

THE MARKET OBSERVER

AUGUST 2009

After rallying 15.9% in the second quarter, stock prices (as measured by the S&P 500) continued to advance through July and early August. Stocks have advanced approximately 12% so far for the year after initially being down 12% through the end of the first quarter. The S&P 500 closed at 1,010.48 on Friday August 7th.

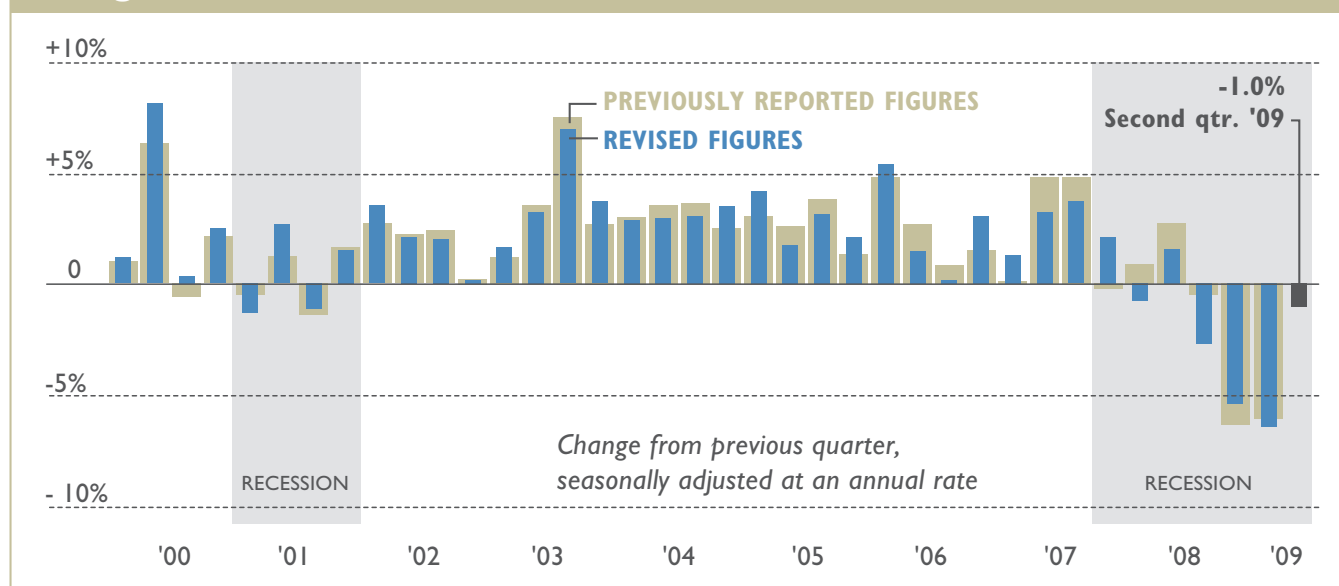
A quick review of the last two years reminds us the market initially declined approximately 17% from 1,565 to the 1,300 level between

October, 2007 and August, 2008 as the sub-prime crisis and economic slowdown were coming to light. It pierced the psychological 1,000 level in the aftermath of the Lehman bankruptcy before panic set in in November, 2008 pushing it to an intra-day low of 741 on November 21st 2008.

The ensuing bounce off the lows fell short of the 1,000 level before the post-Obama “relapse” brought the market to a new intra-day low of 666 on March 6th 2009, when a global financial-system meltdown seemed to be at hand.

The major impetus behind the latest rally appears to be corporate earnings and GDP declines are turning out to be “less bad” than expected. Earnings were expected to decline 35% year over year at the start of the second quarter but now look like that they will decline “only” 25%. US GDP declined at an annual rate of 1% in the second quarter which was also better than expected. While the market has rallied approximately 50% from its March lows, it is still 35% below its October, 2007 peak and 23% below

Change in Real Gross Domestic Product



Source: NY Times, Bureau of Economic Analysis: National Bureau of Economic Research

AUGUST 2009 (continued)



Source: Russell Investment Group, Standard & Poor's, FactSet, J.P. Morgan Asset Management

October, 2008 levels before it first started to price in the possibility of Armageddon.

Government spending was a major source of economic output during the past quarter while consumers and businesses continued to cut back and re-build their balance sheets. This tempered velocity of money in the economy along with constrained labor costs lessens the immediate risk of inflation and leads many prognosticators to believe we will see a slow recovery in economic activity through 2010 and into 2011. Corporate earnings should be poised to inflect positively when this happens

in light of the cost cutting that has taken place, which should eventually bode well for stocks. If it takes five to seven years to regain the earnings lost in the current recession and the market, in turn, recovers to the 1,500 level, this would equate to middling, single digit returns from stocks. Such returns might look good to many investors when compared to money market yields of less than 1/2 of 1%, short-term Muni yields of 1% to 2% and 10 year Treasury yields of 3.5%. Investors who were appropriately allocated and balanced, and were able to ride through the storm of the past two years and still have a 5 year investment window, can make a case to stay the course, especially if the possibility of a complete meltdown is truly behind us.

Ultimately for a sustainable recovery, real economic activity, both consumer and business, will have to replace \$4,500 clunker rebates and Federal Reserve "Quantitative Easing". Real economic growth will have to replace Government borrowing and spending. Such activity should return in time and hopefully the balance sheet re-structuring that our country is currently enduring will leave us in a better shape to deal with new problems that will eventually be encountered around the next corner.

The major risks that might impede such progress (as succinctly stated by Jeff Bronchick in the most recent RCB Newsletter) appear to be "lagging economic and socio-political trends that cannot be solved by anything but the passage of time." A "Perfect Storm" has resulted in an unprecedented level of Governmental involvement in our economy (even though a review of the origins of this crisis can be traced back to Capitol Hill as well as Wall Street.) Going forward, the baton will have to pass back to the private sector. A line from the 5/18/06 New Yorker in an article by Nick Paumgartner comes to mind, "Capitalism without bankruptcy is like Christianity without hell."

In a free market system businesses will fail. Propping them up while borrowing money for new social programs (while we are running deficits related to past initiatives) does not seem to be the basis of a sustainable economic model going forward.

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