



Our economy continues to carve through the bottom of one of the worst recessions in history. Job losses, home foreclosures, and lack of consumer spending are at some of the most severe levels since the Great Depression. While the pain of the recession will continue for many more months, we know now that the worst will be avoided. A “doomsday” scenario, the prospect of which drove the stock and corporate bond markets to shocking lows and the treasury market to unbelievable highs, has been averted – at least for now.

The four-step recovery outlined in our last two letters is continuing very much as projected. We predicted a sequential recovery for 1) the credit markets, 2) the U.S. stock market, 3) the general U.S. economy, and 4) the U.S. housing market, in that order.

First and foremost, the credit markets need to heal. That is happening now evidenced by the shrinking risk premiums, the difference in interest rates between risk-free treasury bonds and other investments which contain various levels of risk. For example, the rate difference between BBB-rated, 10-year corporate bonds and 10-year treasuries, which was over 7% in November, is now 4.4%.¹ Or by another measure, the difference between the 3-month bank-to-bank LIBOR (London Inter-bank Overnight Rate) and 3-month treasury rate was 4.6% in November and is now 0.4%, near its normal historical value.² This means investors – individuals, institutions, and banks – are becoming more willing to make high risk/return investments and participate in the capital markets. This was not the case six months ago when world-class banks would not even lend overnight to other world-class banks.

The second step we outlined was a positive change in the general stock market direction. The stock market is a good predictor of the economy five to six months in advance.³ At quarter-end the S&P 500 Index had moved 35% (adjusted to include dividends) from its March 9th low, indicating that the darkest scenario of a frozen banking system and U.S. economic depression is no longer plausible and that the end of the official recession may be within months. Goldman Sachs is now predicting small but positive 1 – 2% economic growth for 3Q09.⁴

The last of the demolished asset classes to recover will be the housing market. This final step is still distant. The housing market is the slowest to react since it is the most illiquid. While stocks and bonds are bought or sold in seconds, the real estate buying and selling processes take several months. Real estate prices, unlike stock prices, move in long, smooth, multi-year cycles; however, even in the housing sector small signs of recovery are appearing.

This current market downturn is likely one of the most severe we will ever see. Like geologists after a volcanic eruption, economists are now studying the internals of the stressed global capital markets to gather insight. Individual investors should also use this opportunity for a personal stress test, taking time to reflect on their own risk tolerances and discuss future risk/return targets with their financial advisors. How much volatility can each of us take and still sleep well? “Investing through the Toughest of Times – Expert Advice” examines the benefits of continued investing when times are darkest and reviews some contributing thoughts from the investment industry’s finest minds.

SUMMER
2009

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Financial Markets Summary



Through 1Q09, the stock market recorded six consecutive quarterly losses, a streak which occurred only once prior in the past eighty years (1969-70).⁵ That streak was snapped emphatically this quarter as the S&P 500 Index returned 15.9%.⁷ It was the strongest quarter since 1998.² When bear markets turn, they always turn up steepest at the beginning, among a backdrop of disbelief from experts and the public. This is why moving out of the market during downturns is so dangerous for long-term investors.

Volatility also calmed this quarter. The Chicago Board of Options Exchange (CBOE) Volatility Index (VIX) had stubbornly resided above 40 -- a very high reading -- since October. It broke through that floor in April and has been settling near 30.⁶ This still indicates high volatility relative to historical levels but also tells us that much of the uncertainty in the credit crisis has abated.

Despite one of the worst January's in history, most 2009 major indexes are near even. As of mid-2009, with dividends included, the S&P 500 Index has returned +3.2%, and the Dow has returned -2.0%. A wide disparity is appearing between asset classes, illustrating the importance of diversification. Leading components within our portfolios this year include Latin America (+39%), China (+35%), semi-conductors (+30%), and commodities (basic materials up 15%).⁷ Additionally, many of the bank-backed preferreds in which Sharper ♦ Granite invests are up over 30% for the year while continuing to provide hefty, tax-advantaged dividend payments in the 10%/year range. Resisting sale of these battered issues proved beneficial to our clients.

Tilts toward the sectors above helped Sharper ♦ Granite portfolios average a return of 13.1% (net of fees) in 2Q09 at an estimated average risk level of 37% less than that of the S&P 500 Index.⁸ At this risk level investors could have expected to earn 11.0% this quarter based on the returns of the S&P 500 Index and the 90-day treasury. The risk and return of these two points define the Securities Market Line (SML). Thus, we estimate that the average of all Sharper ♦ Granite portfolios beat the S&P 500 Index on a risk-adjusted basis.⁸ Based on this analysis, which compares return and estimated risk data for each portfolio and compares it to the SML, 69% of Sharper ♦ Granite portfolios beat the SML performance benchmark this quarter.⁸

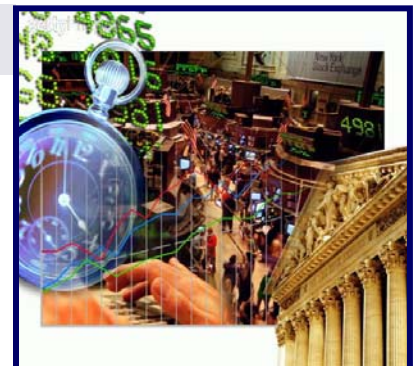
The iBoxx Bond Index, which Sharper ♦ Granite uses as a high-quality bond benchmark, jumped 9.6% this quarter in a major reversal as credit-worthiness fears waned. This benchmark is now up 3.6% for the year.⁷ ●

Investing through the Toughest of Times – Expert Advice

“The best time to buy is when there’s blood in the streets.”

- Baron Rothschild

Rapid changes in our investments affect us in many ways. Sometimes, in almost the same moment we can feel both of the two classic investing emotions: *fear*, “what if my portfolio loses even more money”, and *greed*, “with the markets so low, aren’t there some easy-money opportunities right now?”. We can be pulled both to invest more and invest less almost simultaneously, irrational as this is.



We have discussed in the past how we react from different parts of our brain given different situations. The limbic system, which is the oldest, most primitive, and very emotional part of the brain, drives us to react, often irrationally, toward fear or greed (see “Behavioral Finance,” *Summer 2007*). Within the limbic system, the *anterior insula* is primarily concerned with avoiding risk, and for example, tells us to run from danger, while the *nucleus accumbens* (NAcc), motivates us to seek reward. The prefrontal cortex, the more sophisticated, “human” part of the brain which controls conscious, thoughtful and methodical behavior, tends to get pushed to the back seat when we are making financial decisions due to the predominance of fear or greed associated with financial decisions.

These behavioral finance insights help explain how, in the ten years from 1997 – 2006, the average equity mutual fund earned 8.5% per year, yet the average mutual fund *investor* made only 7.1% per year.⁹ Other studies over different time periods show similar results.

“The markets have averaged an annual rate of return of (about) 9.5% since 1926. But the average investors don’t make anything like that, because they tend to get in at the top and out at the bottom.”

- Burton Malkiel, Princeton University, former Dean of Yale School of Business ¹⁰

Investors as a whole hurt their own returns through self-destructive behavior. In volatile times they ignore their goals and become panicky short-term traders. The result is a well-documented tendency to change strategy and to move in and out of the market at just the wrong times, buying when markets are low and selling when markets are high. “*For investors as a whole,*” notes Warren Buffet, “*returns decrease as motion increases.*” ¹¹

“Perhaps the most important lesson I’ve learned is that no one – not even the most sophisticated investors analyzing the best data – can reliably predict how the market will perform over the next day, week, or year...”

The most successful investors don’t try to predict when the markets will rise or fall. Instead, they save and invest regularly, through both good and bad times, to take advantage of the tendency of stocks to rise over extended periods.”

- Charles Schwab , founder of Charles Schwab & Company ¹²

During troubled times it can be reassuring to review some of the strategies of the best in the investment business. What actions do we observe from the top *institutional investors* like Warren Buffet of Berkshire Hathaway and David Swanson, manager of the Yale Endowment; the leading *academic researchers*, like Merton Miller, Nobel Prize winner from the University of Chicago Business School, Burton Malkiel of Princeton, Robert Shiller of Yale, and Jeremy Siegel of the Wharton School of Business; *investment pioneers* like Charles Schwab, founder of Charles Schwab & Co., and John Bogle, founder of The Vanguard Group; and industry-leading *corporations* like Proctor & Gamble, Wells Fargo, Wal-Mart, Valero Energy and Walt Disney?

Through the market crash of late 2008, Warren Buffet continued investing methodically with the same strategy as always. He did not pick the market bottom perfectly, but his investments in Goldman Sachs, General Electric and Constellation Energy appear to be wise moves that will likely prove profitable down the road.

“No one can pick the bottom... invest when prices are far below intrinsic value and trust in the market’s tendency to correct over time.”

- Warren Buffet, Chief Executive Officer of Berkshire Hathaway ¹³

David Swensen has led Yale’s endowment to 16%/year average returns through the past ten difficult years.¹⁴ Yet he eschews stock picking and market timing, staying invested right on through the tough times. He agrees with John Bogle, founder of the largest mutual fund company in the world, Vanguard Group, that individual investors should focus on asset allocation and utilize index funds, ignoring individual stocks and market timing.¹⁵

“People get it completely backwards... They should be unhappy when prices are high because their contributions will buy less. When prices are down, they should be happy, because they’re getting more bang for their buck”

- David Swensen, Chief Investment Officer of the \$23 billion Yale Endowment ¹⁶

The data may run counter to our limbic system reactions, but it is irrefutable, and it forms the backbone of these experts’ success. These investing leaders repeatedly buy when times seem most dire. The chart below shows the massive gains of early market recoveries and explains why Warren Buffet wanted to enter the market last October just as most were exiting. Unlike other investors, he sees the *opportunity* of a down market more than the threat.

Recoveries Are Front-Loaded ¹⁷

Investment Strategy	Average Return 1 Year after Bear Market
Stayed 100% in stocks through bear market bottom	45%
Stayed in cash until 1 month after the bear market ended	32%
Stayed in cash until 3 months after the bear market ended	19%
Stayed in cash until 6 months after the bear market ended	12%

If avoiding stock picking and market timing temptations are so important, then what about those “experts” on the radio or television like Jim Cramer giving market timing advice and stock recommendations? First, remember that the media must be dynamic and entertaining to capture our attention. Most of the best answers in finance are old and boring: stick to a

long-term strategy, diversify, keep costs low, etc. Daily stock picks and market buy/sell points are far more interesting. Second, much of media's target audience are day-traders and other heavy transactors, who, like gamblers, are drawn to the markets by the appeal of easy money, rather than by a long-term fundamental strategy.

“Jim Cramer is a charlatan. He turns the serious issue of personal financial security into a joke. There is nothing that comes out of James Cramer's mouth that allows people to make intelligent investment decisions.”

- David Swensen, Chief Investment Officer of the \$23 billion Yale Endowment ¹⁶

Academic researchers have studied the “experts” for years, tracking the universe of analysts, media pundits, mutual fund managers and hedge fund managers. The research in this area is deep, consistent and irrefutable. No one consistently picks stocks, bonds, interest rate direction, or market turning points consistently.

Still, along with stock-picking tips, market-timing advice and gimmicks are everywhere. Market charting tools that purport to determine future market direction are advertised daily on CNBC, and in the *Wall Street Journal* and other reputable business media. They are also offered as “trading tools” at many online brokers to help customers “trade like the pro's” and discover the market's future. They are all nonsense.

“There's no free lunch. You can't just scan the newspapers, read research reports, and watch (TV), and hope to earn above-normal rates of return. To beat the market you'll have to invest serious bucks to dig up information no one else has yet. Because it looks easy, many people may be tempted to try it... but most 'active' investors are just wasting their time and money... The smart ones will stop trying... and become indexers.”

- Merton Miller, Nobel Prize winner in economics, University of Chicago Business School ¹⁸

Behavioral finance research shows that viewers or readers will tend to believe they have some special knowledge from information in the media. Market direction predictions, such as those from Jim Cramer and others in the media, help create investors' over-confidence according to behavioral finance experts like Princeton's Burton Malkiel, Yale's Robert Shiller (*Irrational Exuberance*), and Wharton's Jeremy Siegel.

“Investors are often tempted to pursue a difficult course. They attempt to beat the market by timing market cycles... With the abundance of financial news, and commentary at our beck and call, it is extraordinarily difficult to stay aloof from market opinion. As a result one's impulse is to capitulate to fear when the market is plunging or to greed when stocks are soaring.”

- Jeremy Siegel, Wharton School of Business ¹⁹

It is not just leading institutional investors and academic researchers who understand the concept of investing for the future when times are toughest. Top companies recognize this as well and, in tough times when profits are down, actually increase investment through research and development (R&D), expansion, and acquisition.

A recent McKinsey study shows high-performing companies are twice as likely as their industry peers to hike R&D spending during tough times.²⁰ Recently, corporate all-stars Procter & Gamble and Novartis have been doing exactly that. In addition, Wal-Mart has been building in new towns, and Disney just announced a massive expansion of Disney Hong Kong.^{21, 22}

After the 2001 recession, Boston Consulting Group (BCG) studied corporate deals in good times and bad. It found that the average corporate acquisition in downturns created an 8.3% increase in shareholder value after two years, while the average deal in good times resulted in a 6.2% drop in shareholder value.²³ Leading firms are certainly in acquisition mode today. Oracle recently acquired Sun Microsystems, Fiat acquired much of Chrysler's assets at fire-sale prices, Toys 'R' Us bought FAO Schwarz to gain market share, and Valero acquired VeraSun, just when energy companies were most depressed. Wells Fargo stepped up to buy Wachovia bank during the October storm. Recently, in a CNBC interview, then-Wachovia CEO, Robert Steel, implied that given the turnaround in banking-sector health, Wachovia may have indeed survived without the sale. Wells now appears to be the winner in that deal.

The successful, fundamentally-sound institutional investors have learned to conquer the fearful instincts pulsing deep within the brain. They avoid tempting moves that hurt returns and profits, actually investing *more* when the economy is struggling. The academic research verifies the value of their behavior. Leading corporations practice this behavior at the corporate level through increased R&D, acquisitions, and expansions during tough economies.

Like Buffet and Swensen, the individual investor can show nerves of steel. For her, this means continuing with automatic investing programs and 401(k) contributions through downturns, and perhaps even looking to invest more aggressively when times are toughest. Above all, the individual investor should resist liquidating during downturns for purposes of market timing and should stay well diversified using proper asset allocation across index funds to guarantee participation in the upside. All the research shows that as challenging as this is, it is absolutely the optimal strategy.

“Trying to guess the market is a fool’s game. Never underestimate the importance of asset allocation... then use index funds -- indexing wins.”

- John Bogle, founder of The Vanguard Group²⁴ ●

Second Quarter 2009 Economy Review

The leading indicators below confirm our pronouncement last quarter that the U.S. economy is bottoming. Are the world economies following? World growth is currently projected to be -2.9% for 2009, but growth rates will be quite different in different countries.²⁵

While some economists in recent years have discussed the notion of a “decoupling” of the world’s economies from the U.S. economy, this is a myth. The U.S. still leads the world through the global economic cycle. This time is no different.



Responding most quickly and robustly are generally the emerging markets, and we see this again now. Europe tends to follow the U.S. through the cycle. This is especially true today where competing leadership opinions tends to slow European Union monetary policy, relative to that of our U.S. Fed.

“In western Europe, there were similar kinds of irrational exuberance about housing markets and credit markets generally.”

- Deborah Lucas, Professor of Finance, Kellogg Business School ²⁶

European stocks are up 6% for the year.⁷ Inflation, at 0.6%, is the lowest in Europe since records began in 1996.²⁶ The UK, Germany, France and Italy all have negative GDP expectations for 2009.²⁷ The UK is facing its first recession in 16 years, France is suffering from a record high savings rate, and Italy is expecting an 8% unemployment rate in 2009 and negative growth extending through 2010.²⁷

Meanwhile, the emerging market “BRIC” countries listed here are up substantially. 2009 GDP growth is forecast to reach 6% in India and China despite the global recession.²⁷

Viewing the differences in geographical returns reminds us of the value of diversification across countries.

Emerging Market Performance 2009 ⁷

Emerging Market	Mid-2009 Return
China	35%
India	50%
Brazil	58%
Russia	78%

Leading Economic Indicator Summary

↓ **Market Cycle:** We are now entering calendar Q3 (summer), 2009. While summers on average do show market gains, those gains are less than in other seasons.¹⁹ Since 1946, calendar Q3’s average only 5.9% annualized total return, versus 15.0% for Q1’s, 10.8% for Q2’s, and 20.7% for Q4’s.¹⁹ September, the final month of the third quarter, is historically the worst month of the year for stocks. It is the only month that averages a negative return.¹⁹

Interest rate direction is the most significant short-term influence on stock prices.¹⁹ Since September 18th, 2007, we have been in an environment of decreasing rates.

The Federal Reserve has lowered the Fed Funds target rate to 0 – 0.25%, holding it there through their June 24th meeting, and the Fed will keep that target for at least one more quarter. The market is currently betting on a 0.5% increase in the Fed Funds rate by December, and 0.75% by March, 2010.³

Market returns from 1955 - 2006 averaged only 7.2% in the 12 months following rate increases compared to 18.5% following rate decreases.¹⁹ As stock prices improve, low treasury yields will be unattractive to investors, generating even more demand for stocks.

↑	Strong
↑	Mildly Strong
→	Neutral
↓	Mildly Weak
↓	Weak

➤ **Political Cycle:** We are into the first year of President Barack Obama's term. Traditionally, the first year in the presidential cycle is the weakest; however, first-year Democratic presidents have fared better. Since World War II, the first year of the presidential cycle has seen the S&P 500 Index post an average gain of 8.5% overall and 15.7% under Democratic presidents.¹⁹ When the data is reviewed stretching back to 1888, first years are still the worst performers, returning 7.4% overall and 7.3% for Democratic presidents.¹⁹ However, the normal drivers of this phenomenon, post-election tough-medicine programs, are not in play this time around. In fact, we now have the opposite, aggressive fiscal stimulus.

↓ **GDP Growth:** Gross Domestic Product (GDP) is the official measure of the U.S. economy, tallying all goods and services produced in the United States. 1Q09 GDP fell 5.7%, following the previous two quarters' declines of 6.3% and 0.5% respectively.²⁸

At first glance, the 1Q09 report seems disappointing. But the details are in fact much better. Consumption gained 2.2%, beating expectations. Government contribution to GDP unexpectedly contracted, indicating private sector GDP contribution was even higher. Much of the fall was in inventories, which is positive as it implies that companies are working off surpluses. Another "falling" component was in residential construction, which is somewhat positive in that it does not contribute to the oversupply of housing.³

We are projecting 2Q09 GDP to be only slightly negative at -1.5%.³

↓ **Employment:** June was the 18th straight month of non-farm payroll decline; however, the rate of decline is stabilizing.⁵⁵ Job losses tend to reach a nadir one quarter following the steepest GDP contraction.²⁹ 4Q08 was likely the steepest quarter of GDP contraction, and job losses likely peaked in 1Q09.

Another indicator with minimal lag is the initial unemployment claims, which dropped significantly this quarter.³⁰ Historically, the peak in claims occurs within 1-2 months of the recession end point.

Employment in many cases is a lagging indicator for the general economy. When reviewing employment numbers, weekly non-farm data should be observed to complete the economic picture, never the unemployment rate trend, which has political significance but little predictive value.

↓ **Home Price Trends:** The Standard & Poor's/Case-Shiller Index is our preferred data for home price history. Through February the national index is still running at a 19% decline from the previous year.³¹ However, the index is signaling a slowing rate of price decline in some western markets like Los Angeles, San Francisco, San Diego and Denver. Meanwhile, most markets continue to see accelerating price declines, especially Phoenix, New York, Portland, Seattle, and Chicago.³¹ In San Francisco and Los Angeles regions, where most of our clients reside, the 12-month declines as of April were 28% and 21% respectively.

As of January distressed sales still accounted for 45% of all existing home sales.³² The overall mortgage-delinquency rate rose to a new high of 9.1% this past quarter, from 7.9% the previous quarter. Sub-prime delinquencies shot up to 25% while prime delinquencies rose to 6.1%.³³

We anticipate home prices to continue falling nationally for several more quarters, albeit at a slowing rate. Recent increases in long-term mortgage rates will not help the housing story.

↑ **Stock Market:** Of all economic forward-looking indicators, the stock market is one of the best. In the short-term (days and weeks) the stock market moves completely unpredictably. Over several months and years, its purposeful trends are revealed. During recessions, the stock market quite consistently predicts the end of the recession five to six months in advance.³ The S&P 500 Index made a low on March 9th and has since rallied 35%.⁷

↑ **Purchasing and Manufacturing:** The Institute of Supply Management (ISM) Index, the key manufacturing indicator, continued its uptrend in what is some of the economy's most promising data and an indication that the end of the recession is in sight. The April reading of 40.1 continued a four-month reverse in the index since its low point in December.³⁴ Readings below 50 indicate that manufacturing is still contracting.

Durable goods orders actually posted gains from February - April. The April increase was a healthy 1.9%.³⁵ April also saw the first increase in orders for metals and metal products in nine months suggesting that manufacturers have run down their inventories of raw materials to the point where they need to buy more.³⁶

On a negative note, manufacturing capacity utilization fell to a record low of 66% in March, 14% below its long-run average.³⁷

↑ **Inflation Control:** The PCE (Personal Consumption Expenditure) increased much more than expected, but that was due to the sharp drop in imported oil prices early in the year.³

Core inflation, which excludes food and energy prices, has been in the Fed's target range of 1.7 - 1.9 % all year.^{38, 39} Including food and energy, inflation fell 1.3% over the past twelve months through May, the most since 1950.³⁹

Treasuries have been falling as we warned in the *Winter 2009* letter and will continue to be a dangerous place. In June long-term interest rates surged (10-year treasury bond rates increased to around 4%), and short-term rates surged as the market priced in a 0.5% increase in the Fed Funds rate by year end.³ The June 5th movement in short-term rates was so steep that the change was statistically a 6-sigma (1 in 805 year) event.³ But then, we are used to such "fat-tail", statistically rare occurrences in the markets these days.

We believe that inflation will remain tame for at least the next year -- first, because so much excess supply exists in world markets today, and second, because the money being pumped into the economy by the Fed is not being lent by banks to expand the monetary supply.⁴⁰ Note too that the Fed has plenty of tools to mop up this excess liquidity.

Inflation is heavily correlated to employment. Since World War II, inflation has posted sustained gains only in tight labor markets, outside of the oil crisis of the 70's. Typically, inflation does not become an issue until the unemployment rate dips below 5%.⁴¹ It is currently above 9%.

If near-term inflation is so tame, then what about the increasing interest rates in June? The market's implied forecast of future inflation is indicated by the difference between the nominal interest rates on regular Treasury debt and the corresponding real interest rates on Treasury Inflation Protected Securities (TIPS). The current expected inflation rate in the markets is an average of 1.6%/year over the next five years and 1.9%/year over the next ten years. Not coincidentally, this exactly matches the Fed's inflation target.⁴⁰

However, down the road, inflation should eventually pick up and most likely move above the informal 2% target that the Fed favors in its monetary policy. The U.S. central bank will begin tightening in earnest as inflation moves above 3% and anything above 4% will be viewed by the Fed as unacceptable.¹⁹

↓ **Oil Price Control:** Oil prices are a proxy for the global economy. After falling 19%, 64% and 24% in the last three quarters, oil prices rebounded 33% this quarter on speculation of an improving global economy.⁷ OPEC is playing a big role as well; it announced a 4.2 million barrel cut and is sticking to its quotas better than usual. Even the usual quota cheats, Venezuela and Iran, are curbing output.⁴²

Goldman Sachs is projecting \$85 per barrel oil at 2009 year end.⁴³ Increasing oil prices now represent the greatest threat to an economic recovery.

- ↓ **Consumer Spending:** Consumer spending is still weak. The retail sales report showed core sales of -1.3% in March, -0.4% in April, and +0.3 in May.²⁸ Goldman Sachs is forecasting a slight retail decline during all of 2009 totaling -0.5%.⁶⁶

However, the University of Michigan Consumer Confidence reading surged in March to 65, then to 69 in May and June, much improved over the 28-year low of 55 reached in November.⁴⁴ The March gain was the greatest monthly increase in over two years.⁴⁴ The second measure we watch, the Conference Board's Consumer Confidence indicator, surged to 41 in April and to 55 in May after a modest March gain, indicating the confidence nadir may have occurred in February.⁴⁵

- ↓ **Business Capital Spending:** Business capital expenditures fell 38% from the previous year.⁴⁶ Falling corporate outlays in everything from machinery to airplanes accounted for 4.6% of the 5.7% decline in 1Q09 GDP.³⁷

Capital orders excluding defense and aircraft, which economists also use as a proxy for business spending, fell 1.5% in April, continuing a downtrend beginning last July.^{35, 47}

Businesses typically wait until they see signs of economic recovery before adding payroll and buying expensive machines. For that reason, capital spending is typically more of a backward-looking measure.

Tech companies have made the deepest spending cuts, so they are a key place to look for stability going forward.⁴⁸ In June Cisco CEO John Chambers projected "stabilization" in corporate spending joining Intel, Juniper Networks, Texas Instruments and Alcatel-Lucent in upgrading earnings outlooks this quarter.^{49, 50} Forrester Research is now actually calling for an *increase* in business IT spending.⁵¹

- ↓ **Investor Sentiment:** The major sentiment indicators that we track surged from heavily bearish to neutral this quarter as the stock market surged 16%.^{52, 53} We would prefer to see these indicators remain bearish, which would suggest that investors still have not yet pushed their money into the market.

There still seems to be plenty of this cash potential as \$4 trillion in wealth is currently sitting idle in U.S. money market accounts earning an average yield of 0.33%.⁵⁴ This amounts to over 40% of the stock market's total value, an all-time high, and represents a huge pool of potential demand that someday will flow back into stocks, bonds, and other assets of various risk levels.⁵⁵

The supply of equities has been increasing as companies, especially banks, issue stock in secondary offerings to obtain cash to improve their balance sheets. In May alone \$64 billion in secondary stock was issued.⁵⁶ This has a negative effect on stocks as additional supply tends to lower prices. Historically, when the stock market experiences a one-month infusion of \$30 billion or more in stock issuance, the S&P 500 Index declines by an average of 4% over the next 90 days.⁵⁶

- ↑ **Corporate Earnings:** 1Q09 earnings are tracking to a 35% year-over-year decline, but coming in well above expectations despite the fact that 1Q09 GDP was almost as low as that of 4Q08.³⁷ With 85% of the S&P 500 companies reporting, 66% beat estimates by an average of 6%; this is better than the historical norm.³⁰ It means that firms are undertaking the necessary cost cuts to regain profitability in a slowing economy, implying a nice earnings rebound once the economy improves.³

The current price/earnings (P/E) ratio of 17 on forward 2009 earnings estimates is not particularly low by historical measures (P/E has averaged 19.8 since 1998⁵⁷).⁵⁶ However, as discussed in last quarter's letter, this may represent good stock value in today's low inflation environment (see "Are Stocks Cheap Today?", *Spring 2009*). P/E ratios tend to average 19 – inflation rate.¹⁹ With the next-year inflation expectation near flat, this suggests that the current fair P/E ratio is near 19, and thus, we have some price appreciation ahead.

- ↓ **Insider Trading:** This is one of our more disturbing economic indicators. Significant insider buying implies that executives have positive information about their respective companies' outlooks. This quarter, insider buying sank to a rate below \$10 million/day, the lowest level seen in many years.⁵⁸ This implies that managers still lack confidence in their companies' future earnings. Thomson Financial data confirms this trend, flashing a massive mid-April spike in insider selling to a level four times that of the previous 12-month average.⁵⁹
- ↓ **Merger and Acquisition Activity:** Venture capital investment in 1Q09 dropped to lows not seen since before the dot-com bubble.⁶⁰ VC's invested only \$3 billion in 549 young companies in 1Q09, the lowest investment level in twelve years.⁶¹

The time to "liquidity event" (cashing out) for venture capitalist investments is lengthening. In 1998 venture firms invested \$14.1 billion in 1,930 information technology (IT) companies, and fifty of them went public, posting returns of \$2.7 billion. Last year venture funds invested roughly the same amount of money into the same number of IT companies, and only two went public, returning a scant \$249 million.⁶²

"There's every reason to believe that private equity will have tremendous opportunity once we hit bottom"

- Colin Blaydon, Dartmouth Tuck School of Business, Director of the Center for Private Equity & Entrepreneurship⁶³

While keeping their powder dry so far, private equity firms are sitting on \$1 trillion in cash.⁶⁴ This represents a large source of demand potential which could generate demand for equity acquisition soon, especially with today's low corporate valuations. Private equity returns tend to do especially well three to four years after economic downturn. These are the cash-outs of investments made near the previous economic bottom.⁶⁵ ●

Questions?

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Notes and Acknowledgements:

1. Standard & Poor's, Federal Reserve, HIS Global Insight, June 10, 2009
2. CNBC, June 29, 2009
3. Research from Jeremy Siegel, Ph.D., Professor of Finance, Wharton School of Business, May 1, May 16, May 22, June 6, and June 22, 2009
4. Abby Joseph Cohen of Goldman Sachs, June 13, 2009
5. "The U.S. Stock Market's First-Quarter Funk," *BusinessWeek*, April 20, 2009
6. CBOE VIX, May 2009
7. Indexes used: S&P 500 Index, S&P Europe 350 Index (IEV), MSCI Hong Kong Index (EWH), MSCI Brazil Index, Dow Jones Titan Russia Index, Dow Jones Titan India Index, S&P North American Technology-Semiconductors Index (XSD), Barclay's Goldman Sachs Oil Index ETF (OIL), State Street's S&P Latin America 40 (ILF), S&P Basic Materials (XLB). All are YTD through June 30
8. Global Investment Performance Standard's (GIPS) Original Dietz Method used to calculate returns. Arithmetic average used for return measurement. Performance is net of fees and may include assets tracked for clients that lie outside Sharper ♦ Granite direct management. Such assets total less than 4% of total assets. All client portfolios weighted equally in calculation of average client performance. S&P 500 Index returns include dividends. Past performance does not guarantee future results. Normalization to similar risk as S&P 500 uses weighted average beta of all client portfolio assets, then normalizes to beta = 1.0 (S&P 500 Index beta) using the Securities Market Line (SML). The SML is constructed as a line on the beta-return chart between two points, A and B: A is the point representing "risk free" at beta = 0, return = 3 month return of the 90-day Treasury Bill rate on the last day of the quarter as posted in the *Wall Street Journal*. B is the point representing the "market return" at beta = 1, return = 3 month total return (including dividends) of the S&P 500 Index. Beta (asset) = covariance (asset monthly price %Δ vs. S&P 500 Index monthly price change) / variance (asset monthly price %Δ) using Yahoo! Finance historical price data

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