

March 18, 2009

A Change in Sentiment

As we enter the month of April, we will be entering the 17th month of the longest post World War II recession on record, and remain in the midst of the worst economic downturn since the 1930s. At some point, presumably, things will begin to shift towards a more positive scenario, and the equity markets will begin to recover. The difficult part of investing during bear markets like these is in determining the turning points that will signal a bottom and the beginning of a recovery. As we clearly lack the foresight necessary to call that bottom, we strive to listen closely to history and what other people are saying in order to create a broad vision of opinion and precedent. Our periodic market judgments are based upon the thoughts and work of people to whom we are listening.

In that vein, Dr. Alan Sinai's recent comments on the market, delivered in his weekly overview of the macroeconomic landscape strike us as an interesting barometer of market sentiment. Dr. Sinai and his team at Decision Economics have been extremely accurate at forecasting the turning points in the economy over the years, and our association with his team stretches back over a decade. No bell will ring to announce the end of a bear market and the beginning of a recovery, but Sinai's recent comments strike us as a data point that can be added to our overall analysis of the economy and the markets.

The tactical call that Dr. Sinai makes is relatively modest, changing his broad strategic asset allocation model (a one to three year forecast) from a position he describes as "hunkered down", with an equity weighting of 35%, to one of a "strongly underweight" equity allocation of 45%. Further, his macroeconomic call on the overall economy slightly increased the probability of a 1930s style depression scenario to 25%, a frightening thought indeed. Clearly, this is no misty-eyed optimist. That said, Dr. Sinai admittedly has turned less bearish on the markets in recent weeks, and now looks towards an end to the current protracted recession as well as to a recovery in the broader equity markets in the future.

The underlying change to the sentiment expressed by Dr. Sinai and Decision Economics is based simply upon the passage of time. He analyzes the lineup of fundamentals going forward and notes that "yesterday doesn't matter". He sees less weakness in the US economy moving forward, and after a bleak Q2 of this year, sees positive GDP growth in the third and fourth quarters, and real economic growth in the 2-3% range for 2010. Certainly an enormous amount of uncertainty still exists, and the broad range of estimates that he puts forward for the S&P based upon forward operating earnings in the \$60-\$65 range are wholly predicated on the almost unknowable level of write downs that will emerge over the next twelve months. His conclusion of a 2009 S&P 500 range of between 600-825 may be wide as to be rendered meaningless to investors, but the more indicative sentiment that he expresses is that the end of the recession is in sight, and that some recovery in 2010, and earnings growth in the S&P is now probable.

Consumer spending, which represents over 70% of the GDP, is the key to any recovery, and Dr. Sinai feels that the historic and unprecedented declines in

consumer spending will flatten and even reverse as the full weight of the extraordinary policy measures taken in Washington begin to have an effect. The transfer of money from the government to the consumers within the Economic Recovery Plan combined with the Federal Reserve's continued use of their balance sheet to provide funds to the financial system are the types of extraordinary policy measures that Sinai feels will ultimately lead us to recovery. Just as importantly, he points to a change in tone by the current administration, from an anti-business rhetoric to one that more confidently embraces a more pro-market posture, in particular with regard to mark to market accounting and the uptick rule for short sellers. All of this, to Dr. Sinai, begins to point towards a turning of the page, as the recession ends and the markets begin to recover.

No pundit, economist or sooth will be able to let us know when it is safe to climb back into the markets, and when the market will ultimately turn. We feel strongly that it is important to remember our history and to keep the antennae up and alert to signs of recovery, and in that spirit, we take note of Dr. Sinai's comments this week. History tells us that the broad equity markets anticipate the end of a recession by roughly six months, which we discussed extensively in our market update in November*. Dr. Sinai and Decision Economics now have a provisional estimate of the end of the recession in October or November of this year. Certainly, Dr. Sinai tempers his shift in equity allocation and strongly cautions that the mess that we are in remains severe and that there are problems, including the removal of the toxic assets from the balance sheets of our troubled banks, which he deems insoluble. He does, however, note that at some point we must begin to look forward, and that recovery is inevitable, and in light this change of sentiment on Sinai's part – though clearly not an 'all-clear' signal – we are starting to move our portfolios towards a slight bias on the long-market side.

*http://www.wrhambrecht.com/pdf/where_we_are_now.pdf

Best regards,



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