



INVESTMENT COMMENTARY

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BEGINNING OF THE END OF THE RECESSION? SIGNS OF POSSIBLE ECONOMIC STABILIZATION ARE STARTING TO APPEAR

The waning weeks of March offered investors a sigh of relief as equity markets demonstrated a strong rebound after the abysmal months of January and February. While “happy days” may not be here again for some time, there are some encouraging signs, while tentative, that the economy may be showing some life. Consumer spending rose slightly in February, as did consumer sentiment in the latest survey by the University of Michigan. The latest retail sales report was better than expected. Mortgage rates are at historic lows. Home sales are up slightly, and even if a majority of the sales involve foreclosed properties selling at greatly reduced prices – it is still a sign of some activity returning to the housing sector. The latest durable goods data showed a slight gain in big-ticket purchases which manufacturers can only hope translates into the beginning of a trend.

Have we hit a bottom? No one can say with any degree of certainty when a recession has ended until months after the recession has ended. However, as the first quarter of 2009 comes to an end, there are some economic indicators which could be interpreted as signals the economy is nearing its bottom. It seems like it was only months ago when all the debate was centered on whether or not we were in a recession or just a mild downturn. Now, all the debate swirls around whether or not this current rally is a bear market rally or the beginning of a new bull market. The simple fact is no one can say with any certainty when a recession has started or when it has ended until the event has long passed.

While not wanting to sound overly optimistic, there are numerous small signs appearing that indicate we may be nearing the beginning of the end of this prolonged recession which is now poised to be the longest recession since the Great Depression.

More Than A Half Dozen States Now Have Unemployment Rates That Exceed 10%

EMPLOYMENT The grim employment predictions of Q4 2008 have grown even dimmer as we close out the first quarter of this year. Previously, some labor officials thought we may top-out at near an 8.5% national unemployment rate at the height of the recession, it now appears we will not only suffer a much higher rate of joblessness – but the rate could remain elevated for years to come. In early March, Federal Reserve Chairman Bernanke said it was within the realm of possibility that the nationwide average unemployment rate could rise above 10% “for a period of time.” The latest labor department figures show unemployment is a growing problem across a wide sector of the entire economy - with forty-nine states registering increased rates of joblessness and more than a half dozen states already suffering unemployment rates that exceed 10%.

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As we go to press, the outlook for the March employment numbers are bleak. Analysts expect to see the economy has shed another 600,000 plus jobs in March. If the numbers come in as high as expected, it will be the fourth straight month the economy has lost more than 600,000 jobs. Not only are private sector jobs in jeopardy, even the Postmaster General, John Potter has announced the U.S. Postal Service is considering shedding huge numbers of workers in an effort to avoid, “losses of historic proportions.” The post office plans to offer an early retirement package to nearly 150,000 hourly workers, eliminate nearly 1,500 management positions, close numerous district offices, limit rural mail service, use more temp workers, and possibly limit mail service to five days a week. Some analysts are forecasting what could best be described as the mother of all jobless recoveries. According to the UCLA Anderson School of Management’s quarterly economic forecast, the national unemployment rate should spike in mid 2010 near 10.5%, but will remain at above 9% even as late as the beginning of 2012. Keep in mind, all these forecasts were made before the most recent news regarding the latest round of problems plaguing GM and Chrysler. No matter what possible solution Washington deems necessary for helping GM and Chrysler to survive – the automakers will face a minimum loss of tens of thousands of additional jobs as more production lines will be permanently shut down.

California’s Foreclosure Sales Surge May Be The Strongest Signal Yet Housing Is Recovering

HOUSING SECTOR Home prices continue to spiral downward. Tight credit, a bleak economic outlook, and ballooning job cuts are all placing tremendous stress on home prices. Defaults on FHA insured mortgages are still increasing, 7.5% of FHA loans are now classified as “seriously delinquent” (90 days or more overdue, in foreclosure, or in bankruptcy). Foreclosures accounted for 58% of all existing California home sales in February – up from 33% a year earlier. Latest figures show CA home prices dropped 41% from a year earlier – median price sank from \$418,620 (Feb. 2008) to \$247,590 (Feb. 2009) – during the same period, the U.S. median price fell 16% nationwide according to National Assoc. of Realtors. The CA price drop has led to an 83% increase in the number of homes sold in Feb. y/y (338,970 units in 2008, 620,410 units in 2009). Many analysts follow the CA housing sector closely in the belief that CA led the nation into the foreclosure mess and CA will be the first to rebound from it – and what is selling right now in CA are foreclosures. CA banks have slashed foreclosed property prices to the bone in an attempt to rid the unwanted properties from their balance sheets. The huge surge in sales in CA may be a sign that home prices are beginning to find a bottom. It would make sense that the true bottom in home prices would be discovered in the most discounted market - foreclosed properties. Some analysts believe this coming year will see the steep decline in “sunbelt area” home prices leveling off, but a new sharp plunge in home prices in many of the nation’s largest metro areas, especially those which have experienced a spike in unemployment. PMI Mortgage Insurance Co. forecasts home prices will fall in more than half of the largest U.S. cities through 2010. The PMI report sees possible steep declines in the greater New York and Washington areas due to the deteriorating economic outlook and surging unemployment numbers.

The American Consumer Will Be Under Tremendous Pressure For The Next 12-18 Months

ECONOMY While there are numerous signals that the economic downturn may be slowing, the U.S. consumer faces a rough road ahead for the immediate future. The latest Federal Reserve report shows U.S. household wealth shrank a sixth quarter in a row at the end of 2008. The total net worth of households fell to \$51.48 trillion in the fourth quarter from \$56.59 trillion in the third quarter. The 9.0% drop was the largest ever. The deteriorating job market has mired consumer confidence at a three-decade low rate for months. Personal credit is tightening and Americans are saving money at a historically elevated level in an effort to cushion against the recession.

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Analysts predict anywhere from a 45% to near 60% contraction in available lines of credit for credit-card holders. Banks are rewriting their underwriting standards which will result in a huge number of current credit-card holders being re-classified as non-creditworthy and therefore having their lines of credit pulled. Banking experts foresee the \$5 trillion credit-card available lines possibly contracting by \$2 trillion in 2009 and another half trillion cut in 2010. In an economy where consumer spending makes up 70% of gross domestic product, the recent mix of consumer thrift and contracting credit availability are a worrisome sign for a speedy recovery from the recession. Consumer confidence is a critical component in turning the economy around. With the loss of personal wealth, climbing unemployment, tightening credit and a general sense the economy is not going to improve anytime soon - the consumer is being hammered. The mind-set of the American consumer is a vital gauge of how the overall economy will fare – the economy will struggle as long as the typical American consumer feels stressed out about their own financial well being.

OUTLOOK The Dow industrials are up 20% in the past four calendar weeks, but there is still a great deal of volatility in the market. Since the beginning of March, the Dow has had seven triple-digit point gains and six triple-digit point losses. There are a host of statistics indicating the economy may be stabilizing, but there is still an array of possible troubles ahead – credit card crunch, commercial property crisis, and the uncertainty that still surrounds the toxic assets on some bank balance sheets. The recent changes in the U.S. accounting standards on how banks value billions of dollars in securities on their balance sheet may help strengthen the banking sector and loosen up credit markets, but some accountants claim the change in standards is nothing more than new-age accounting hocus-pocus – only time will tell if the new standards help.

Current Asset Prices Reflect Expectations For A Protracted Period Of Anemic Economic Activity.

INVESTING Excessive liquidity (easy credit) led to mal-investment on a global basis. The unwinding, or deleveraging, of this global investment bubble has wreaked havoc in the world's financial markets. Global economic upheaval has greatly depressed prices for financial assets and commodities. Current asset prices reflect expectations for a protracted period of anemic economic activity. This recession started in the fourth quarter of 2007 and asset prices have declined sharply since then.

Declines Since Highs of Fourth Quarter 2007

S&P 500 total return -47%
Deutsche Bank Base Metals Fund -50%
Light Sweet Crude Oil -45%
Barclay's High Yield Index -40%
Dow Jones U.S. Real Estate Index -65%

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While the entirety of negative economic news may not be behind us, it appears most of it has already been discounted by the financial markets. Asset valuations are attractive and should move much higher as the global economy stabilizes and ultimately begins to once again expand.

The nascent signs of economic stabilization are beginning to appear. The rate at which the economy has been deteriorating should abate in the next quarter. The process of absorbing the losses related to the investment bubble will be lengthy and could cause economic growth to be below the historical trend for several more quarters. Fortunately, asset prices should begin to increase in anticipation of the improvement in the global economy. There is an increased probability that annual returns on stocks could approach double digits in the coming three, five and ten year periods. Just as the decline in asset prices was not a straight line, one should not expect the rebound to be in a straight line. The general trend should be positive but very jagged.

Investors should begin the process of slowly shifting back into stocks, commodities, lower credit fixed income and real estate. Patience is paramount. The financial crisis may not be over yet, but there are some positive signs the worst of the crisis may be behind us.



SUMMARY



- **Commit some capital to foreign and emerging markets**
- **Investment grade corporate bonds and preferred stocks are attractive**
- **Add to positions in small, mid and large cap U.S. stocks**
- **Base metals, energy and agricultural commodities are attractive for total return and hedging**
- **Current asset prices afford investors excellent upside over the next three to five years**
- **U.S. Treasuries should be held for hedging purposes and not as a total return investment**
- **Commitment to high yield corporate bonds and publicly traded real estate should be limited**
 - **The global financial crisis has abated but economic growth will remain constrained for several quarters**
- **Australian Dollar, Canadian Dollar, Chinese Yuan and commodity-based emerging market currencies should show strength**

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