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Is the Mug Half Full? Or Is the Mug Half Empty?

Most everyone enjoys a good cup of coffee. When we talk about the "mug" we've pulled down from our kitchen cabinet, we need to be certain we are talking about the same mug. Is it the chipped and worn mug with the words "Our Country's Economy" stenciled on it, or is it the fresher, more recently purchased one with the words "The Equity Markets" painted thereon?

Why? Because the answer to the query which is the title to Westover's quarterly newsletter depends on which one we're holding in our hands. The economy's mug is half empty while the market's mug is half full.

Let's do a quick review of the last year or so.

- September 15, 2008: Lehman Brothers files for bankruptcy; Bank of America announces it has agreed to buy Merrill Lynch.
- September 16: Our government announces it has purchased an 80% stake in the world's largest insurer, AIG; the Reserve Primary Fund, a money market fund, "breaks the buck" falling below \$1 per share.
- September 25: The FDIC seizes Washington Mutual, making it the biggest bank failure in our history.
- September 29: The House of Representatives, fearing Main Street backlash, gets weak knees and rejects the bailout bill. In reaction, the Dow Jones Industrial Average plummets 7% in ONE DAY. Compare that one day move to a Dow which historically didn't move 7% in one year! In fact in 7 of the last 20 years the Dow was either up less than 7% or down less than 7% for the entire 365 days.

- Volatility and fear now grip the markets in a ferocious bear hug. The Dow drops 7.3% on October 9th, drops 7.9% on October 14th and another 7.7% on December 1st.
- October 21: The Fed provides over \$540 billion to help meet money market redemptions and to keep the dollar from "busting" again.
- February 11, 2009: Congress agrees on a \$789 billion stimulus plan.
- April 30, then June 1: First Chrysler, then GM throws in the bankruptcy towel.
- Our economy's GDP contracts 6.2% in the last quarter of '08, the most in over 25 years, only to be followed by a 6.4% drop in the first quarter of '09. (Remember that 6.4% number, you'll see it later in this newsletter.)
- The Morningstar database of mutual funds examines all 3,734 funds which invest primarily in U.S. stocks. All but one loses value in 2008. All 978 funds which invest in non-U.S. stocks have a negative return. Every one of the 144 domestic and foreign real estate funds lose share value, as do all 128 natural resource funds. In other words, out of more than 4,000 equity funds all but one of them lose value in 2008.
- The S&P 500 Index, the bellwether for all large U.S. companies, drops like a bowling ball dropped from the Ben Franklin Bridge, going from 1251 on September 12th (the last trading day before Lehman's collapse) to 676 on March 9th, a harrowing 45.96% drop in just 6 months.
- Unemployment gets worse and worse, pushing 10% by September 2009, and finally,
- Warren Buffett gets buffeted. In 2008, his flagship company, Berkshire Hathaway, has its worst annual performance in the last two decades, performing more poorly than the 38% decline in the Standard & Poor's 500 Index.

**"So Other Than That Mrs. Lincoln,
How Did You Enjoy The Play?"**

That gruesome question can best describe what turned out to be the worst performing stock market year since the 1930s. 2008 was biblically bad - locusts, floods and darkness bad.

Then, to add insult to injury, the first quarter of 2009 was so bad that the markets' 46% drop, from the last quarter of 2008 through the first quarter of 2009, was the worst six-

month performance since FDR won the first of his four presidential elections in 1932. That's 77 years ago folks.

I remember the Philadelphia 76ers' 9 wins, 73 loss record during the 1972-73 basketball season. They lost their first 15 games, and later went on another 20 game losing streak. The Sixers finished an NBA record 59 games behind the Boston Celtics that year. Their .110 winning percentage record is the lowest in the history of the NBA. That's what the stock market's 2008 and Q1 of 2009 performance felt like to me.

But then...

The worm turned. Instead of the worst of times, it became the best of times. The United States stock market has just finished its best six months since 1933, FDR's first year in office, jumping back 53% from those March lows.

Should history be a guide, then that strong recovery might suggest that the market can go higher still. Since World War Two, and not counting the 2009 rise, there have been eight periods when the S&P 500 rose at least 30 per cent in a six month time frame -- 1963, 1971, 1975, 1980, 1982-83, 1997 and 1999. Twelve months later, the index had made further gains in seven of those eight periods.

The only exception was 1980 when the country experienced a double dip recession. So, will that happen this time? It could, but I doubt that it will.

Here are five reasons:

1. History

See the previous paragraphs.

2. The curmudgeon, James Grant

Grant is the editor of *Grant's Interest Rate Observer*. His monthly publication is economically to the right of Adam Smith. In Mr. Grant's ideal world, the Fed would never have used its extraordinary powers for rescue purposes, the Treasury would never have flooded the financial system with boatloads of recovery money, interest rates would be several stories higher than the floor we see today, Alan Greenspan is Darth Vader brought to life, and the United States should still be on the gold standard.

If there ever was a glass half empty guy, it would be Mr. Grant. Well, surprise of all surprises. His missive, which I

read regularly in order to set the parameters of that rightward extreme point of view, came out in September with a conclusion that this is now the best time in history to be in the market!

After noting that this recession has seen the steepest decline in manufacturing and trade inventories since 1943, the lowest capacity utilization since 1967 and the sharpest fall in industrial production since 1943, he points to the academic study of economist Michael Darda of MKM Partners.

According to Darda "[T]he most important determinant of the strength of an economic recovery is the depth of the downturn that preceded it. There are no exceptions to this rule, including the 1929-1939 period." Call this the Darda Dictum.

Grant notes that Ben Bernanke, Paul Volker and the herd of economists who read each others' predictions collectively forecast an anemic 2.4% GDP growth for 2010. Yet to Grant this recession most resembles that of 1981-82 when the GDP last shrank at a rate of 6.4%. The next 6 quarters GDP growth roared back at rates of 5.1% to 9.3% per quarter.

Grant quotes English economist Arthur Pigou thusly: "The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born not an infant, but a giant." In other words, the general press and mainstream economists are too caught up in the overwhelming downslide we experienced starting last fall to recognize and acknowledge the incredible bounce we now enjoy and will continue to enjoy.

By flooding the system with \$1.2 trillion in the last twelve months, the Fed is perilously putting the value and integrity of the U.S. dollar at risk, he argues. It all but invites our foreign creditors to ask, "What is the dollar anyway?" Indeed, you may remember hearing of the secret talks the Middle East oil producing countries had recently with Russia and China allegedly in regard to creating a world-based currency for oil in substitution for the greenback. Keeping interest rates at or near zero "has lit a fire under the stock and debt markets" he says. Well, if Grant's right, and if Bernanke holds to his stated intention of freezing rates near zero for the foreseeable future, then the stock market should continue to rise.

Finally, Grant embraces our newfound consumer sensitivity to debt, to savings and to prices. He notes that falling prices in the Depression ultimately "opened wallets." The bargains consumers and investors found got snapped up. Similarly today, bargain hunting will stabilize real estate and other

markets. Indeed, and as an example, the supply of unsold houses is down 39% from the year before in Detroit of all places. Why? Bargains are to be found.

When I read Grant saying all this, I felt that Rush Limbaugh had just announced he'd had an epiphany and that he now believed that Barack Obama was the best president since Ronald Reagan.

3. Wall Street's Wise Men

Barron's recently surveyed the top ten strategists and investment officers. Nine out of ten thought the S&P 500 Index would end higher than it was sitting when the survey was undertaken in early September. Collectively, they predicted that the S&P 500 would finish the year at 1056, when it was then at 1016.

As I write this newsletter, the S&P 500 has hit the magic 1056 number, so can it go higher still? Henry McVey of Morgan Stanley sees 1095 by year's end, Thomas Lee of JPMorgan Chase believes it will end at 1100 and John Praveen of Prudential International has an 1175 handle on it.

Bob Doll, the Vice Chairman and Chief Investment Officer of Blackrock, believes there should be improvement in year-over-year corporate earnings this quarter, that equity valuations are reasonable and that stock market annual returns around 6% to 8% over the next several years are likely. If so, who wouldn't be happy? While the equity markets generated a 12.9% total average return from 1900 until 1999, when the century turned, so did the markets. From 2000 through 2008 equities lost 2.3% per annum. I'm a big believer in the concept of reversion to the mean!

4. Economic and Market Data

A low inflation environment should be market friendly to global equities. Earnings momentum will bring more retail investors, as well as fund managers who don't want to be accused of "missing the party," back into the market. The trillions of dollars, which used to be in money markets earning something, are now earning nothing; soon that will prove more than tiresome.

Credit markets are thawing. Mortgage rates are dropping. Balance sheets, both company-type and human, are being repaired and bolstered.

Investor sentiment is still negative. That's actually a good predictor for continued upward movement. The poor retail investor typically gets it exactly backwards when it comes to predicting market movements. Numerous academic studies confirm this truism. He sells when he should buy, gets out when he should get in. Be truthful now, did any of you get more conservative last spring? Are any of you patiently waiting for the perfect time to get back into the market now?

There is an uptrend in corporate earnings estimates, with many more revisions to the upside than the downside. In August there were 41% to the upside, compared to 14% for July and many months before that with less than 10%.

It is now fairly well agreed that the US and global recessions are in the process of ending. Ben Bernanke has so opined with respect to us. And, just the other day, the Reserve Bank of Australia became the first G-20 central bank to actually raise its interest rate, signaling its belief that the financial brakes in that commodity-sensitive country need to be applied just a bit.

The leading economic indicators, as measured by the Conference Board, have been trending decisively upward since March.

Lastly, the Organization for Economic Cooperation and Development measures industrial production based on data from manufacturers, miners and utility companies. Collectively they make up 20% of our economy, but more importantly they move roughly in step with the economy as a whole. Starting in July, all indicators turned in an upward direction and have continued in that direction since.

5. The technician, Don Hays

He's shouting that recovery is at hand, and more is to come. I don't understand his charts, but get his message. Translated so a fundamental investor like me can understand it, his voodoo charts say, "All points of the technical compass point north." Here's his September 2009 executive summary in his own words: "Hays Advisory believes the bottom has been made and investors will make significant gains over the next few years."

I might not place my faith in Bollinger bands, MACD and 50-day moving averages, but I do understand English. That means his reading of the market's charts favor the equity investor for the next couple of years.

So, in conclusion, when I go to the kitchen cabinet to grab a

mug for my morning java, I take the one on which it is written "Half Full." What does your mug say?

Listen to the Music

Steve Siegel is the winner of our July Newsletter Quiz. He's also the first repeat winner we've had, I believe. Mr. Siegel is the president of the Siegel Group, a New Jersey-based, nationally acclaimed consulting firm specializing in tax consulting and estate planning for family business owners, entrepreneurs and the professionals who assist them. He holds degrees from Georgetown, Harvard and NYU.

Steve correctly named three women -- Graff, Evert and Navratilova -- who have won more Grand Slam tennis tournaments than Roger Federer; he also identified Andre Agassi as the player who lost to Sampras in Pete's first Grand Slam as well as his last. Finally, he correctly determined that filling the Eagles Lincoln Financial Field with \$100 bills from Washington's \$700 billion TARP largesse would require 58 feet, or 6 stories of greenbacks.

Here's a timely two-part quiz: The Phillies won the World Series last year, and are presently playing the Rockies in the playoffs this year. What National League team last won two consecutive World Series, and name three players who played on both teams. Hopefully, this will encourage lots of participation.

All readers with the correct answer will be put in a hat, and my staff will pick the winner. If you win, we'll send you a credit for \$100 to the restaurant of your choice. But no internet sleuthing.

I leave you with this question: If they were to end with a loss to the Rockies, would you call the Phillies season, winning the Eastern Division but falling short in the post season, half full or half empty?

Either way I wish you best of luck with our quiz.

October 9, 2009