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After a Tough First Quarter, Investors Have Cause For Cautious Optimism

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While many analysts expect U.S. corporate earnings and overall economic data to remain weak by historical standards, there may well be enough of an improvement over the prior months and quarters to spark some optimism that there are better times ahead.

For instance, a 5% to 6% contraction in first quarter gross domestic product (GDP) will look decent vs. the wrenching 6.3% decline the U.S. economy experienced in the fourth quarter. Mix in some still weak - but improving - corporate earnings season and there may be reason to hope that U.S. President Barack Obama's prediction of an economic rebound in 2010 may not be off target after all.

Eddie Cohen, a market historian who is chief investment officer for Stavis & Cohen Financial, a Houston-Texas financial-management firm, points out that the U.S. stock market has endured three protracted bear markets since 1900 (1906-1921, 1929-1942 and 1966-1982) and sees evidence that the United States may be ensconced on one of those periods again.

While Cohen sees some positive indicators, he continues to advise that caution (or even cautious optimism) be the order of the day.

“Plenty of questions still need to be answered before we can proclaim an end to the bearishness and a definitive market recovery," Cohen said. “At least, we have started to see some rays of sunshine on the horizon, and that is encouraging. Still, this environment is not the time to be a hero."

But there are three significant wildcards at play here that could keep the market from sinking into an even deeper malaise - and that could, in fact, be a catalyst for higher stock prices and perhaps even an improved economy in the months to come. Those three wildcards include:

- There's an estimated $4 trillion in cash in investors' hands on the sidelines - capital that could be drawn in to further pump up the markets, should the recent rally continue.
- The federal government has already committed to funding $11.6 trillion in stimulus initiatives, and the sheer magnitude of that government intervention

could play a substantial role in determining just how long this downturn lasts - or how quickly it ends.
- Stocks are, in many cases, currently trading at levels not seen since the late 1990s, meaning the market is dangling bargains too enticing to ignore.

Cohen believes that investors need to remain cautious and to understand that market sentiment can literally turn on a dime, especially if the volatility levels remain high [there's some evidence that volatility has diminished somewhat in the past week, and is currently below what is usually expected for the start of the corporate earnings cycle]. However, the Texas investment advisor also foresees some potentially positive developments on the horizon and believes that patient long-term investors who are willing to ride out the short-term volatility may want to commit some money to stocks in profit from these low valuations.

Given that there is “an estimated $4 trillion in cash on the sidelines right now … as investors become more confident, some of these funds could potentially find their way into equities and help drive the markets higher,” Cohen said.

The Quarter That Was

When 2008 came to a close, investors hoped the nightmare had ended and some normalcy would return to the economy and the markets. It was not to be. During the first three months of the New Year, a $787 billion stimulus package, multiple blueprints for rescuing the nation’s banking system and a honeymoon period for a new presidential administration that was one of the shortest in U.S. history made it very clear that the nation’s economic nightmare was continuing.

A Sign of Things to Come?

Although the U.S. stock market's overall first-quarter performance was pretty dismal, a late-quarter rally that's carried over into April is being viewed by some as a signal that the U.S. economy is on the road to recovery. It doesn't hurt that there's an estimated $4 trillion in cash on the sidelines, ready to pump stock prices up even more should the current rally continue.

Market/ Index	Year Close (12/31/08)	Qtr Close (03/31/09)	YTD Change
Dow Jones Industrial	8,776.39	7,608.92	-13.30%
NASDAQ	1,577.03	1,528.59	-3.07%
S&P 500	903.25	797.87	-11.67%
Russell 2000	499.45	422.75	-15.36%
Fed Funds Rate	0.25%	0.25%	0 bps
10 yr Treasury (Yield)	2.24%	2.68%	+44 bps

Sources: *Brounes & Associates, Money Morning Staff Research*

Much of the data portrayed an economy in decline despite the promises by U.S. Federal Reserve Chairman Ben S. Bernanke’s that better times were coming. The U.S. Commerce Department initially reported that fourth-quarter GDP was down 3.8%, its worst showing in 27 years, though not as bad as many economists had projected. A few months later, however, Commerce Department analysts revised that statistic downward to 6.3% and confirmed that the recession had worsened.

Jobless statistics became the barometer for the nation’s declining economic health, as company after company announced major cutbacks. On Jan. 26 - in a single day so bad that it was labeled as “Black Monday” - about 75,000 jobs were eliminated ad the likes of Caterpillar Inc. (CAT), Sprint Nextel Corp. (S), Home Depot Inc. (HD), Texas Instruments Inc. (TXN), General Motors and others announced major job cuts. Even before that dark Monday, there had already been 170,000 job cuts announced that month - and that’s after a 2008 that saw the recession claim 2.6 million jobs.

“Some of the worst job losses are ahead of us, not behind us," Wells Fargo & Co. (WFC) senior economist Scott Anderson told ***USA Today*** at the time.

One-time global giant Citigroup Inc. (C) fell briefly into penny stock territory and came within a heartbeat of nationalization as the U.S. government finally opted to inject more money into the former financial-sector stalwart. A late-quarter restructuring plan seemed to better position Citi.

Nor did the trouble stop with the banks. Two of the U.S. Big Three automakers - General Motors Corp. (GM) and Chrysler LLC - moved closer to bankruptcy as the government rejected the American carmakers’ plans for reorganizing. Indeed, the Obama administration even “suggested” GM’s CEO pursue other endeavors, and laid down serious guidelines regarding future intervention. Even so, bankruptcy may be unavoidable.

But then a funny thing happened on the way to Great Depression II. Citi, Bank of America Corp. (BAC) and JPMorgan Chase & Co. (JPM) each announced promising results for the first two months of the year, surprising investors and igniting a late-quarter stock market rally. In an interesting parallel development, a “surprise" announcement by Wells Fargo & Co. (WFC) last week added fuel to that already-existing rally in financial-sector stocks, and in the market in general.

Some confidence returned to the boardroom - at least within the healthcare sector - as major deals involving Merck & Co. Inc. (MRK) and Schering-Plough Corp. (SGP) ($41.1 billion) and Roche Holding AG (ADR: RHHBY) and Genentech Inc. (DNA) ($46.8 billion) moved forward.

Electronics retailing giant Best Buy Co. Inc. (BBY) reported better-than-expected profits as consumer activity suddenly picked up (at least, above the dismal levels of the fourth quarter). The credit markets began to thaw a bit as corporations issued new debt and the U.S. Federal Reserve offered up a plan to buy U.S. Treasuries as a way of keeping interest rates low.

Though the Dow Jones Industrial Average declined 13.3% for the quarter, March was its best-performing month since October 2002. The tech-heavy Nasdaq Composite Index declined 3.07%, but enjoyed a March that was actually its best month ever. The Standard & Poor’s 500 Index declined 11.67%.

Some of the late-quarter economic reports seem to reflect this brighter outlook. In manufacturing, for instance, factories continued to struggle as industrial production fell to the lowest level in almost seven years, though a favorable durable goods report offered some optimism as the first quarter came to a close.

Home sales likewise offered some cause for optimism, rising in February as buyers took advantage of low rates and a tax-break for first-time homeowners. Retail sales statistics were a bit better than expected - especially after removing dismal auto sales from the mix. And inflation - a much-feared foe with the level of government spending that’s taking place - remained well under control, even as talk of deflation also seemed to subside.

Stocks continued their strong run, even after the quarter closed. Since then, in fact, the Dow has rallied 6%, the S&P 8% and the Nasdaq 8%.

Sound Strategies to Follow No Matter Which Way the Market Moves

Nat Levy, a principal with Houston-based McNeil, Levy & Friedman LP, is a five-decade veteran of the financial-services sector, and has seen his share of uncertainty. In the near term, it rarely pays to prognosticate - so he doesn’t.

“I am unable to predict short-term market or economic movements and don’t know of anyone who can do more than guess at this," Levy says.

Even so, at a time when many investors are talking about “new rules," or “new realities," Levy says it pays to stay the course.

The one prediction he will offer is that some investors will look back on miscues they made today with more than a little regret.

“Right now, we find ourselves in one of those “if only I had…’ periods,” said Levy. “My one educated guess is that in five years from now we’ll look back and think “If only I had invested in this; if only I had remained invested in that, etc.’.”

Stavis & Cohen Financial’s Cohen points to the usual suspects like automakers and banks as industries that continue to face considerable challenges in the periods ahead. While he sees signs of renewed housing activity in terms of new and existing home sales, he acknowledges that prices continue to fall each month, foreclosures are increasing, and the newly laid-off workers could exacerbate those trends.

Cohen - like ***Money Morning*** - believes that commercial real estate may be the next shoe to drop; vacancies are increasing, rents are under pressure, and banks may not be willing to loan large sums of money to related companies looking to refinance.

Because inflation could become a problem, Cohen says investors should have some exposure to gold in today’s environment.

“The unprecedented level of government intervention has added significant liquidity to the marketplace, but, ultimately may lead to higher levels of inflation," he said. “Gold can serve as a potential hedge against such price pressures. Additionally, as the country’s debt and deficit positions mount, the dollar could remain under pressure and gold can be viewed as an insurance policy against a weak currency and the uncertain times faced today and in the future."

Cohen states that investors can invest in gold directly by purchasing bullion or through funds or exchange-traded funds - one being the **SPDR Gold Shares** exchange-traded fund, or ETF, (GLD) that track the price movements of the so-called “yellow metal.” His firm uses a manager who buys bullions and stores it in a vault, which he says gives his firm’s clients the opportunity to access a product whose price moves more in lockstep with the market price of gold, and is even more cost effective than gold funds or ETFs.

In terms of stocks, Cohen believes investors should consider small-cap shares.

“Historically, coming out of recessionary times, small-caps are among the best performing equity asset classes," he says. “Granted, many of these companies may have struggled during the dire economic times as investors shun anything other than industry leaders. Now may represent a decent time for cautiously optimistic investors to again look at small-cap companies, particularly when combined with some exposure to gold as a hedge against renewed downside pressures on stocks."

Cohen recognizes that the newly enacted government programs could prove helpful in jump-starting the U.S. economy - which should enable the recent upward move in stock prices to continue. In particular, he sees some successes in the Fed’s attempts to get corporations and municipalities borrowing again.

“The credit markets definitely are showing signs of life," said Cohen. “In the first quarter, domestic companies issued over $350 billion in new investment-grade paper and interest rate spreads between [corporate bonds] and Treasuries are coming down. Likewise, according to Lipper, investment-grade [municipal bonds] were up 4% to 5% in the first quarter and investor demand for such offerings seems to be on the rise. In fact, the state of California moved up a recent sale of $4 billion in bonds by a day to accommodate the demand for what turned out to be one of the largest tax-exempt offerings since 2007."

Mortgage-market distress could also create some investment opportunities for investors who do their homework, Cohen says.

“I am a firm believer that challenges create opportunities, and no products have experienced more significant challenges over the past few years than mortgage-related securities," said Cohen. “Amid the subprime debacle and related credit crisis, all mortgage products have struggled and even the higher-quality paper is being priced as if it is a toxic asset. We use a fixed-income manager who has been buying up more stable mortgage-backed issues at what he perceives to be tremendous values because of the negativity that has enveloped the entire asset class."

A market historian to the end, Cohen likes to return to what he knows best when attempting to analyze just where he believes the markets will head next.

“Dating back to 2000 through mid-March, the equity market lost about 3% in value, so history may suggest we are about halfway through what some would call a secular bear market," Cohen said. “During such times, it is quite common to experience periods when markets really take off. In fact, during the last few weeks in March, equities rose over 20% and some investors have pointed to that move as evidence that the market had bottomed and the turnaround had begun. In reality, since October 2007, we have seen six rallies of various magnitudes."

*[**Editor's Note**: Ron Brounes, CPA, is a regular contributor to* Money Morning. *A technical financial writer, Brounes, is president of Brounes & Associates, a Houston, Tex.-based consulting firm that provides writing, communications, and educational services for financial services professionals. Back in March, Brounes wrote about how the Obama stimulus package would affect your income taxes*.