforcing negatives which may be exactly what some legislators want in order to rush through various packages they favor.

At this point the market is long overdue for a substantive rally; the timing of which is elusive but it could come at virtually any moment. At the same time it appears that an initial upside thrust probably will not be the start of a lasting upturn. Any rally attempt has to be examined closely to determine whether or not it has the necessary characteristics to be self-sustaining.

2009 Market Data		Prior Close	Last	Change	% Daily	% YTD	% Jan.	% Feb	% Mar	1st Qtr.
D J Industrials	.DJIA	6875.84	6594.44	(281.40)	(4.09)	(24.86)	(8.84)	(11.72)	(6.63)	(24.86)
S&P 500	SPX	712.87	682.55	(30.32)	(4.25)	(24.43)	(8.57)	(10.99)	(7.15)	(24.43)
NASDAQ Comp	COMP	1353.70	1299.60	(54.20)	(4.00)	(17.59)	(6.38)	(6.68)	(5.68)	(17.59)
SOX Index	SOX	191.49	200.27	8.78	4.59	(5.61)	(1.84)	(5.11)	(0.60)	(5.61)
Biotech Index	BTK	583.32	556.26	(27.06)	(4.64)	(14.05)	(1.95)	(6.01)	(6.73)	(14.05)
DJ Transports	.TRAN	2405.72	2241.43	(164.29)	(6.83)	(36.63)	(16.16)	(15.73)	(10.31)	(36.63)
DJ Utilities	.UTIL	307.35	296.26	(11.09)	(3.61)	(20.09)	(0.29)	(12.37)	(8.55)	(20.09)
Volatility Index	VIX	47.56	50.17	2.61	5.49	25.43	12.10	3.37	8.24	25.43
S&P Midcap 400	MID	432.02	411.09	(20.93)	(4.84)	(23.63)	(7.36)	(9.87)	(8.53)	(23.63)
S&P 100	.OEX	337.95	324.25	(13.70)	(4.05)	(24.86)	(9.33)	(11.01)	(6.88)	(24.86)
Gold ETF	GLD	88.99	91.99	3.00	3.37	6.32	5.54	1.45	(0.69)	6.32
Russell 1000 Index	.RUI	387.33	370.83	(16.50)	(4.26)	(23.97)	(8.29)	(10.67)	(7.20)	(23.97)
Russell 2000 Index	.RUT	371.30	349.45	(21.85)	(5.88)	(30.03)	(11.20)	(12.29)	(10.17)	(30.03)

Source: Standard & Poor's

Government action goes boink?

By Guy LeBas, Chief Fixed Income Strategist

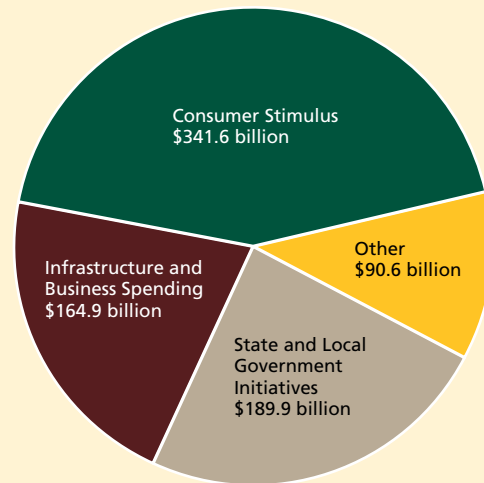


If no one can remember the last time two \$500 billion plus pieces of government action were announced/passed in the course of seven days, that's probably because it's never happened before. Following February's unveiling of TARP-2, a revamped plan clear only in its opacity, Congress passed and President Obama signed into legislation a \$787 billion behemoth of a fiscal stimulus package now dubbed the American Recovery and Reinvestment Act of 2009, or ARARA (Chart C). Including the Federal Reserve's contribution to TARP-2, the stimulus bill brings the total one week price tag of government action to a whopping \$3.19 trillion. That's an impressive figure, and in ordinary times, that TARP-2 announcement would be more than enough to send the financial system into a euphoric state and the stimulus package more than enough to provide an economic jolt, but these are no ordinary times.

There's no easy conclusion to draw from the announcement on the structure of the revamped TARP plan, largely because there were no easy details present in Treasury Secretary Tim Geithner's announcement. On a conceptual level, the TARP-2 contains four major provisions aimed at supporting banking system capital, removing hot stove assets from bank balance sheets, fund increased consumer and business lending, and create a barrier against further homeowner foreclosure. While it's clear that the goals of TARP-2 are oriented in the right direction, the success or failure of the plan will depend on the details, which are fraught with potential devils, including the most troubling of all: how to price the hot stove assets the Treasury proposes the Public-Private Investment Fund will purchase. Until we see further details fleshed out, we remain skeptical that any program will be able to stimulate confidence in the financial sector. The markets, judging by the swift and sustained rise in Treasury prices and drop in the S&P 500, seem to agree.

As for the economic stimulus package, the ARARA, there are a number of components which show promise—namely the spending portions of the bill—and a number of components which don't—namely the tax cut provisions. Though ARARA's size, both in dollar terms and in pages is impressive, whether the stimulus package has the desired effect on the domestic economy and financial system is yet another matter. At the end of the day, there are too many moving parts in today's economy and financial system to render precise expectations, but in general, we're optimistic that the program, which represents 5% of GDP, will provide a needed boost. Still, there's likely to be some unforeseen fallout that could cause subtle provisions of the bill to cause collateral damage in the capital markets.

Chart C: Stimulus Package Breakdown



(Source: ARARA 2009)

It's important to remember a few things in the broader context of stimulus packages: first of all, these things take time to work. Tax rebates take time to mail, credits take time to hit the bottom line, and even infrastructure spending projects take time to launch, shovel-ready or not. In that sense, there's unlikely to be any significant benefit from the ARARA, save for improved confidence, for at least three months down the road. Moreover, even in an optimistic case, the maximum impact of the \$787 billion in tax cuts and spending projects won't hit until early 2010. Second of all, there's simply not enough government capital out there to replace the amount of private capital that's been withdrawn from the economy and financial system. While government spending projects can take up slack in times of weakness, even countries with a more socialist tilt have long-run government spending plans which represent a relatively small fraction of total GDP. In that sense, the American Recovery and Reinvestment Act is not, and in fact cannot be, a panacea for all of our economy's woes. Even if the bill were perfectly designed by all economists' standards, the domestic economy would still be facing falling output, at least through the first half of 2009. What aggressive government spending can do, however, is the limit the pace and severity of a decline and, perhaps more importantly, buoy the spirits and spending desires of consumers, who still, despite recent pullbacks, account for more than 70% of total activity.

JANNEY MONTGOMERY SCOTT LLC

1801 Market Street, Philadelphia, PA 19103 • 215.665.6000

WWW.JMSONLINE.COM • Member: NYSE • FINRA • SIPC

The information is sent to you for informative purposes only and in no event should be construed as a representation by us or as an offer to sell, or solicitation of an offer to buy any securities. The factual information given herein is taken from sources that we believe to be reliable, but is not guaranteed by us as to accuracy or completeness. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation or needs of individual investors. Employees of Janney Montgomery Scott LLC or its affiliates may, at times, release written or oral commentary, technical analysis or trading strategies that differ from the opinions expressed within.