



First Quarter 2009- A Buyers Strike, then Reflation

The first quarter started with a buyer's strike that was followed by a reflation fueled rally. To understand this better, we will walk you through both of these terms below. The quarter started poorly for the stock market, declining for all of January and February before bottoming in early March. Even with over a 25% recovery from the bottom, the S&P 500 still finished down over 11% for the quarter as earnings estimates declined precipitously. This is the sixth quarter in a row of stock declines.

If you watch CNBC, you may have heard the commentators talk about a "buyers strike." This means the market is declining because investors aren't willing to buy yet, and a lack of buying allows the market to drift lower. You could extend that concept to say that consumers were not buying either as economic fears and limited access to credit curbed their consumption appetite. This concept seems to characterize several trends we saw in a tough first quarter including:

- A weaker stock market
- Weak consumer spending
- Weaker capital spending, and finally
- Weakening exports

"Reflation" is the idea that government actions, both here and abroad, are designed to "reflate" or at least put a floor in under the economy. The term was coined by Strategas Research Group and we have seen it used by other groups lately. While the economy looks weak right now, the market is beginning to factor in some recovery. Government stimulus programs have been a regular occurrence for the past year, both here and overseas. The latest of these was signed into law by President Obama and included tax cuts, additional spending on infrastructure and aid to U.S. States. Additionally, the Federal Reserve has been very active and implementing new plans to help the banks through the financial crisis. Many of these plans have been designed to help create markets for illiquid securities the banks are holding, but we have also seen the tried and true method of lowering overnight rates as well. Overnight rates are now targeted in a range between 0.00% and 0.25%. These are unprecedented steps that have been taken to bolster the economic outlook and at some point they should produce results.

The first quarter started with concerns about a buyers strike and recession, and then finished with a strong rally that appears to have been based on the reflation trade. Early in the quarter, concerns about the banks continued difficulties and missteps by the administration led to a very weak stock market. Critics were concerned that the stimulus plan approved by the government was more focused on expanding social programs than economic stimulus. Additionally, the stock market was underwhelmed by Treasury Secretary Geithner's initial attempts to explain the administrations plans to rescue the banks. The administration has refined their plans and we saw a late quarter rally as the leading economic indicators showed signs of bottoming out. We found that investors became hopeful for a recovery as retail sales were not as bad as expected, and auto sales came in poorly... but still ahead of expectations. This slowing in the rate of decline is the type of information that the market will need in order to enjoy better performance. We still think the market is trying to put a bottom in place.



What does a reflation trade look like?

Since the recent market bottom on March 6, 2009 the market has favored groups that would benefit from economic growth. We present the performance by group for the S&P 500 from the beginning of the year through March 5, and then from March 6 until April 13. Both of these charts are courtesy of Bloomberg.



The stronger groups during the beginning of the quarter tended to be the more predictable groups, something you would expect during economic uncertainty. The better groups coming off the bottom were those that would benefit from the resumption of economic growth. The financials went from worst to first, losing 50% then experiencing a 70% plus rebound. Remember though, they needed a 100% bounce to get back to even.

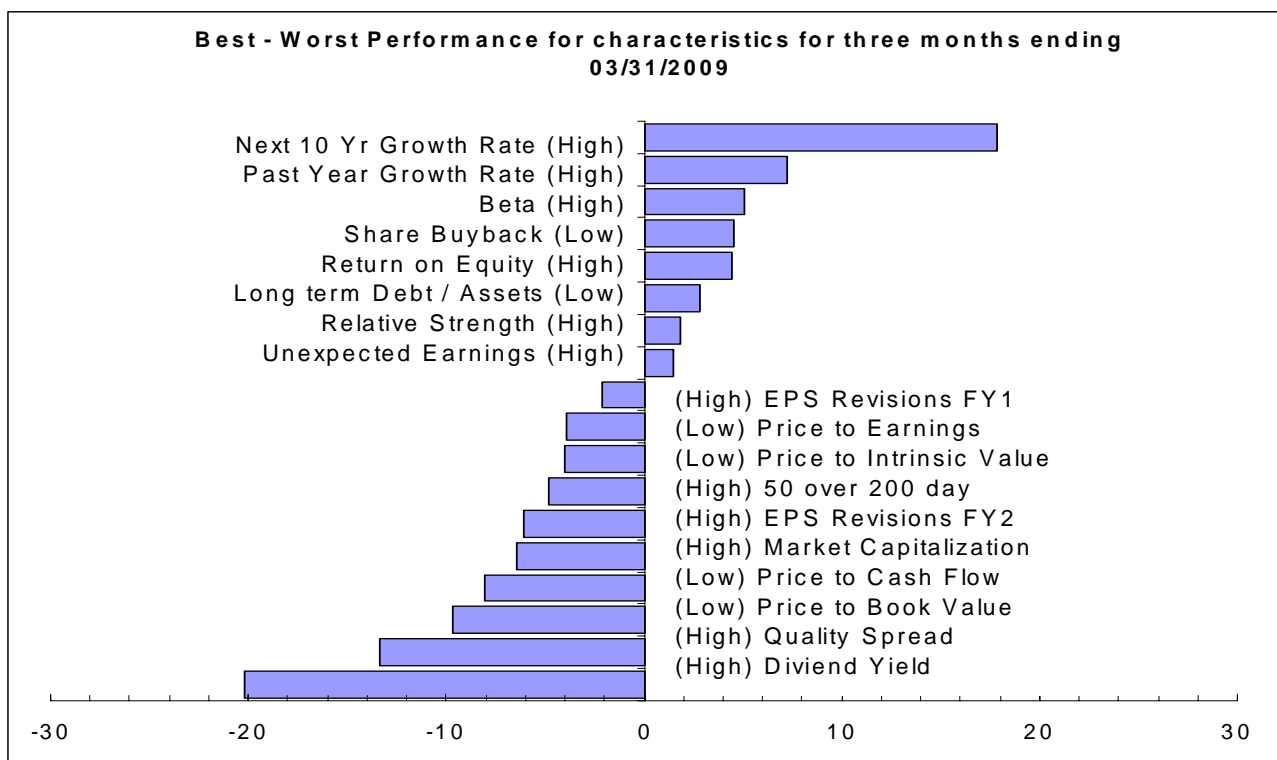
Normally, we are not fans of calling for groups in the bottom of performance to become the leadership moving forward. The only time that you get quick shifts in sector leadership are when the market rebounds off of a bear market low. If the recent low was the bottom, then the recent leadership should be sustainable.

We expect that there will be some modest economic recovery over the next year, and are positioned for it. The recovery may be muted as the consumer continues to increase their savings rate and some of the mechanisms promoting over-consumption are gone now. We expect that cash out financing is unlikely to occur given the destruction of value in the real estate market. Also, lenders are tightening up on other types of consumer loans as well. Americans are likely to get back to export oriented production, and restrain consumption for several years. Consumers should benefit from lower oil prices, and we are seeing that the trade deficit is already starting to come down based on those lower prices and consumers curbed their appetite for imported goods.

What worked during the quarter?

For the first quarter, investors sought companies that had higher trailing and expected earnings growth rates than the market in general. They also looked for the more volatile stocks and companies with financial strength. This jibes with the strength that we saw in Technology stocks for the quarter, and our sense that we are beginning a growth cycle. It is not surprising that investors would look for growth investments given the poor GDP numbers we have seen and the expectations that overall growth remains muted in the future.

S&P 500: Difference between Top ranked quintile and bottom ranked quintile returns



Source: Bloomberg, Baseline, Ford, Todd Estimates. Past performance is not indicative of future results.

During the quarter investors penalized high yielding, better quality stocks with larger capitalizations and better values. The bear market finally got around to the larger cap stocks and we saw some elements of capitulation in this group prior to the selling climax on March 6, 2009. We wonder whether this is the beginning of a period like 2003 when investors looked for the lowest quality, lowest priced stocks during that economic recovery. We do not think a repeat of 2003 is likely, but we sense the market is going to reward economically sensitive stocks as government efforts at reflation appear to be succeeding. The very low priced stocks that have a need for financing probably will not get it as the banking system is compromised. Our friends at Strategas are suggesting “The worst of the best” are attractive, which implies that companies needing some financing but still being strong enough to finance are going to be where the market looks to get aggressive. We believe the market will look to take on more risk in the coming year as a recovery unfolds, and will be looking for companies that fit those characteristics.



How did Todd do?

Our Large Cap product generally outperformed the market in the first quarter. We modestly beat or matched the S&P 500, and significantly outperformed the Russell 1000 Value. We believe the value index is likely to underperform the S&P 500 for some time to come as investors find earnings growth hard to come by. Our outperformance came despite the fact that we favor large cap, attractively valued stocks in a period when those factors contributed to underperformance.

We have had overweightings versus the S&P 500 in the technology and industrial sectors, and below market weightings in the financials. We changed some of our financial holdings during March to bring the portfolio to a market weighting versus the S&P 500. With the 76% surge in financials since March 6, we are modestly underweighted again right now as the names that recovered the best were the most speculative ones rebounding off of the bottom. We expect to do more changes within the financial sector during the upcoming quarter.

Our overweighting in industrials did not help us during the entire quarter, but helped us during the rally off the March 6 bottom. We are starting to look at Consumer Discretionary names. If the economy does rebound, this group will probably be part of the leadership as it has in the past.

We found that stock selection helped our results in the Consumer Discretionary, Energy, Industrials and Materials sector. Stock selection in the financials detracted from our performance.

Summary

The market is expecting some form of economic recovery, and has staged a great rally from the low point. Bottoms in markets are built over time though, and we would not be surprised to see the market give up some of its' recent gains as first quarter earnings come in weak. We believe that after a period of digestion, the market should start to act better as the year goes on. Massive government spending, coupled with low rates and pent up demand should lead to a modestly better economy as the year wears on. We are not talking about a record setting recovery, but the market doesn't need that to have a substantial rebound after one of the worst market declines on record. As the economic news gets "less bad" we are watching the market closely for continued clues that the deflation trade plays out. When this occurs, we are prepared to increase our weightings in those stocks that should benefit from this trend.

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Todd Investment Advisors
4-17-09
S&P 500- 870
10 year Government yield- 2.93%

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