



MCCABE CAPITAL MANAGERS, LTD.

2011 Renaissance Boulevard, Suite 210, King of Prussia, PA 19406
Tel.: (610) 277-8890 Fax: (610) 277-6903

First Quarter 2009 Economic Commentary

James L. McCabe, Ph.D.

Adam B. Landau, CAIA

In the first quarter of 2009 the macroeconomic environment remained extremely challenging. We've spoken for some time about a handful of economic releases that we were monitoring particularly closely because we felt that collectively these data points would serve as a guidepost for the trajectory of the economy, and the markets as well. During the quarter the numbers revealed ongoing stresses in the system, though the important "second derivative" that we often mention – indicating the pace of decline or growth – was in some cases positive, a cause for guarded long-term optimism.

The Institute for Supply Management reports on the manufacturing and non-manufacturing sectors, often considered the most reliable near-term economic barometers available, served as a case in point. The manufacturing index steadied during the quarter after dropping precipitously in the fall, though the March release of 36.3 was still historically low and well below the 50.0 point that bifurcates growth and contraction. On the non-manufacturing side, which represents roughly 90% of the economy, the reading trended down during the quarter to a March release of 40.8. This was driven largely by payroll slashing by retailers coming off an extremely difficult fourth quarter. Consumer confidence also appeared shaken early in the quarter, though readings appeared better in March.

There is other evidence that the pace of economic decline in the U.S., and to a lesser extent globally, is starting to diminish. Several bright spots have appeared in the U.S. economic outlook, which suggest that at least the worst may be behind us. First, recent retail sales and personal consumption data suggest that consumption may have increased in the first quarter. This fact has not been lost on market participants, as the S&P 500 Retailing Index is up 5.7% YTD, outperforming the S&P 500 by over 16%. In addition, recent housing related data and auto sales information have been generally positive. Sales of both existing and new homes rose in February, with existing house sales rising by 5.1%, and new home sales by 4.7%. Housing starts and single family dwelling permits rose significantly in February, growing 22% and 11%, respectively. The just released March data were mixed, with the construction of single family homes holding steady, but with multi-family home starts declining. March permit applications fell off some which may make February 2009 an exception. However, during the prior 48 years of the data series, an increase in housing permits of the February size has always marked the bottom of a housing correction and the March level of housing starts (510,000 units annualized) was still higher than the record low 480,000 pace reached in January. The seasonally-adjusted annual sales rate came in at 9.86 million vehicles, well ahead of the just over 9 million January and February rate in each month, and much better than forecasts of below 9 million vehicles.

The economy is now receiving income boosts which could further increase consumption. The IRS will soon adjust withholding schedules for the new federal tax cut. This will boost income by approximately \$4.5 billion per month. There will also be special payments to social security recipients in May worth \$13.5 billion. These two factors will boost disposable personal income growth by 3.7% during the second quarter.

These favorable U.S. macroeconomic data, together with encouraging signs around the world, such as the recently announced March Purchasing Managers Index (PMI) for Chinese manufacturing and the Y15 trillion Japanese stimulus package, indicate that the decline in world GDP in 2009 may be less than forecast.

Because the S&P 500 is now fairly, if not undervalued, and the balance of risk to the global growth forecast is on the upside, equity markets are likely to remain above the early March bottom and to advance later in the year, if not earlier. The main downside risk is that the modest gains in retail sales, which occurred during the first two months of 2009, may not be sustainable. (In fact, the preliminary March numbers showed a 1.1% decline, although there are seasonal adjustment issues.) There is the possibility of a relapse because of job losses, falling asset prices (especially in the housing sector), and rising savings rates. In addition, the financial sector is by no means stabilized. The securitized loan market has yet to be restored and banks are highly reluctant to extend credit for fear that they may have to write down certain legacy assets still on their balance sheets. The government's willingness to make highly leveraged, non-recourse loans to private investors to buy assets should bolster prices somewhat, but the gains may not be large enough to contain the balance sheet risks for the banks.

A continuing onslaught of governmental intervention had a palpable impact on both indicators of credit conditions and markets themselves, particularly in the fixed income arena. New fiscal stimulus, as well as an announced budget of historic magnitude, helped cause yields of Treasury securities to rise, particularly longer-dated maturities as the yield curve bear-steepened over the quarter. At the short-end rates stayed low as the Fed kept the funds rate close to 0% and implemented a quantitative easing program in March. We believe that there will be significant improvement in the economy in the second half of the year as a result of the plethora of government measures combined with natural market forces. While there may be a price to pay for these measures down the road, we believe that at the current time distress in the banking system will likely prevent the bulk of Fed liquidity from proving to be inflationary.

From a valuation perspective, the U.S. equity market appears likely to have reached a sustainable bottom with the S&P at 667 in early March and is now trading at, or slightly below, fair value. At 14.5x normalized earnings (defined as a ten-year rolling average adjusted for inflation), the S&P 500 is fairly priced on a historical basis while underpriced if we recapture the record profit margins of the last ten years. This is based on Robert Shiller's data which looks as far back as the 1800s and excludes the tech bubble. During this period, the average price to normalized earnings was 16x. The recent market bottom at 11.6x normalized earnings was one standard deviation below Shiller's historic average, with only about 16% of the observed price to normalized earnings levels below it. Market bottoms below 11.6x normalized earnings occurred during periods of double-digit inflation or deflation. This is not to say that the early-March bottom will not be retested, only that it is likely not to be penetrated. Conclusive evidence that a floor for the economy and corporate earnings is about to be reached will be needed to drive equity markets in a sustained upward direction.

Given attractive valuations and a sufficiently long horizon, clients are likely to be rewarded for deploying some cash to stocks. A normalization back toward trend in earnings and multiples implies double digit compound annual returns, even if the process takes five years to complete.

Though they were noticeably less volatile and illiquid than in the fourth quarter of 2008, global markets were generally weak, with the MSCI World Index declining by 10.7%. The S&P 500 was down 11%, mainly due to financials which ended the quarter off about 26%. While there were few areas that would be considered safe havens, within the domestic market investors were better served sticking with large cap names, as the Russell 1000 outpaced the Russell 2000 by almost 4.5% on a relative basis (-10.46% vs. -14.95%). It was also a quarter dominated by the growth style, as the Russell 1000 Growth return of -4.12% was substantially ahead of the Russell 1000 Value return of -16.77%, based largely on the latter's exposure to the financial sector. The true value globally was found in emerging markets, as the MSCI Emerging Market Index was up 0.95%, led by Latin America and Asia. The MSCI Emerging Market Latin America and Asian regional indices were up 4.90% and 1.55% respectively.

With regard to fixed income, we believe that defensive high yield, investment grade corporates, and municipals all represent potential value. Within each sector, however, security analysis and risk control are going to be important to maintain as there will be a likely bifurcation between winners and losers. Since the sharp rally in the S&P 500 began in early March, the credit spread (i.e., the excess of the actual taxable or taxable equivalent yield of these securities to the default-free yield) has not diminished substantially from the crisis levels of the fall and is nearly twice that observed a year ago in these spaces. While that presents a genuine buying opportunity, it does not come without risks. Economic stress may lead to downgrades and potential defaults, even in the normally stable local government sector. Our focus continues to be on municipalities that went into the recession with manageable debt burdens, diverse tax bases, and some financial flexibility. Within the taxable sectors we continue to look for opportunities that limit duration risk in an effort to limit volatility should Treasury rates rise in the future. Further, we will focus on investments made in companies that can weather a slowdown in economic growth and have business models supportive of supporting coupon payments over the life of their debt.

In one respect, the credit market has not confirmed the recent sharp stock market advance. Even though the Fed has taken extraordinary measure to facilitate bond issuance, the Baa corporate credit spread of the current magnitude implies default rates not seen since the Great Depression and may not augur well for a sustained equity market rise. The story in high yield is much the same, even as spreads trended downward during the quarter, rewarding those investors who had taken positions in the space. This downward trend left spreads to end the first quarter at 1531 basis points – well off the early December wide of 1925 basis points, but still substantially higher than the 20-year average of 583 basis points and the previous all-time wide set in September 2002 around 1100 basis points. Unless these spreads contract, a substantial and lasting economic recovery cannot be expected.

We believe that the taxable bonds described above are likely to outperform equities at current price levels in the short to intermediate term. Credit fundamentals may well deteriorate going forward, but balance sheet metrics such as debt coverage ratios have remained far superior to those exhibited during the past two recessions. If the recent stock market advance is justified, credit spreads for these instruments will narrow sharply, producing double digit total returns over a one- to two-year period. This would make them an even better value than the equity market. If

current credit spreads have it right, then the current stock market rally will peter out and investment grade quality corporate bonds should still provide a better return than stocks. For this reason we are adding to our fixed income positions in this category where possible and maintaining our current exposure where accounts may already be at or above their targets.

Alternative investment strategies were to some extent a mixed bag, though they largely fared better than equities. For example, the Credit Suisse/Tremont AllHedge Index ended the quarter off 0.61%, with Global Macro managers performing particularly well, up 7.37% as a group. In many situations we utilized managed futures to our benefit in 2008, as their negative correlations to equities led to a positive return for the year of over 10%. Those accounts that carried the resultant overweight in the space were not once again rewarded from an absolute perspective, but the drop in value of less than 3% still showed their diversification benefit in a period of weak equity markets. As a whole, the hedge fund industry has come under a great deal of scrutiny of late. While we recognize that this asset class is particularly subject to idiosyncratic outcomes, we do believe that the trends across the industry – namely lower fees, less overcrowding, and less restrictive liquidity provisions – that are being shaped as a result of the scrutiny will be of benefit to future investors.

We are grateful for your allowing us to manage your funds and for your continued confidence and support.

The forecasts and opinions in this piece may not actually come to pass. Information in this report does not pertain to any MCM product and is not a solicitation for any product. They should not be construed as recommendations, but as illustrations of broader economic themes. The views and opinions expressed above are those of the portfolio management team at the time of writing and are subject to change based on market, economic and other conditions. They should not be construed as recommendations, but as illustrations of broader economic themes. All information is subject to change.

Equity securities are more volatile than bonds and subject to greater risks. Small and mid-sized company stocks involve greater risks than those customarily associated with larger companies. Bonds are subject to interest rate, price and credit risks. Prices tend to be inversely affected by changes in interest rates. Unlike stocks and bonds, U.S. Treasury securities are guaranteed as to payment of principal and interest if held to maturity. Note that it is not possible to invest in a market index.

The financial instruments described may not be suitable for all investors. Investment in alternative investment products requires that the investor meet certain suitability standards, and therefore, investment in these alternative investment products may not be suitable for all investors.

This material may not be reproduced, shown or quoted to members of the general public or used in written form as sales literature.