

Truth or consequences ahead for investors

Optimism may evaporate if the economy doesn't provide justification for the stock market's sudden rise

In the quarter that just ended the Dow Jones industrial average rose an astonishing 838 points, or 11 percent. It posted its best quarter since 2003. When you



SUMMING IT UP

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consider that stocks had fallen sharply in the early part of the year, the rally is even more remarkable. Since the 12-year low, on March 9, the market is up 29 percent, yet the Dow remains down 3.8 percent for the year and down 40 percent from its all-time high on Oct. 9, 2007. The Dow has traded in positive territory only one day this year. The S&P finished the quarter up 15 percent for the quarter and 1.8 percent year to date. A sell-off on July 2 erased the gain for the year.

The Dow's recovery is because investors' outlooks are rosier. Talk of another depression has abated, and an appetite for risk returned to the markets. As risk tolerance increased, a powerful rally ensued. But is it sustainable? Signs of weariness became evident even before the end of the quarter. As quarterly earnings season approaches, it is time for the economy to put up or shut up. Earnings better justify the market rise. If there is no truth in the market's outlook, then we will pay the consequences.

What caused a more positive outlook? The Federal Reserve and the federal government had already waged a mighty war against the recession. A veritable alphabet soup of programs was created to smite the problems in the economy. The Obama administration unveiled a stimulus program, but the economy and the markets still plummeted. Barack Obama became the first president to encounter a bear market in the first quarter of his term.

Surely when the books are written after this debacle, they will include a reference, if not an exposition, of the white-knuckle time that the most powerful people in our nation – a president, a Federal Reserve chairman, a U.S. Treasury secretary and Congress – could not resolve. Full nationalization of some banks was in the wind. General Motors and Chrysler succumbed to government ownership. Billions of taxpayers' money was injected into financial institutions including AIG and others, yet nothing seemed to work.

The catalyst for the turnaround was plain spoken, blunt and realistic testimony that Federal Reserve Chairman Ben Bernanke gave to Congress, followed by a bold stroke that was perhaps the

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last-ditch effort before nationalization of the financial system. The Fed began buying long-term Treasury bonds, and committed to doing so into the future. Thus, we saw the U.S. government, through the U.S. Treasury, issue massive amounts of bonds, which were in turn purchased by the U.S. government through the Federal Reserve. This created massive amounts of money. So, the Fed monetized the debt issued by the Treasury, and greatly increased the money supply. The purpose was to drive down long-term interest rates to make money cheaper and more plentiful. The policy is inflationary, but that was the purpose. Bernanke used to be known as "Helicopter Ben" because he said once that we could fly around the country and drop \$100 bills from helicopters if necessary. He came close to doing just that. Obviously frightened of what he saw ahead, Bernanke took drastic measures. He did things that could not even have been envisioned a few months before. He was so concerned about a depression and a deflationary economy that he was prepared to test the limits of Fed powers and the law. Some might say he exceeded his authority. When the books are written, his conduct and stewardship will be parsed and fault will be found, but desperate times call for desperate measures. His effort was truly the equivalent of a "Hail Mary" pass.

The markets responded and credit loosened. Credit spreads tightened. Long-term interest rates fell. The stock market roared forward. One can argue whether it was morally right to rescue the economy rather than let it fail and then recover. Is there danger in telling the financial institutions that no matter how badly they behave we will rescue them? Moreover, they have discovered that they will make gobs of money either way.

Now, a counterweight to the government's efforts is those same financial institutions. First they hoarded the bailout money that the government gave them. Then they withdrew credit from the economy, especially from small business and consumers. Their

Continued on next page

Continued from previous page

actions may yet undo government efforts and tip the economy further into recession or worse. It is interesting to note that the head of the German government, Angela Merkel, has told German banks in blunt terms to lend money.

A hint of optimism crept back into the minds of investors and consumers. At this point, it is uncertain whether this outlook is well-founded. Will we really see a V-shaped recovery? Can the effort to unwind the massive leveraging that occurred during the bubble days be over so quickly? Can all of Wall Street's hocus pocus be purged so quickly? Can the banks clean their balance sheets so quickly? For what it is worth, I don't think so. I believe that this a long, slow process. And if

those who extend credit do not begin reaching out to businesses and consumers, then we are in for an even more protracted and painful process.

Capitalism has been severely tested. Its flaws are showing, and now it is up to the stewards of the economy to show they can get the system back on track.

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