



## 2009 – 1ST QUARTER REVIEW AND PREVIEW



### BOB'S CORNER

Did anyone see Ben Bernake's interview on the March 15<sup>th</sup> 60 Minutes show? Very impressive particularly as he reiterated many of our same thoughts on the economy and market over the last 9 months. In essence, he believes like us, that patience is going to be the key during this bottoming of the cycle.

Typically we see about a five month bottom or consolidation time period before the market starts to show a solid and consistent upward trend. We both agree that this time around it will take longer and more likely be 10-12 months in total. This takes us to November or December of this year. He also stated his belief in the American process and our ability to facilitate change. We have been talking to this point for six months, and although we would like to see the changes come quicker, it is still much better than the Japanese 1990 crisis that took almost 12 years before any credible changes were made to their banking industry. The Nikkei index went from 39,000 to 7,500 and until 2003 did not climb over 15,000. This will not happen in the United States!

As part of our continued effort to keep you informed and hopefully, a little more at ease, we started Bob's Blog a few months ago. We write our thoughts every Tuesday for your reading enjoyment. You can find this on our website at [www.allstarfinancial.com](http://www.allstarfinancial.com), along with our quarterly newsletters and weekly market wraps. It has been a challenging time in the business of managing money and emotions, but I hope you will find some comfort in knowing that our process has enabled us to foretell the downside coming. If you have a chance, reread our newsletters starting in the fall of 2006. It is kind of scary how close we came in the timeline of the market downturn. What we failed to do is comprehend how extreme the fall would be.

Thank you for your continued trust in the All Star Team!

## NO PAIN, NO GAIN!

### MARKET OVERVIEW

The year began with the U.S. economy squarely in the middle of its steepest slowdown since the early 1980's and experiencing its worst financial crisis since the Depression. While many efforts have been made to draw comparisons between today and earlier periods in our economic history (as well as Japan's "lost decade" of the 1990's and the recession of 1973-1975), it is clear that this slowdown features characteristics all its own. This crisis, created in large part by an overheated and under-regulated financial marketplace, will likely result in major changes to the financial and banking systems.

A notable difference between today's recession and the experiences of Japan in the 1990's and the 1930's Depression is that government response has been *massive* and *swift*. It should also be noted that unlike the downturns of the 1970s and 1980s, Americans are not confronted with crippling inflation.

A combination of fiscal and monetary stimulus has injected literally trillions of dollars into the system in an effort to keep the engines of the economy lubricated and functioning. In the first quarter of 2009, those initiatives included:

1. \$800 billion of fiscal stimulus through the American Recovery and Reinvestment Act of 2009. The package includes tax cuts, tax incentives, infrastructure investment, healthcare and education funding, as well as aid to cash strapped local and state governments.
2. \$700 billion of Troubled Assets Relief Program (TARP) funds continuing to be provided to struggling banks and AIG. General Motors and Chrysler also received government loans through the use of TARP money. Some banks are already discussing plans to repay the money they received.
3. \$218 billion in new bank guarantees from the FDIC, lowering the cost of funds for banks and consumers.
4. \$250 billion in commercial paper funding provided by the Federal Reserve (the Fed) to help corporations finance business activity through the crisis.
5. \$300 billion in Fannie Mae and Freddie Mac mortgage debt purchases by the Federal Reserve to help keep mortgage rates low.

The Fed provided an additional \$1 trillion in liquidity during the credit crisis and indicates it will keep interest rates near the 0% level "for the foreseeable" future. The total commitment from the Federal Reserve, the U.S. Treasury and Congress is just shy of \$4 trillion, equal to 25% of the nation's Gross Domestic Product (GDP). The impact may take some time to be fully realized, but policymakers have made clear their plan is to beat this recession into submission. A turnaround in the economy could happen more quickly than many market pundits predict.

### ECONOMY

#### THE 1ST QUARTER

The government reported a 6.3% decline in the nation's GDP for the 4<sup>th</sup> quarter of 2008, and all indications are that the 1<sup>st</sup> quarter of 2009 experienced a similar contraction. Consumers and businesses pulled in the reins on spending. Personal spending declined for two consecutive quarters in the second half of 2008, the first time that occurred in 18 years. It was down 4.3% in the 4<sup>th</sup> quarter. Business spending dropped 22%, exports fell 24% and corporate profits declined 28%. All of this led to a rise in unemployment, which topped the 8% level by February.



The only source of growth in economic activity has been the government, which spent \$2.1 trillion during the last quarter of 2008, a number likely to continue growing until the economy responds. An important point of good news is that inflation has remained in check due in large part to the moderation of energy prices that has occurred since last summer.

Some early signs of relief appeared late in the 1<sup>st</sup> quarter. Durable goods orders increased 3.4% in February, a potential signal that the manufacturing sector may be bouncing off a bottom. This seemed to be confirmed by two consecutive months of modest gains in the ISM Manufacturing Index in January and February.

The very troubled housing market even showed signs of turning a corner as existing home sales rose 5.1% and new home sales climbed 4.7% in February. These are only early signs and as a whole the real estate market still remains soft. Another helpful sign is a decline in 30-year mortgage rates, which at 4.63% at quarter's end, may spur the market and has led to a surge in mortgage refinancing applications. Total mortgage applications rose 20% from a year ago and 55% from the previous month.

### **LOOKING AHEAD**

The recession is likely to extend through the first half of 2009 and maybe even beyond. Many economists anticipate a gradual recovery to develop near the end of the year as the impact of lower interest rates and government stimulus works its way through the economy. Some projections call for a 3% contraction in GDP for 2009. One of the weakest areas is sure to be employment. The unemployment rate could reach 10% and stay there into 2010. Consumers will likely remain cautious about spending, but we may have seen the biggest declines in this area. While corporate earnings are likely to be lower in the near term, we expect the worst of the declines in business and residential investment are behind us.

The government is clearly committed to playing a bigger role in the economy throughout the year. This will be important given the weakness elsewhere, but this involvement should begin to contribute to the early stages of a recovery, and the low interest rate environment is likely to encourage more business spending and housing purchases.

## **BOND MARKET**

### **THE 1ST QUARTER**

Investors' infatuation with only the safest segments of the bond market (i.e. Treasury securities) finally gave way in the 1<sup>st</sup> quarter as bond spreads (yields of corporate bonds compared to Treasury bonds) narrowed from what had been historically wide levels. In a challenging investment environment the bond market, as measured by the Barclays Aggregate Bond Index, gained 0.12% for the quarter.

Leading the way were high yield bonds generating a 5.02% gain. Growing concerns about future inflation threats in the wake of massive government spending spurred interest in Treasury Inflation Protected Securities (TIPS), which returned 4.97%. Municipal bonds returned 4.2% as the stimulus package eased credit conditions for financially strapped municipalities. By contrast, government bonds, the favorite safe harbor in 2008, lost 1.18% in the 1<sup>st</sup> quarter.

### **LOOKING AHEAD**

For the first time in the five-year history of a quarterly survey of investment managers conducted by Russell Investment, professional money managers are more bullish on fixed income asset classes than on equities. We anticipate that active intervention by the Federal Reserve will continue, which will benefit corporate, high yield, and municipal bonds going forward. The potential of a weaker dollar in the future may also make it prudent to include overseas bonds in a fixed income portfolio.

## **DOMESTIC STOCK MARKET**

### **THE 1ST QUARTER**

The U.S. stock market (as measured by the Russell 3000 Index) lost 10.8% in the 1<sup>st</sup> quarter. The damage could have been much worse had it not been for a significant recovery in stocks that helped to wipe out much of the 25% decline that occurred in the first two months of the year. Investor sentiment appeared to shift gears from the gloom of the current economy to the potential of a recovery (stocks typically rebound months before the economy does).

Growth stocks fared better during the quarter losing only 4.5% while value stocks dropped 17% due in large part to continued weakness in the financial sector. Large-cap stocks declined 10.5% while small-cap issues were harder hit, dropping 15% over the three-month period, though small caps started to rally heavily in March. From an industry perspective, financial and banking stocks continued to drag down the rest of the market as major firms in that sector struggled under the weight of their toxic asset holdings. The financial sector lost 29% while industrial stocks and autos fell 22%. Technology stocks were the bright spot in the equity markets gaining 4%. Materials stocks such as steel and other commodity-based firms managed to lose just 3% in the quarter.



## Performance Update

### Annualized Returns

Market Index	1st Qtr	1 Year	2 Years	3 Years	5 Years
DJ Ind Average	-12.43	-35.95	-19.32	-9.52	-3.59
S&P 500	-10.93	-38.05	-23.35	-13.07	-4.78
Russell 2000	-14.95	-37.50	-26.26	-16.80	-5.24
S&P Mid-Cap 400	-8.66	-36.09	-22.90	-13.61	-2.84
<b>Russell 3000</b>	<b>-10.80</b>	<b>-38.20</b>	<b>-23.81</b>	<b>-13.55</b>	<b>-4.59</b>
MSCI EAFE	-14.64	-48.19	-29.87	-16.70	-4.44
MSCI Em Mrkt USD	0.52	-48.40	-21.67	-10.23	3.41
NASDAQ Comp	-3.07	-32.93	-20.55	-13.23	-5.18
Lehman High-Yield	5.98	-19.31	-11.87	-4.66	-0.10
Lehman Agg Bond	0.12	3.13	5.37	5.78	4.13
Lehman Credit Index	-1.22	-6.88	-1.44	1.24	1.20
Lehman Gov Bond	-0.99	6.95	9.18	8.09	5.24
Lehman Corp	-1.78	-5.21	-0.71	1.82	1.62

*The above annualized total returns and betas represent All Star Financial models. Your actual beta may differ depending on your portfolio holdings.*

### LOOKING AHEAD

While stocks rebounded sharply in March, some caution may yet be in order as it marked the third rally of 15% or more during the bear market dating back to late 2007. A volatile environment is likely to persist in the coming months as economic data either surprises or disappoints the markets.

While stocks look attractively priced from the standpoint of the price/earnings ratio, ongoing questions about the strength of corporate earnings in the near term make the actual value more difficult to assess. The rate of decline in earnings growth has slowed, perhaps a sign that some stability will occur soon.

Growth stocks seem to be more favorably positioned than value stocks for the rest of 2009. This is due to steady growth in the Health Care sector and solid balance sheets for Technology companies and other growth firms. Small cap stocks should be well positioned and often do well in the front end of an economic recovery.

### INTERNATIONAL MARKETS

#### THE 1ST QUARTER

Foreign stocks declined 13.1% during the 1<sup>st</sup> quarter, but returns varied widely by region and country allowing investors to benefit from utilizing a diversified approach. Emerging markets were relatively strong and remain the sole source of growth in the global economy today. The MSCI Emerging Markets Index rose 0.52% for the quarter.

China announced a significant economic stimulus package and stocks in China and Taiwan responded with gains. Most of the downside in foreign markets occurred in the developed nations of Europe and Japan with declines ranging from 14% to 17%.

### LOOKING AHEAD

The recession that started in the U.S. clearly has spread on a global scale and is likely to last throughout the year. Emerging nations such as China and India will be able to maintain at least moderate growth levels. Latin America, led by Brazil, also appears to be in relatively strong shape.

Our focus in foreign markets will continue to be in Emerging Markets, especially the stronger regions. We will couple this with core foreign exposure and eventually foreign small cap stocks again, when the global recovery comes more into focus.

### SUMMARY

*We are realistic optimists!* Glimmers of hope started showing up in the economy by March. This led to a nice rally in the stock market as they moved off their lows. It is too soon to tell if it is the beginning of a broad-based market recovery or just a rebound off extreme market lows. Our sense is the economy has more progress to make before a permanent rally in stocks occurs. Two things have to happen, 1) savings rate per capita increases to 8% - 10%, and 2) consumer debt needs to shrink. We are making good progress on both fronts. Still, long term investors should take note of many historically low valuations in many sectors of the market, and look to add these exposures when market conditions allow.

*Opportunities abound!* We have mentioned several areas of opportunities; corporate, high-yield, and municipal bond markets are all at extremely good prices, selling at discounts of as much as 30%. Growth stocks have not been this cheap on a relative basis for decades, and small cap stocks have traditionally led during the early stages of a bull market. Eventually, some inflation protection will be attractive as well.

**It is time to stop focusing on the crisis and start focusing on the opportunities!!!**



## What Type of Investor Are You?

With the domestic and international stock markets dropping anywhere from 50% - 70% from their peak just 18 months ago, how much **FEAR** has crept into your thinking and decision making process? Have you contemplated stopping the monthly investment into your 401K plan?

We would argue that this is the best time to get more aggressive and increase your monthly investments, not decrease them or stop entirely. The dollar-cost averaging approach to investing is one of the best approaches to help reduce volatility and increase your total return.

The analysis below shows four hypothetical scenarios during the previous bear market from 2000 to 2002. The question is *what type of investor are you?*

Investor Type	Post Bear Market Portfolio Balance (as of January 2004)	% Shortfall vs. Stay-the-Course Investor (as of January 2004)	Projected Balance Short-fall vs. Stay-the-Course Investor after 30 years
<b>The Stay-the-Course Investor</b> – maintains dollar-cost averaging of \$500/month throughout a bear market.	\$33,502	---	\$617,331
<b>The Bear Market Dodger</b> – Effectively avoids the bear market by shifting 100% of new contributions to cash before incurring any losses (April 1, 2000), and shift 100% of new contributions back into stocks as the market resumes a long-term uptrend to January 1, 2004.	\$33,357	-0.4%	\$614,660
<b>The Bear Market Refugee</b> – Shifts all new contributions to cash at after the market drops 20% (March 2001), and shifts 100% of new contributions back into stocks as the market resumes a long-term uptrend to January 1, 2004.	\$31,799	-5.1%	\$585,951
<b>The Doomsday Capitulator</b> – Shifts 100% of new contributions to cash at the bear market's cyclical low point (October 2002), and shifts 100% of new contributions back into stocks as the market resumes a long-term uptrend to January 1, 2004.	\$31,616	-5.6%	\$582,579

\*Starting with a balance of \$10,000 on January 1, 2000, each of the four investor types amassed these balances as of January 1, 2004. For the 30 years after 1/1/2004, a 10.2% assumed annual rate of return was used as that was the average S&P 500 annual return from 12/31/1927 – 8/31/2008.

Maintaining the dollar-cost averaging through the bear market of 2000 – 2002 proved to be beneficial because you were buying more shares at lower prices. As a result, you are able to reap bigger portfolio gains when the market recovers.

**IT'S ALL ABOUT BUYING MORE SHARES AT THIS TIME!!**

## STAY THE COURSE

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