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Near term market outlook

Client Newsletter

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Since March 9 of last year, the market has seen a steady, if uneven rise. This rise has largely been fueled by the policies of the Federal Reserve.

The Fed provided massive bailouts of the banking sector, enormous liquidity to the credit markets and interest rates at near zero percent. The result has been a return of confidence to the economy and a willingness to take risk. A year ago banks would not even lend to each other. Companies were unable to roll over one week commercial paper. The entire system seemed about to collapse. Indeed Treasury officials have described that time as looking into their grave. A Depression loomed. Chairman Bernanke said recently that we avoided a Depression.

President Obama said we would not let our banks fail, and many took him at his word, but what did that mean? Did it mean nationalization? Nationalization of the banks was certainly on the table. It wasn't until the Fed announced a policy of buying long term U.S. Treasuries, that the markets believed there was a future. And so, the Federal Reserve began buying massive amounts of long term and bonds issued by the U.S. government and housing bonds. Millions were made just by buying U.S. Bonds and selling them back to the government at the Fed. In order to pay for these bond purchases, the Fed issued massive amounts of bonds. The Fed balance sheet ballooned. Surprisingly the Fed had little difficulty finding buyers for the bonds, and also they were able to sell at low interest rates. Of course the dollar fell in value, but so did most commodity prices and inflation remained benign. Investors returned to all markets, credit and equity, and the riskiest stocks with the worst credit ratings did the best. (See the Dash to Trash, Client Newsletter 2nd Qtr 2009). For instance Bank of America increased 66% in one week. Subsequently their CEO has been forced to retire, and they have announced a host of bad news. But BA was not alone and a lot of companies with big problems saw their stocks rise dramatically. Since we try to buy quality stocks, we did not participate wholly in this run up. Our stocks rose too, just not as much. We also held cash during the early part of this run-up, until we felt more comfortable with its prospects.

Now, the U.S. has issued massive amounts of new debt that we, our children and grandchildren will have to pay. We continue to issue more. We have adopted a new health care bill that will add billions to the budget along with higher taxes, and not even a clear plan for paying the bill. It all sounds like a recipe for disaster. Chairman Bernanke warns that all the deficit spending and new debt will be a drag on our economy. We will make less, consume less, have fewer jobs, lower GDP, and lower standard of living than we otherwise would have had.

In the meantime bankers pay themselves record bonuses, equivalent to the best days in 2007. Prompting some to note that we bailed them out, they profited from the disaster they created, and we continue to suffer while they ride high.

But as bad as things are in the U.S., in many ways they are worse in other countries and that may be what saved our skin. We looked less bad. Investors bought our debt. Interest rates remained low, the dollar recovered some against the Europe but declined against Asian currencies, and inflation rates remained low. In part this was because investors lost confidence in the Euro so the dollar looked stronger. The U.S. economy appeared stronger than its European counterparts, so investors bought American stocks. China went on a massive spending stimulus package but it is difficult to buy their currency so it was no competition for the dollar. Yes, they pushed up commodity prices, but overall the price of commodities, mostly food fell.

The result is that the Fed is perhaps slightly more concerned about deflation than inflation, and they have plenty of room to keep interest rates low. Unemployment is still stubbornly high. Manufacturing is showing signs of life. Retailing is a bright spot even as consumer credit contracts. Housing is seen to be bottoming. Commercial loans are being absorbed by the Hi Yield market, but the banks continue their pattern of freezing credit and draining money from the system. Indeed the banks may be the biggest risk to our recovery. Remember that after the Savings & Loan crisis, which was much smaller than the current disaster, over 2500 bankers went to jail.

I expect the U.S. equity markets to continue their tortoise like rise. I prefer them to fixed income which will suffer in the next up leg of interest rates, which may come as early as this fall. Clients should remain diversified with International equities as well. Don't fight the trends.

As always we are pleased to be able to manage your accounts. Our firm has grown 67% year over year. We are adding new client principally because of referrals. If you know someone who could benefit from our service, please send them our way. The bigger and stronger we are, the better job we can do for you.

Best personal regards,

William D. Rutherford, President
Rutherford Investment Management LLC.

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