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Big Ben to the rescue

Quarterly Newsletter
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President Barrack Obama's administration took office in January of this year. Initially we saw a market rally based on optimism, no doubt inspired in part by the epic change represented by the dramatic election campaign and the election of a President offering so much hope in a time of despair.

The hope and the rally were short lived. Punctuated by the testimony of the new Treasury Secretary Timothy Geithner, it was soon obvious that the new President had no silver bullet.

With the hope dashed, a market rout began and President Obama gained the distinction of being the first President to preside over a bear market in the first sixty days of his administration, with the Dow plunging over 20% as the administration displayed the lack of a plan or execution to aid the economy. Consumer confidence fell, retail sales were weak, and unemployment soared. Banks continued to hoard money and limit credit lines, exacerbating the slowdown.

The Federal Reserve had cut interest rates to near zero. An alphabet soup of programs had been introduced to free up the credit markets, aid bank lending and housing markets. The President had unveiled his stimulus package and housing relief package; and while there was the occasional uptick in the economic outlook, generally the trend was down.

Finally, the Fed did what had become inevitable and about the only thing, they had not tried: buy long-term treasury bonds. No congressional approval was needed, no political gymnastics. Ben Bernanke made perhaps the boldest decision of his career; the Federal Reserve began buying back U.S. Government debt by simply printing money. Ben rode to the rescue.

The purpose of this move was to lower long-term interest rates, make home mortgages more affordable and do what had been needed to be done since the beginning, solve the housing problem. Better late than never. (See my Daily Journal of Commerce columns of July and August 2008.)

The markets immediately responded to the Fed action and began the biggest rally since 1933, eventually rising over 20%. Not only had President Obama presided over a bear market (down over 20%) but also over a bull market (up over 20%) all within the first 90 days of his administration.

Our portfolios held up relatively well in the down markets because of their defensive qualities, down, but less than the markets. However, in the days, especially the big up days, they underperformed the markets (though up) because of our less aggressive holdings. Some of the best performance of the quarter came from consumer discretionary stocks, of which we have few, because of the defensive nature of our portfolios. For defensive reasons, we are over weighted in healthcare, but these stocks were largely crushed after the Obama inauguration speech that promised to squeeze health care costs.

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Fortunately, we were nearly fully invested in our equity portfolios during this rally, so we did benefit. We will be monitoring our holdings to see if adjustments are needed in light of the changed circumstances. But there are still many risks in the market, some macro issues that are quite disturbing, some are international and some domestic.

Buying long-term treasuries should help clear the housing markets, and indeed, we are seeing progress, but many commercial loans are heading into problems and many companies have debt to rollover. It remains to be seen if the credit markets and the banks are receptive to lending, if not, we can expect more problems.

The treasury is about to embark on stress tests for banks. There will be less stress now that FASB (Financial Accounting Standard Board) has relaxed the so-called mark to market rules, allowing institutions far more latitude in the pricing of their holdings. While the rule change will result in fewer markdowns, it also has effect of lessening bank interest in the government's effort to clear bank balance sheets of "toxic assets".

Banks are even considering borrowing money from the government at low rates, to buy loans of other banks, eventually profiting from the bank caused mortgage problems. No doubt, more bonuses will be paid in celebration and we will be able to get back to the normal business of private jets and office remodels.

There may be more Madoffs in the weeds. It is already been reported that one national bank was operating a branch in the office of a newly discovered Ponzi scheme.

We need the banks to be strong to lead us out of this mess. So far, we have been disappointed.

While we have had a strong rally in the last few weeks, especially in consumer discretionary stocks where we have few holdings, I do expect a retest of the March 9 lows. The retest should come in the late spring. If we have that retest and are successful, I expect the economy to turn up in the fourth quarter of this year. If we fail the retest, the economy may continue in its downward trend. In any event, a recovery will take some time, so we will have to be patient.

At Rutherford Investment, we continue to believe in transparency and accountability. Our investment process is clear and understandable. No hedge funds here, no derivatives, no bells and whistles, just plain blocking and tackling. An independent accounting firm relying on international reporting standards has audited our performance since the start of our firm. We have no hidden fees. We are proud of our record, and proud to serve you, our clients.

If you have, any questions, at any time, do not hesitate to call. We appreciate the opportunity to serve you.

William D. Rutherford, President
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