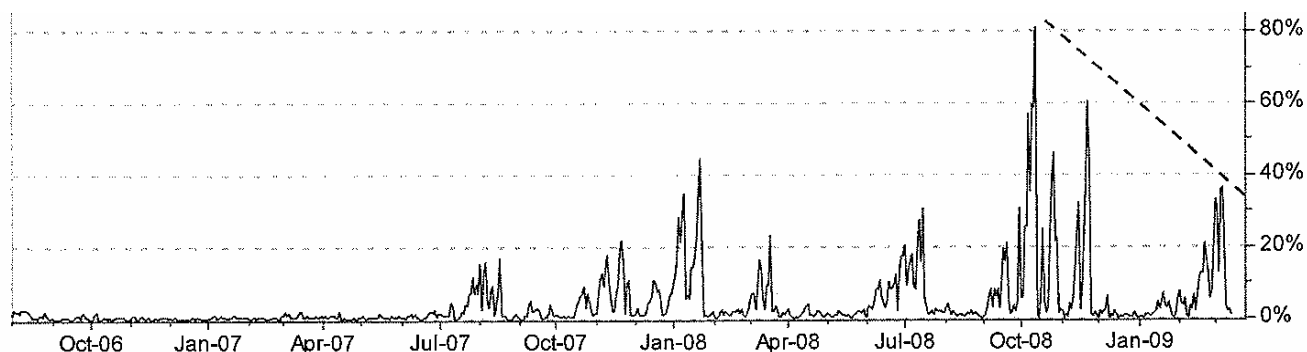


After more than a year of the Federal Reserve and Treasury Department leading economic policy the first quarter saw some of the first tastes of the new administration's fiscal policy: massive spending programs and plans for tax increases. Unfortunately, the President is not following the lessons taught in a 2007 paper written by one of his leading economic advisors, Christina Romer, and her husband. In that paper the Romers concluded that "tax changes have very large effects on output." They found that a "tax increase of one percent of GDP lowers real GDP by roughly three percent." Whether it was tax increases on income or carbon, these likely policy directions made investors question when a recovery would take place. With these doubts, already jittery markets remained extremely volatile. For the first several weeks of the new year volatility reigned but when netted out little was gained or lost. Then, on February 10, Treasury Secretary Geithner lost the market's confidence. In a speech where the outline of a plan to help the banking industry was expected, the Secretary reported that no plan had yet to be put together. The stock market lost five percent that day and continued lower for the next month losing nearly a quarter of its value.

A month later, with stocks at their nadir, things began to change. The Treasury Department had a plan, home sales and permits began to rise, and positive comments from Fed Chairman Bernanke began a rally that has retraced the February decline and brought us back to the range the market indexes have been in since last October.

Whether this is just a bear market rally or the beginning of a new bull market is a subject much debated. There is evidence that points in both directions. But as the recession goes on I think the evidence becomes stronger that this bear market may have seen its worst. First, there are many technical indicators which make this rally look promising. One is the number of stocks making new lows as the market index was declining. Chart 1, courtesy of the ISI Group, shows that over 80% of stocks hit new 52 week lows at the bottom of the market last October. The November low for the index was lower than in October, but note that the number of stocks hitting lows declined to about 60%. The pattern repeated when the market bottomed in March, a lower low for the index yet the number of stocks hitting lows fell to about 37%. This pattern

**CHART 1. 52-WEEK NEW LOWS AS A PERCENT OF ISSUES**



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shows that investors are becoming more discriminating about what they are selling, and that is positive.

Another positive, for contrarian investors, is the bearishness that pervades. In March, investor surveys showed bearishness at its highest level in the last twenty years. Despite the rally, bearishness remains quite elevated, another positive.

What will really determine whether a sustainable advance in stocks can occur is a recovery in the economy. According to one of my research sources, there have been 570 global policy initiatives in the past twenty months. More than three quarters of them have been in the past six months. Chart Two shows a chart of the ISI Company Surveys. This research firm compiles weekly survey data of companies from many industries, forming an index in which high levels indicate good business conditions. Late last year, as the markets were in a panic and consumers stopped spending, the index quickly fell to the very low levels they are at today. The positive side of the story is that they have stabilized for the last three months and are now at the highest level they have been at all year.

**CHART 2. ISI GROUP COMPANY SURVEY INDEX**



Mimicking the collapse in the company surveys Chart Three from Barclay's Capital shows how industrial production (blue line) is very weak. Note the close relationship between the gold (consumption) and blue lines. It makes sense that there should be a close relationship between consumption and production and usually there is. But not now. Although consumption has been weak companies appear to have over-reacted and sold off inventory rather than produce new goods. At some point companies will run out of product and have to start producing again.

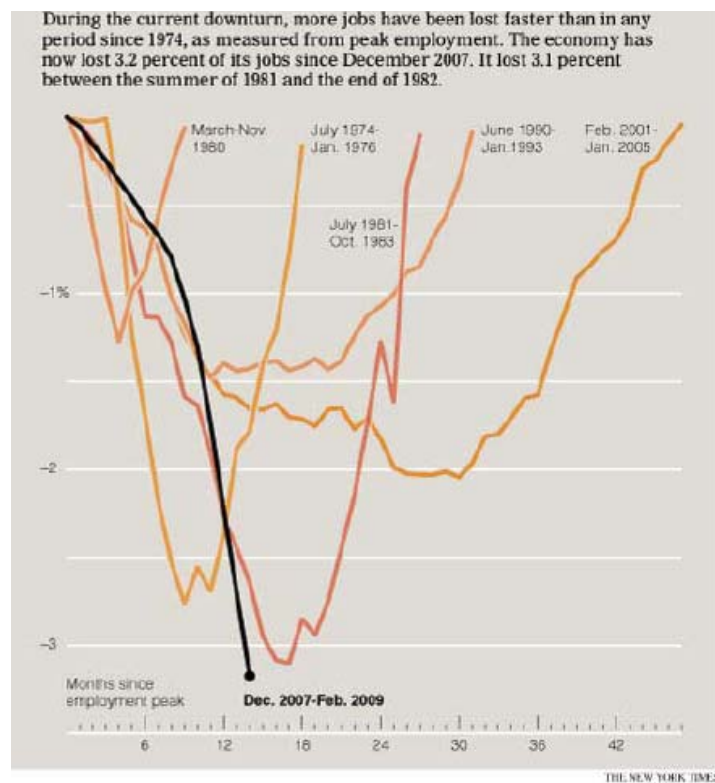
More specifically, there have been several fundamental indicators that appear to be stabilizing in recent weeks. US car sales, consumer confidence, retail sales and housing starts have all moved to higher, albeit at very low, levels. Purchasing Manager Indexes in Russia, Hong Kong, Poland, India, UK, Spain and Japan have moved higher. The same can be said of industrial production in Brazil and Korea.

### CHART 3. MONTH-TO-MONTH PRODUCTION VS. CONSUMPTION



I have seen economists' estimates deteriorate over the past several months and now the recovery is not expected to begin until next year. The forecasts also call for a shallow recovery. In fact, they seem to be expecting the same kind of recovery we have experienced over the last couple of recessions. Given the very steep and severe decline we have just experienced and the huge monetary and fiscal responses all over the world, I will not be surprised if the recovery is stronger than most envision. Chart Four from The New York Times, shows job losses in the last

### CHART 4. JOB LOSSES IN RECENT DOWNTURNS



several economic downturns. Employment statistics are lagging indicators, and so can't be used for timing recoveries, but, they do tell a story about historic economic recoveries. Note how long it took for the employment figures to brighten during the recessions of the 1990 and 2001. Overall job loss was muted as were the recoveries. The present day employment picture looks much more like the cyclical downturns of the 1960s, 1970s and 1980s. Job losses were sharp but so were the recoveries.

Another lesson to take away from Chart Four is that this recession is nothing new. Our economy has been through recessions before and it was not the end of the economy. If anything, these periods can cleanse the system. Consider the retail environment today. Linens and Things and Mervyn's have both disappeared. These were

companies that grew on debt and were unable to survive a credit crunch. The category survivor, Bed Bath & Beyond, has grown without loading their balance sheet up with debt. They were

able to survive the crunch and will emerge a strong company in a much more benign business environment.

All that said, there are still many things to be concerned about. The banking system is not healthy yet. There is talk of tax increases and protectionist tendencies that could be counterproductive. It is still difficult to get a loan for many borrowers indicating the credit crunch is alive and well.

Still, the TARP and TALF, capital infusions, even a modest improvement in the mark to market rules are all moving the banking system in the right direction. The fact that housing starts have increased shows there is lending going on in the system. And, we have those 570 policy initiatives by the world's governments worth tens of trillions of dollars. We even have our stimulus package passed by Congress whose major impact won't be for a couple of years. By then we may need it as much of the current accommodation is being reversed.

We are becoming less defensive and are investing with an eye toward economic recovery. For stocks this means a renewed focus on companies with greater sensitivity to economic growth. For bonds this means we are looking to benefit from the premium yields available in sectors such as corporate bonds. We are also looking to focus more on domestic businesses and assets as it is likely that our economy recovers first which should provide support for the dollar.