



The First Ones Over the Wall Market Commentary May 1st 2009

Forecasting the markets movement over short periods of time with any degree of consistency can be an exercise in futility. Though there can be a certain satisfaction in being prescient enough to pick the bottom, it is more important to understand and identify the factors that lead to and define the cycles of bull and bear markets. Identifying the trend rather than the turning point of any market can be more profitable for long-term investors.

Whether this is the start of the next bull market or a failed attempt to rally will only be evident in hindsight, but for the moment we continue to maintain a cautious stance. If our skepticism is rewarded there will be more attractive entry points in the coming months. On the other hand, if this is in fact the start of a more substantial move, there should be a number of opportunities to participate if history is any guide.

It is important to remember that the first ones over the wall are either heroes or dead and we have never enjoyed those odds.

The equity markets have rallied off the March lows erasing much of the year to date deficit and in the case of the tech heavy NASDAQ, has moved firmly into positive territory up 8.89%. The S&P 500, assisted by a strong rally in the financials is now only negative -3.37% for the year with the EAFE and the Dow trailing slightly, down -4.17% and -6.92% respectively.¹

However, when viewing the market declines since the market peaked in October of 2007 the performance is a bit more sobering. The S&P 500 has declined 44.2%, the NASDAQ has fallen 39.9%, and the EAFE is negative 50.3%.² Even with the recent rally, the indexes are still trading well below their highs and the recent move has only improved the averages performance by a small margin.

The current rally has been based on the hope that the rate of economic decline is slowing and that it will eventually bottom out and stabilize. As every pundit will fondly quote, markets tend to rally six months prior to an economic bottom. Optimists point to “green shoots” as represented by the pace of decline improving in jobless claims that are terrible but not increasing significantly, GDP that only fell -6.1% annually in the first quarter, and home prices according to the Case-Shiller report that were down (-18.8%) after a decline in January of (-19.4%).

Participation in the current rally has been predominately limited to retail investors with institutional investors remaining on the sidelines. The lack of involvement by the quants and hedge funds has been noticeable with the exception of their short positions and empirical data points to these short positions being responsible for a sizeable percentage of the markets recent gains.

On a positive note, trading volume has increased significantly since the March lows were established. Higher volumes are considered indicative of investor confidence and a willingness to commit new capital to the markets. Average daily volume in the month of March was 50% higher than the trailing five-year average.³

However, the dollar amount of transactions was significantly less than the five-year average. Trading volume increased due to company's shares trading at historically low prices. Certain financial and auto stocks have generated significant volume as speculators have traded the shares on a daily basis. When a stock trading at \$2 per share becomes the most active issue on the Big Board, trading volume will naturally increase.

In all fairness, consumer confidence and spending have come in higher than expected, corporate earnings while still weak could have been worse, and there are signs of greater liquidity and stability in the credit markets.

¹ Source: Bloomberg.com

² Source: Bloomberg.com

³ Source: NYSE.com



Our only concern is that these green shoots could easily be killed by a quick frost and betting on a recovery with the available data seems a bit thin.

In short we have been skeptical of the current rally :

- Housing Prices have declined for 31 consecutive months as inventory levels remain near their highs.⁴
- Consumer spending increases may be a one time event due to larger than expected tax refunds and government rebates
- Unemployment shows no sign of stabilizing
- Speculative high beta stocks have led the rally without any real improvement in their financial health
- Institutional investors have remained on the sidelines, while retail and day traders have been the primary participants
- With the government stress test looming there is a great deal of uncertainty in the financial sector regarding capitalization requirements

We don't know where the markets will trade over the next six days or six months, but we would like to see greater evidence of an economy that is stabilizing before we would be comfortable increasing our equity exposure in any meaningful way. Anticipating a potential decline in the rate of descent for the economy is a far cry from an economy that is bottoming let alone recovering and our desire to protect capital is too great to take a chance.

We don't need to be the first ones over the wall; we just need to win the battle.

In such volatile times, we appreciate the confidence you have entrusted in us and look forward to speaking with you in the coming weeks.

Sincerely,

Brad L J Griswold
Managing Partner

NASDAQ Composite Index (NASDAQ) Measures all Nasdaq domestic and non-US based common stocks listed on the Nasdaq Stock Market. The market value, the last sale price multiplied by total shares outstanding, is calculated throughout the day, and is related to the total value of the Index.

Dow Jones Industrial Average (Dow) Comprised of 30 stocks that are major factors in their industries, and widely held by individuals and institutional investors.

Standard & Poor's 500 Stock Index (S&P) An unmanaged capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

EAFE The **Europe, Australasia, and Far East Index** from Morgan Stanley Capital International. An unmanaged, market-value weighted index designed to measure the overall condition of overseas markets.

Case Shiller Index: The S&P/Case-Shiller Home Price Indices measures the residential housing market, tracking changes in the value of the residential real estate market in 20 metropolitan regions across the United States

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⁴ Source: Standard & Poors S&P Case Shiller Index