



Commentary on the Third Quarter 2009

October 1, 2009

It has been twelve months since Lehman Brothers filed for bankruptcy and six months since the stock market bottomed in the subsequent firestorm. Although the decrease in volatility during recent months has been a welcome respite, there is much debate as to where we are and where we go from here. Policymakers sound cautious, investors seem optimistic, and economists are divided and debating about which group is right. The stock market's rally clearly reflects expectations of a quick recovery. Regardless of the merits of that consensus or the degree to which it will be fulfilled, we would like to outline what has changed in the past six months and what challenges we see ahead.

The Recovery of the Banking Sector and Financial Markets

While the rally's third quarter encore has been fueled by better-than-expected economic data and corporate earnings reports, both of these catalysts require functioning financial markets and a solvent banking system. Thus, the recovery of the banking and financial industries has been requisite to any broader economic stabilization. As a consequence, policy makers have taken many emergency and unconventional actions in an attempt to save and protect the financial sector. Economists and investors alike have also viewed the health of the financial markets as a proxy for the broader market. Just as the precipitous decline in global stock markets earlier this year reflected fears of an international financial meltdown, the initial reversal and steep second-quarter rally were driven by the realization that emergency government measures were strong enough to buttress the failing financial framework. We believe that policymakers will continue to support the financial markets however possible, will refrain from taking any action that could jeopardize the still-fragile banking system, and will increase their support should the financial markets find itself in trouble again.

Since the banking system has been the focus of government concern and support, they have been the largest beneficiaries of government intervention. Last quarter, we highlighted where the TARP money had been allocated and who got how much. Yet the TARP was just one of many tools that central banks around the world utilized to provide capital, credit, and liquidity to financial institutions. Governments continue to capitalize large commercial banks as needed, short and long-term are being held down at artificially low levels, and central banks continue to facilitate liquidity through various guarantees and collateral arrangements. And although banking balance sheets remain weak, profit margins are wide thanks to government support. With numerous governments committed to propping up the banking system, it is hard to imagine a return to the panic of just six months ago.

Existing and Potential challenges

Although the world economy is no longer in crisis mode, many challenges lie ahead. Large banks chosen as essential engines for the monetary system have been saved, but the broader economy is still floundering and bottoming. As we outlined last quarter, inflation remains our



primary concern in the mid- to long-term. For the past 18 months, treasuries and central banks around the world doused the economic calamity with unprecedented amounts of currency, credit, and stimulus. While these actions extinguished the crisis, it also flooded the global marketplace with liquidity. Unless this flood of money can be drained from the system in an efficient and timely matter, inflation will further weaken the system that policymakers set out to save.

We continue to take caution in our interpretation of what inflation will really mean in the next economic cycle. While it is true that the world is flooded with unprecedented liquidity, it doesn't necessarily mean an across the board inflation. For instance, the world has been battling a silent deflationary labor environment for over a decade now. This labor cost compression is caused by a huge growth in worldwide availability of increasingly capable and skilled labor. So, it remains to be seen how the velocity of all this liquidity will interact with the continual huge growth in available quality labor. Another instance is gold. Though its industrial uses are now limited, gold supply is finite. In gold's case, we believe the unprecedented increases in liquidity will, eventually, find its way into that finite market.

A secondary challenge to the nascent recovery is that many factors which drove past economic expansions are either absent or greatly weakened. Although the crisis phase of the downturn is most likely over, the damage to the global economy has been done. Dampened demand, credit contraction, and subdued asset values are forcing businesses and households to de-lever; that is, borrow and spend less, while saving more. Consumers are tightening their belts, wary of unemployment prospects, falling wages, and depleted savings. Similarly, businesses are cutting costs and running leaner, in order to survive this economic cycle. While there have definitely been improvements in corporate earnings, revenues remain weak. Furthermore, it remains to be seen how the economy will fare as the government begins to extract itself from various industries. Policymakers, economists, and investors are at odd over whether we are headed for a self-sustained (albeit slow) recovery or a double-dip recession.

Yet, here again, we are tracking carefully how consumer demands are recovering worldwide. While the notion of de-coupling is being fiercely speculated, it remains to be seen whether the demand for fundamental goods like food and vital resources in the developing world have indeed separated from a weakened developed world consumer sector.

Housing Market Update

In our previous newsletter we stated that the recovery of the U.S. equity markets also hinges upon the recovery of the housing market. In the past couple of months, we have been reviewing data from across the country and it seems that home prices have hit bottom, which guides our expectation of stability in the housing market. The Bay Area has already seen an initial bounce off its lows. This is a testament to the resilience of our neighborhood, as well as the importance of employment opportunities to real estate valuations. Supply concerns are being kept in check though, by banks who are still retaining massive inventories of homes. We anticipate high inventories to remain until lending and employment rates improve. Additionally, a confluence of



political and economic factors should keep interest rates and mortgage rates artificially low for the next year or two. There is also a lot of chatter regarding an extension of homebuyer tax credits, into 2010. The stabilization taking place is also helping to buoy the capital markets. We continue to monitor the level of housing inventory. Conventional wisdom is that it needs to decrease to a five month level before the housing market can recover. We shall see how governmental policies intervene with this wisdom. Ultimately, will the government stimulus need to be permanent in order for demand to persevere? It will be interesting to see.

Portfolio Updates

Our managed portfolios continue to make the case for index investing with strategic management and regular rebalancing. Our redeployment of cash back in April has continued to reap benefits in the third quarter. In July, we decided to rebalance portfolios in response to the sharp rise in nearly all asset classes and to ensure that allocations continued to represent client risk/return profiles. We also made a strategic shift by reallocating some capital from equities to commodities, mainly agriculture and gold. Sector inflation continues to be a paramount concern and commodities have traditionally performed well in these environments. In early September, we reduced our equity allocations to raise cash in response to the market's movements. We feel that these adjustments are necessary until such time when the new economic market order asserts itself. Our adjustments are more often than normal; but, these are not normal times.

Website

On a final note, we have launched our redesigned website www.morlingfinancialadvisors.com and encourage you to check it out.

Sincerely,

Your MFA Team