



Investment Commentary

Quarter Ended March 31, 2009

A March rally in stocks closed another very difficult quarter for most financial assets. Volatility in equities was extreme, as both bull and bear markets (up/down 20% or more) occurred during the period; moves of this magnitude often take years to develop. However, in contrast to last year's universal collapse, there was a wide divergence in results. Not surprisingly, those market sectors most damaged through last year's decline, generally the more speculative asset classes, rebounded the most in the late quarter rally. Always a telling measure, dividends experienced their worst quarter in over 50 years. In fact, S&P 500 companies cut dividends by \$42 billion in the first quarter, more than the record \$40 billion that was eliminated during all of 2008. While the majority of dividend reductions occurred within the financial sector, companies in virtually every industry are striving to improve liquidity and shore up balance sheets.

Considering the panicked state from which it started, segments of the credit market showed signs of improvement as the quarter progressed. A raft of government programs helped to stabilize short-term debt markets worldwide, and foster a surge of new bond offerings by high quality companies.

Outside of this realm, however, the fixed income world remains perilous. Lower rated companies can borrow only at rates approximating 15-20%, while the securitization market, formerly a primary source of funding for many consumer related industries (autos, credit cards), remains dormant.

A Different World

Financial markets currently face more uncertainty than at any time in decades, with this fact reflected in asset prices of all kinds. Treasury yields remain historically low, credit spreads high, and stock prices under pressure. Most attribute the continuing distress to the severity of the ongoing recession, pointing to troubled banks, rising unemployment, indebted consumers, and a depressed housing industry. While there is no debating these negatives, each was present last year and is, therefore, old news. Moreover, no one should be surprised that the economy and corporate earnings remain under duress at this point. **Something new had to occur for the weakness in financial assets to accelerate as it did in the first quarter. In our view, that "something" has taken two forms: (i) a massive increase in government involvement in the economy and (ii) potentially ill-timed policy making.**

Left to the powerful forces of free market capitalism, recessions run their course, and bear markets give way to bulls. **Over long periods, the US economy has shown an amazing propensity to fix itself, even when the outlook was bleak.** For example, recall when the Japanese could do no wrong in the 1980's, and America had, supposedly, been left behind. Indeed, despite the very real and serious problems, we have opined that the current economic recession would not morph into Great Depression II because neither the Federal Reserve nor our elected officials would make the same mistakes that led to the 1930's depression (tightened monetary policy, trade protectionism, and higher taxes). We got the first part right, as the Federal Reserve has both lowered interest rates to near zero and committed to purchase nearly two trillion dollars of Treasury and mortgage-backed securities in an

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“Financial markets currently face more uncertainty than at any time in decades, with this fact reflected in asset prices of all kinds.”

effort to revive the credit markets. Remarkably, however, the new administration and Congress have started down the path of perhaps the gravest of missteps made during the 1930's, that of enacting protectionist economic legislation. Specifically, the “Buy America” provision in the recent stimulus bill mandates that American steel be used in all tax-payer funded infrastructure projects, and reeks of Smoot-Hawley and other protectionist legislation that caused enormous damage in the past.

Potentially as harmful, the Congress has committed to raising both corporate and personal income taxes. For the record, the US already has one of the highest corporate tax rates in the industrialized world, taxing profits at 35% and then taxing the same earnings again when they are passed along to shareholders in the form of dividends. Of equal concern is the prospect of raising individual tax rates on earned income, capital gains, and dividends. These trade and tax policies warrant vigorous debate during the best of times, though are unthinkable during a severe economic downturn. Protectionism reduces trade and hinders profits. Higher taxes, particularly those on small business, reduces employment, as growing companies have always been the driver of new job creation. Through time, capitalism spawns occasional booms and busts. Having just

ended a period of egregious excess, the US is now moving in a radically different direction. **A veritable alphabet soup of government programs (TARP, TALF, TGLP, PPIP) have been created to bail out companies and industries that have been deemed too big to fail, and consumers who were, in many cases, reckless with their finances.** While some argue that dramatic action is required, it is ironic that the Treasury/Federal Reserve is mimicking the policies of the early 2000's that created the current economic and credit debacle in the first place, that of excessive borrowing and spending. Ben Franklin is reputed to have said that “the definition of insanity is doing the same thing over and over and expecting a different result”, a thought worth remembering today.

More lasting in importance, the US government now has, or will have, major influence over many of America's most important industries, including financial services, auto, health care, and energy/utilities. Our Founding Fathers would likely be mortified to see government micro managing the economy, and playing favorites in the process. Foretelling our current state, Thomas Jefferson opined “I predict future happiness for Americans if they can prevent the government from wasting the labors of the people under the pretense of taking care of them”. **In the short run, unprece-**

dent government measures have helped support the economy, and will hopefully shorten the duration and magnitude of this difficult recession. Longer term, we worry that big government will crowd out private capital, induce higher inflation, and reduce the growth rate of GDP. One must look only as far as “old Europe” to see the damaging effects of government interference with capitalism.

With so much government led “stimulus” and support, the world has been flooded with US dollars. **While a near-term stabilization of the economy is likely, these are immense activities in size and scope, and the unintended consequences over time may be dramatic.** As noted, one obvious risk is that of accelerating inflation, a condition that has historically been detrimental to investors and savers alike. Another is that certain industries may suffer disproportionately from government scrutiny. These developments will merit our attention going forward, and may cause us to adjust investment strategy accordingly.

The Markets

Of late, investors have enjoyed a long awaited stock market rally. Beginning March 9th, the S&P 500 took a mere 13 days to surge 21%, marking the fastest 20% rebound from a bear market low

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since 1938. This advance is not surprising, since **when markets fall dramatically, as they have, all that is often required for a move off the bottom is for circumstances to become less bad.** To this point, while economic conditions remain weak, the rate of deterioration has definitely slowed. Recent data on housing, durable goods orders, and manufacturing have improved marginally. Rising commodity prices, including copper, lumber, and oil, also suggest that the global economy may be starting to improve.

While headwinds remain, a more constructive view on the current stock rally might be warranted were it not for the abysmal activity among all but the highest quality corporate bonds. Investment grade bonds rallied in January, but have fallen again of late, refusing to advance in tandem with the stock market. Debt of financial services companies has been particularly weak, trading at their lowest levels since Lehman Brothers failed. Presently, corporate debt is pricing in default levels far worse than at any time in history. By some estimates, prices suggest a default rate of 25% over the next five years; to put this in context, the worst five-year default rate since 1970 is only 2.4%. The current market environment means one of two things: the economy is headed for deeply troubled times or, bonds are absurdly cheap. While economic condi-

tions are clearly unsettled, it seems reasonable to expect that the vast majority of investment grade companies will work their way through the current turmoil. If this statement proves accurate, debt maturities will be met.

Where Do We Go From Here?

As to the ubiquitous question of whether stocks have bottomed, our view is that we have witnessed the low (Dow 6,500) **if** the President's budget proposals are moved to "the middle", and **if** Congress enacts no further damaging legislation on the trade front. If not, and huge government intervention is more than a temporary force, protectionist policies persist in angering our trading partners, and significant tax increases are used as a piggy bank to fund large government programs, then stocks may fall sharply from current levels. These are not meant as political statements, rather are observations of economic and financial market history.

The last seven months or so have been the most challenging period in generations for investors. Extraordinary events, seemingly on a daily basis, have created dramatic changes in the investment landscape, and challenged the basic tenets of investing and risk management. Indeed, risk has popped up everywhere, even in places that were unthink-

able in the past. In coming months, the weak economic and earnings picture will likely sustain a cloudy outlook for financial assets. Longer-term, though, many time-honored elements of successful wealth management remain relevant. While few strategies fully avoided this bear market, buying low and selling high is still a reasonable goal. If you add balance, diversification and patience to the notion of owning quality companies at reasonable prices, it doesn't sound so far-fetched that equity returns will be rewarding again. Over the near-term, fixed income instruments should continue to offer reasonable returns when compared with inflation. Finally, and most importantly, it is critical that investors are comfortable with their investments – what they are, how they are allocated, and the extent to which near-term liquidity is required. It is this comfort that will enable all of us to work through today's trials and take advantage of the better days that surely lie ahead. 🌟

Managing Director Profile



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John J. Sobel
Managing Director

John has over 17 years of experience in the investment industry. He joined Lodestar in 2000 after holding the position of Portfolio Manager with Salomon Smith Barney in Seattle, Washington.

John earned his undergraduate degree (BA) from the University of California at Los Angeles, and received a Master's in Business Administration degree from the University of Washington in Finance and Marketing.

In addition to spending time with his family, and involvement in community affairs, John enjoys an annual fishing expedition to the ocean waters off the southwest coast of Alaska.

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Market Snapshot - March 31, 2009

<u>Equity Indices</u>	<u>Quarter</u>	<u>Interest Rates</u>	<u>3/31/09</u>	<u>3/31/08</u>
S&P 500	(10.98)%	5-Year Tax-Exempt AA	2.22%	3.02%
Dow Industrials	(12.42)%	5-Year US Treasury Notes	1.77%	2.57%
NASDAQ	(3.07)%			
Wilshire 5000 Index	(10.72)%	<u>Commodities</u>		
		Gold	\$916.50	\$933.50
		Oil - WTI (\$/Barrel)	\$49.66	\$101.58

“Lodestar”: 1 *A guiding principle, interest, or ambition.* 2. *A star, especially Polaris, that is used as a point of reference.*

Lodestar Investment Counsel was formed in 1989, as an independent registered investment advisor, with the above definitions firmly in mind. All of our principals have extensive experience working with high net worth individuals, families, corporate and individual retirement plans, and charitable organizations, like those who make up our client base today.

We recognize and respect the need to grow and preserve our clients' core

assets. Our services are designed to provide a risk-averse approach to long-term capital appreciation, that is tailored to the unique financial circumstances and needs of each specific investor. We provide discretionary account management for taxable, tax-exempt, balanced and fixed-income portfolios.

To assure that all our clients receive a high level of personal service, our minimum account is \$1 million in investable assets. In all aspects of our

business, we strive to adhere to the guiding principles of focus, consistency and service.

We would welcome the opportunity to meet with you, or others you know who might benefit from our services.

*Robert H. Dearborn
Peter W. Flanzger
William A. Goldstein
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