



# INVESTMENT COMMENTARY

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## Signs Of Hope For Economic Recovery *Pace of Economic Contraction is Slowing and Signs of Impending Growth are Multiplying*

The second quarter of 2009 comes to an end in an environment of increasing bullishness mixed with a trace of anxiety. Most analysts and economists are in agreement the worst of the recession is over, but are divided on how strong the recovery will be. Treasury Secretary Tim Geithner, commenting on the overall economy, gave a guarded appraisal that we are now in the “early stages of repair.” We agree with Mr. Geithner, the economy is beginning to recover and will improve in 2010, but there are still some major hurdles ahead. Wall Street and global markets have been bullish – the S&P 500 has rallied nearly 40% from its intraday low of 667 in March. The bulls sense the U.S. economy will continue to improve in 2010, helped by an uptick in auto sales, an improving housing market, and a surge in capital investment. The latest consumer confidence report showed the biggest jump in six years, and demonstrated consumers are considerably less pessimistic than they were earlier this year. Economists expect the economy will show some degree of improvement as the majority of economic stimulus money begins to make its way down to Main Street in the near future.

### The S&P 500 Has Rallied Nearly 40% Since Its Intraday Low Of 667 In March

Bearish investors claim the 40% rally in the S&P isn't based on a 40% increase in fundamentals. Central to their gloomy outlook is the extraordinary pressures they see facing the American consumer. The bears remind us that the American consumer is responsible for nearly 70% of GDP, and they feel it is nearly impossible to have a quick economic rebound with one in every ten homeowners in trouble, unemployment nearing 10%, tight credit, and gasoline prices increasing almost daily for the last two months. The way the bears see it, the extraordinary level of debt the consumer is under will hamper the recovery and limit market gains until the burden can be worked off.

While we agree American consumers are under a great deal of pressure as they deleverage, the American economy is showing numerous signs that the pace of the economic contraction is slowing and we expect some degree of positive growth before the end of the year.

**Manufacturing Sector:** The most recent Business Outlook Survey reports most of the indicators of future activity show continued improvement. The survey suggests many executives are becoming more optimistic that a recovery in business will occur in the next six months. The latest manufacturing data shows some improvement across much of the sector. The Philadelphia Fed Index, a reading of manufacturing in the mid-Atlantic region, has improved

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to a minus 2.2 in June – up from a minus 22.6 in May of 2008. U.S. industrial production tumbled once again in May – down 1.1%. April’s output was revised downward to 0.7%. Also, orders for U.S. durable goods jumped unexpectedly in May. All of the data seems to indicate companies are beginning to gain confidence the recession is ebbing. Of course, the major story during the 2nd quarter was the bankruptcy of both Chrysler and GM. No one is certain what the U.S. auto industry will look like in a few years, but it is undeniable it will produce some winners and losers as it goes through this historical transformation. Currently, industry analysts are worried about the future of many of the auto parts suppliers. Already under pressure from the overall drop in auto production, many vendors question how they will survive the lengthy shut down of numerous production lines. An auto parts manufacturer trade group predicted widespread bankruptcies for parts vendors after the administration’s auto task force rejected a planned \$10 billion bailout. Economists fear the loss of suppliers will impact the entire auto industry as Ford, Toyota, and Honda also depend on the same suppliers for their parts as Chrysler and GM.

### **The Housing Sector Continues To Be The Most Problematic Segment Of The Economy**

**Housing:** The housing sector continues to struggle and is proving to be the most problematic segment of the overall economy. May’s new home construction climbed far above expectations. New housing starts jumped 17.2% for the month, and existing home sales ticked up slightly. Home prices continue to fall, and many economists think the worst isn’t over for the housing market. They point to the fact that year over year housing starts were 45.3% lower than the pace of construction in May 2008. Inventories of unsold homes are still far too high in relationship to new-home sales – the ratio of those “for sale” properties to those “sold” in April exceeded a 10 month supply. Noted Yale economist Robert Shiller says further declines in house prices are highly likely due to the faltering economy. A recent study by Harvard University reports unemployment, underemployment, and debt has put home ownership beyond the reach of a growing segment of buyers. Deutsche Bank is now predicting a further decline of 40.6% in the New York metro area going forward from the first quarter of 2009 due to the slumping economy. They are forecasting median home prices will suffer a total loss from peak to trough of 52.1% in the greater New York area. Rising job losses and sharply discounted foreclosure sales are placing fantastic downward pressure on home prices. Prices are still falling, and a large percentage of the existing home sales are on deeply discounted foreclosed properties which are priced for a quick sale. The state of California has placed a 90 day moratorium on foreclosures. Real estate analysts see the move as nothing more than a ploy to buy time – the fundamentals of high unemployment, tight credit standards, higher mortgage rates, and underwater homeowners will remain unchanged by September when the moratorium expires. Perhaps the most ominous news in the housing sector is the recent increase in mortgage rates. Treasury bond yields, to which mortgage rates are linked, began rising late last month. The rise in rates has already chilled the refinance boom triggered by lower rates earlier this year and could kill any nascent recovery in housing. While we don’t expect any sudden surge in interest rates, the impact the slight increase in rates has had on the mortgage market is a stark reminder of just how weak the housing market remains.

**Financial Sector:** The payback of the TARP funds by some of the largest financial institutions was very welcome news, but as Sheila Bair, chairwoman of the FDIC, warned, “while the banking crisis has subsided somewhat, it is far from over.” She said there are still “many more bank failures ahead.” So far in 2009, forty insured institutions have failed – the most bank failures since 1992, but still a very small percentage of the thousands of banks that constitute the American banking system. Analysts worry about bank losses in commercial real estate and the mounting defaults in credit cards. U.S. credit card defaults rose to record highs in May. American Express said its default rate climbed to 10.4% in May from April’s 9.90%. Bank of America reported its default rate soared

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to 12.50% in May from April's 10.47%. Revolving credit, closely linked to credit card debt, totaled over \$939 billion in March. The Federal Reserve reported 6.5% of credit card debt was at least 30 days past due in the first quarter – the highest percentage since it began tracking the data in 1990. Lending institutions face a dilemma as federal accounting regulations require credit card companies to reduce the value of any debt on its books to zero which have been delinquent for over six months. Faced with the prospect of having to write off the entire overdue balance, some banks are now reported to be cutting deals with over-extended card holders and settle for 40% or 50% of the original unpaid balance in hopes of recovering something on the overdue accounts before the six month expiration date.

### **The Latest Federal Reserve Report Claims Inflation Will Remain Subdued For Some Time**

**Inflation:** Inflation remains calm, but gas prices are worrying some economists. The latest Consumer Price Index fell 1.3% year over year – the sharpest decline since April, 1950. The CPI data would suggest there is virtually no evidence of inflation on the horizon, but to some analysts the rising oil prices are viewed as a harbinger of returning inflation. These analysts claim if oil prices level off, the inflationary bullet may be dodged, but if they continue to climb – stagflation could follow. With worldwide oil inventories still high and demand low – it is difficult to explain why oil prices have run up so far, so fast. A weak dollar has helped push global oil prices higher, but the drop in the dollar comes nowhere near explaining the recent surge in gasoline prices. We expect gas prices to ease in late summer (historically, they peak in early July) and agree with the latest report from the Federal Reserve that “inflation will remain subdued for some time.”

### **A Growing Number Of Economists Are Now Predicting A Protracted Jobless Recovery**

**Employment:** The latest unemployment data showed jobless claims edging upward. The numbers were higher than most observers had expected. Analysts saw the increased claims as being worrisome that the recovery may be weaker than anticipated. While the worst of the tsunami-size waves of job losses appear to be over, many economists are concerned the jobless claims are still as high as they are for being this late into the recession. Policymakers caution that any recovery later this year will not be strong enough to prevent unemployment from climbing even higher into early 2010. Skeptical economists are predicting the nationwide unemployment rate will top-out in the 10% -11.5 % range in the latter half of 2010 and will recede very slowly over the next few years as the nation experiences a painful jobless recovery. The latest data shows a broad recession with the unemployment rate rising in 48 states. Eight states reported jobless rates at their highest level in the history of the 34 year-old records kept by the Labor Department. It is important to remember that as bleak as these job numbers are, unemployment figures are a lagging indicator – historically, employment figures show no improvement until the recession is past and sometimes not until the recovery is well under way.

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## OECD Forecast Indicates The Worst May Be Ending In The Global Economic Slowdown

**Global Economy:** The Organization for Economic Cooperation and Development revised upward its latest assessment of the world economy. The forecast said the worst may be ending in the global slowdown. The OECD report was especially bright in its forecast for the U.S. and Japan. The declaration credited both nations' government stimulus measures as being responsible for the improving economic outlook. The OECD now forecasts the Japanese economy will grow 0.7% in 2010 and the U.S. economy should grow 0.9% in 2010. The report projects no growth for the 16 nations using the euro currency in 2010. The OECD criticized the European governments' lack of public spending during the slowdown for a more sluggish recovery. On the geopolitical front, North Korea and Iran are possible wild cards in global stability. Events in Iran are more problematic due to their strategic location and oil producing capacity. It is impossible to know how far events in Tehran may spin out of control and what the official Iranian response will be to the threat they perceive from protesters and foreign influence. Any serious disruption to the global oil market has the capacity to cause severe worldwide financial turmoil.



### Summary



- **Neutral weighting in U.S. equities**
- **Neutral weighting in foreign and emerging market equities**
  - **Long-Term (5-6 years) U.S. equities could double**
- **Overweight investment grade corporate bonds and preferred stock**
- **Maintain very limited positions in high yield bonds and real estate**
- **Intermediate U.S. Treasuries attractive for total return and hedging**
- **Inflation Protected Treasuries (TIPS) attractive as long-term holdings**
  - **Agriculture remains favorite commodity. Base metals and precious metals overbought. Energy could have significant correction**
- **Canadian dollar and emerging market currencies should appreciate long-term in relation to the U.S. dollar**
- **Covered call writing (selling call option contracts against equity holdings) very attractive for additional income and risk adverse investors**
  - **Significant correction possible in U.S. stock market due to profit taking after substantial gains since March low**
  - **Global financial crisis abated but economic growth will be muted**
  - **Government and consumer debt will be a drag on economic rebound**

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