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“THE ‘AVERAGE’ ANALYST WILL PROBABLY FARE ABOUT THE SAME AS THE AVERAGE MEMBER OF ANY OTHER PROFESSION.. BUT FOR THE OUTSTANDING MAN WHO COMBINES NATIVE ABILITY, A FLAIR FOR THE SUBJECT, AND A COURAGEOUS INDEPENDENT SPIRIT- THE SKY IS THE LIMIT.

Benjamin Graham (1894- 976)

THE U.S. ECONOMY

General Observations

The Equity and Fixed income markets have been on a tear ever since it bottomed at the intraday low of 666(S&P 500) on Friday, March 6. We should have recognized immediately that this devilish number was the bear market low. After calling for a low in October the subsequent sell off in March caught most investors by surprise. It took me a few weeks to conclude that this indeed was the probable the low. In retrospect, the closing low of 676.53 was made that Monday, March 9. On that day, Citi’s CEO Vikram Pandit sent an internal memo to employees stating that the bank was profitable during the first two months of the year. The news hit the markets the next day followed by a jump of 6.4% by the Standard and Poor’s 500. Then on March 18th, the Federal Reserve Chairman Bernanke announced the expansion of their Quantitative Easing to include purchases of US Treasuries. On May 7th, the Fed announced the relatively benign results of the stress tests on several banks and along the way President Obama coined the phrase “green shoots” have been sprouting up in numerous economic indicators.

The Equity markets (S&P 500) rose to a new high for the year on the last trading day of July after taking out the June 12 high the previous Monday. Over the past two weeks, this index broke out above its 200-day moving average, which started to turn up on July 16 for the first time since it peaked on January 3, 2008. After seeing a devilish bottom, we mentioned in notes to our clients that we were setting up a potentially very bullish inverted head-and-shoulders technical formation formation on June 4. The rally over the past two weeks has been fueled by positive Q2 earnings surprises and bolstered by investors becoming increasingly optimistic that Gridlock will frustrate the Obama Administration’s push for a radical and expensive change in the health care system, requiring higher taxes. In other words, Gridlock in DC could be the Goldilocks scenario for a bullish stock market!

The Economic Outlook – Is this Global Recovery Sustainable or will the Skeptics be Vindicated?

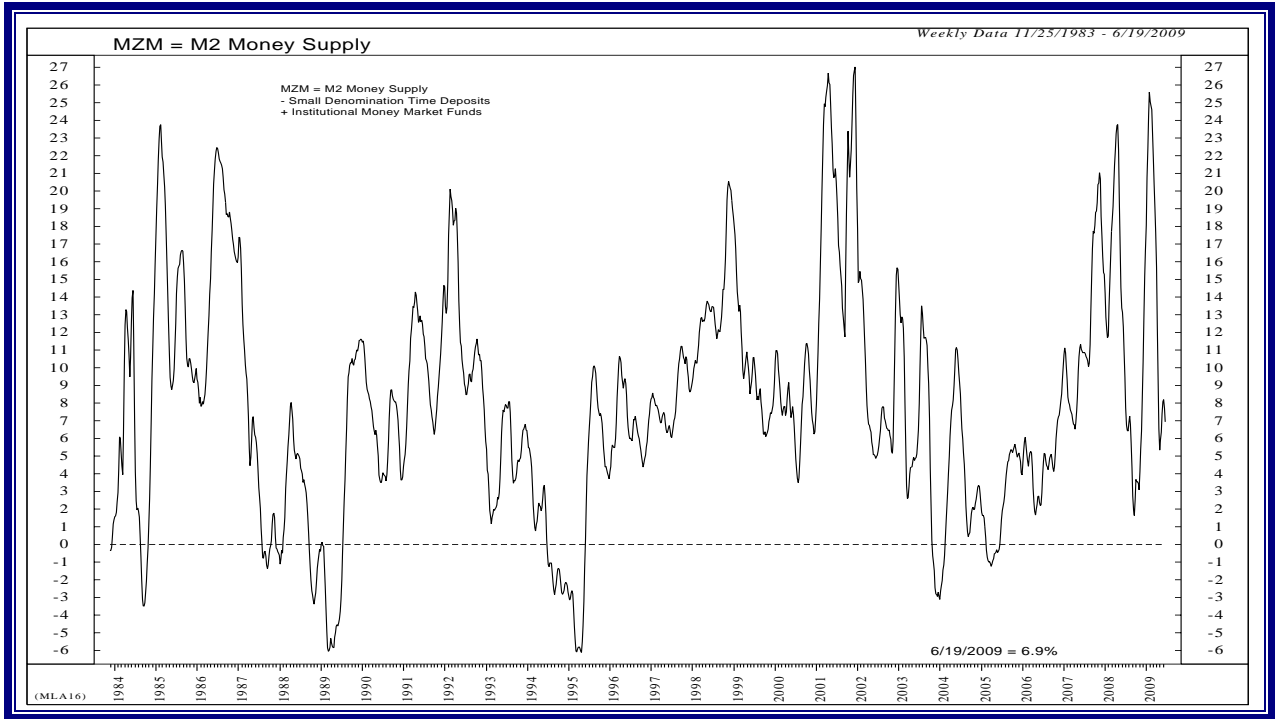
- ❖ **We continue to see further evidence that the US and Global recession is approaching an end** as economic indicators continue to produce less negative results over the past several months. For example the ISM manufacturing index just reported rose 4.1 points in July, the most in nearly four years, to 48.9, indicating that manufacturing activity was nearly unchanged from the month before. That was much better than the consensus, which has underestimated the actual reading in six of the past seven months. Although economists expected a rise of 1.7 points to 46.5, we expected a more robust number. All five components increased, led by new orders and production, which both rose significantly above the 50 threshold, indicating growth. New orders jumped 6.1 points to 55.3, and production added 5.4 points to 57.9 -- their highest readings in two years. Employment contracted at a much slower rate, jumping 4.9 points to 45.6. Inventories contracted at a slightly slower rate. Supplier deliveries rose further into expansion territory.

- ❖ **The level of the PMI generated a new expansion signal for the economy.** The PMI corresponds to 2.4% real GDP growth, according to the ISM. Our analysis puts it closer to 2.0%. Nevertheless, ISM says "the data suggests that we will see growth in Q3 if the trends continue." This report supports our view that the recovery has already begun last month. The historical correlation with industrial production suggests an imminent recovery should now be in place.
- ❖ **Better news on 2nd quarter US GDP growth as the number** fell only -1.0% in the 2nd quarter, down from an downward revised -6.4% in the 1st quarter. The benchmark GDP revision showed that the recession was worse than previously reported. 1Q real GDP declined -6.4%, and in 2008 real GDP declined -1.9% 4Q/4Q versus -0.8% previously reported. These negative numbers reflect the effects of one of the steepest recession we have experienced since the Great Depression and resulting in an unemployment rate of up to 9.5%, the highest level in 25 years. In comparison during the 1982 recession, one of the worst since World War II, unemployment reached 10.8% and the economy fell 1.8%. In this context, it's not surprising that y/y wage inflation gains are the smallest on record for the Employment Cost Index in 2Q of 2009 (+1.8% y/y). These figures reinforce our view that there is a good likelihood the the US economy should return to positive GDP growth in 3Q as the inventory bounce plays out. The 3Q cyclical bounce story remains entrenched, given the -\$141 billion decline in inventories in 2Q (the level of GDP equals final sales plus the change in inventories, setting up a bounce).
- ❖ **Home prices and more positive earnings surprises pushed the equity markets higher again this week.** Surprisingly, with signs of improvements in the economy, the Government Bond markets were also higher. Corporate bond spreads continued to narrow; single-A and better spreads are tighter than they were before the Lehman collapse. Oil prices rallied \$1 to close just over \$69 a barrel. Also, for the third week in a row, the US dollar fell against European currencies.
- ❖ **Cash for Clunkers Update:** With survey data showing dealers were running close to using up the maximum 1bn for the Cash for Clunkers program, policymakers scrambled to extend more money to keep the program going. The House overwhelmingly passed legislation to provide an additional 2bn for the program before leaving for August recess on Friday. The action moves to the Senate where some roadblocks need to be overcome for passage. First, Senators are demanding information on sales (amount, type of sales) before moving ahead on new money. Second, some Senators want to amend the house bill. This is important because if the house bill is changed slightly, there is really no way for the house to come into session and concur with senate changes. With Senate passage, adding an additional \$2BN to the program can boost sales from the current target of 250k to 750k over time. Auto sales did improve smartly in July thanks to the "Cash for Clunkers" (CFC) program. In the past, the auto industry often provided incentives to boost sales when they were depressed. The industry itself is so depressed that it doesn't have the resources to do it again this time. So the federal government, which is the largest shareholder in GM, provided \$1bn to destroy about 250,000 clunkers in exchange for purchases of as many new cars. As a result, the seasonally adjusted and annualized rate of motor vehicle sales jumped from 9.7mu during June to 11.3mu in July. That will be a big plus for the month's retail sales. But sales are likely to drop off quickly unless Congress provides more funding for the program soon.
- ❖ **Vehicle sales have been running between a 9-10 million seasonally adjusted annual rate (SAAR).** Adding an extra 250,000 cars each month would be a boost of 3 million at an annual rate, which is a substantial increase in sales. However, to the extent these cars are in inventories that are not being replaced, or come from abroad, the impact on real GDP will be muted. But the baseline view that the government remains interested in pursuing policies that help growth generally still remains intact, and 3Q is likely to see a pop.
- ❖ **The housing data is shown some signs of decelerating weakness.** While mortgage applications fell -6.3% w/w last week, new home sales rose +11.0% m/m to 384,000, and more importantly there is some evidence of stability in home prices. While the Case-Shiller index was down -17.1% y/y, it was more stable m/m. Housing is one of the most seasonal pieces of GDP, and even during the recession there were stories that "housing is bottoming" in the off-season (moving in time for the next school year is still popular for families). As we move through the rest of 2009, the

bar becomes lower and lower for the impact of mortgage rates for this reason, but as we start to get into the 2010 Spring selling season, rates significantly above 6% are likely to again create housing headwinds. While there have been many government policies on housing - a tax credit for homeownership, foreclosure relief, and action on the Fed's balance sheet to buy mortgage securities - we still have not solved the fundamental problem of excess housing inventory, but we'll take "less bad" data in 3Q.

- ❖ **The S&P/Case-Shiller Composite-20 Home Price Index rose** for the first time in over three years in May. This index of Home Prices from 20 US cities was up only a half percent over the previous month, by still 17% below prices one year ago and 32% below prices in August of 2006. In other housing related news, the Sales of New Homes in the US rose 11% to 384,000 in June. This apparent bottoming of housing prices is not limited to the US. The Economist noted that "The Land Registry's survey of housing prices in England and Wales recorded its first advance, 0.1%, in 17 months." As someone who is "long" Princeton real estate, I follow with personal interest the reports generated by one of the tenants in our building, Sotheby's, on the Princeton housing market. The Princeton market in no way typifies the US housing market but it often confirms what is experienced around the country. One of the owners, whom I often run into in my comings and goings, indicated last week that in July Princeton single family home sales - in terms of number of homes- had risen 50% from June. The reality is that home prices have fallen and, as a result, sales have increased. This reality is true in Princeton as well as in many communities in the US. This is in now way means that we are at the start of a residential market rally, but it may ease buyers' fears that the houses they purchase will decline in value the very next month.
- ❖ **Has US manufacturing recession bottomed?** It looks that way. July's Purchasing Managers Index (PMI) climbed to 48.9, after falling to a 28-year low of 32.9 in December. Especially encouraging was the jump in the production index to near 60 last month. Orders and export indexes have also recovered from December's record lows, and were both back above 50 in July. Manufacturers continue to cut payrolls, though at a slower pace. The prices-paid index is no longer signaling deflation, rebounding to 55.0 last month. It was at a six-decade low of 18.0 in December.
- ❖ **Construction spending unexpectedly rose 0.3% in June, its second increase in three months and above expectations for a 0.5% decline.** Is the construction slump nearing a bottom? Hopefully. Residential construction rose for the second time in three months in June. Nonresidential construction, however, suffered a setback, falling the past two months, with recent gains revised away. Both real residential and nonresidential construction were drags on real GDP last quarter, though declines slowed from Q1, considerably for nonresidential. The 3-ma in housing starts leads real residential investment in the GDP accounts and suggests it could start contributing to growth during the second half. Nonresidential investment is holding around recent lows, with half the categories at or near record highs, and half falling. Amusement & recreation, commercial, and communications building has been especially weak, though the latter is stalled at recent lows. Public construction spending continues to hit new highs. Also, May's spending was upwardly revised to -0.8% from -0.9%. Within the private sector, nonresidential spending fell for a third month, slipping 0.5% in June.. But the residential sector increased 0.5%, also its second gain in three months. Public construction climbed for a fifth straight month, rising 1.0% to a record high.. Despite the monthly gain, overall construction spending is down 10.2% from a year ago, but the rate of decline has begun to stabilize.
- ❖ **We expect flat growth in the current quarter with positive growth in the the fourth quarter for an overall decline for the year of about 2.0%.** This sequential improvement is occurring because of expansionary monetary policy against the background of the Federal Reserve maintaining the Federal funds rate at 0-0.25% . In addition, the fiscal stimulus of \$787 billion should impact the economy in the second half of 2009 and carry throughout 2010. See [Exhibit I](#) MZM monetary growth
- ❖ **As a lagging indicator ,we would expect unemployment could rise to over 10% by year end.** We still conclude that because eof the deleveraging of balance sheets the current recovery will most likely be relatively weak by historical standards since consumption , still 70% of the U.S. economy will be restrained. The consumer savings rate has risen to 6.9% this past May and compares to negative rates before the recession began. The contraction of debt among households and non financial corporations last reported dropped 0.7% and the first such event since the early 1950's. The dropped in the budget deficit projected by the Center on Budget and Policy Priorities is projected at \$350 billion in 2010-11 time frame. These deleveraging secular forces are projected to slow the US economic recovery by as much as a full 10% of gdp growth in the next ensuing year.

EXHIBIT I



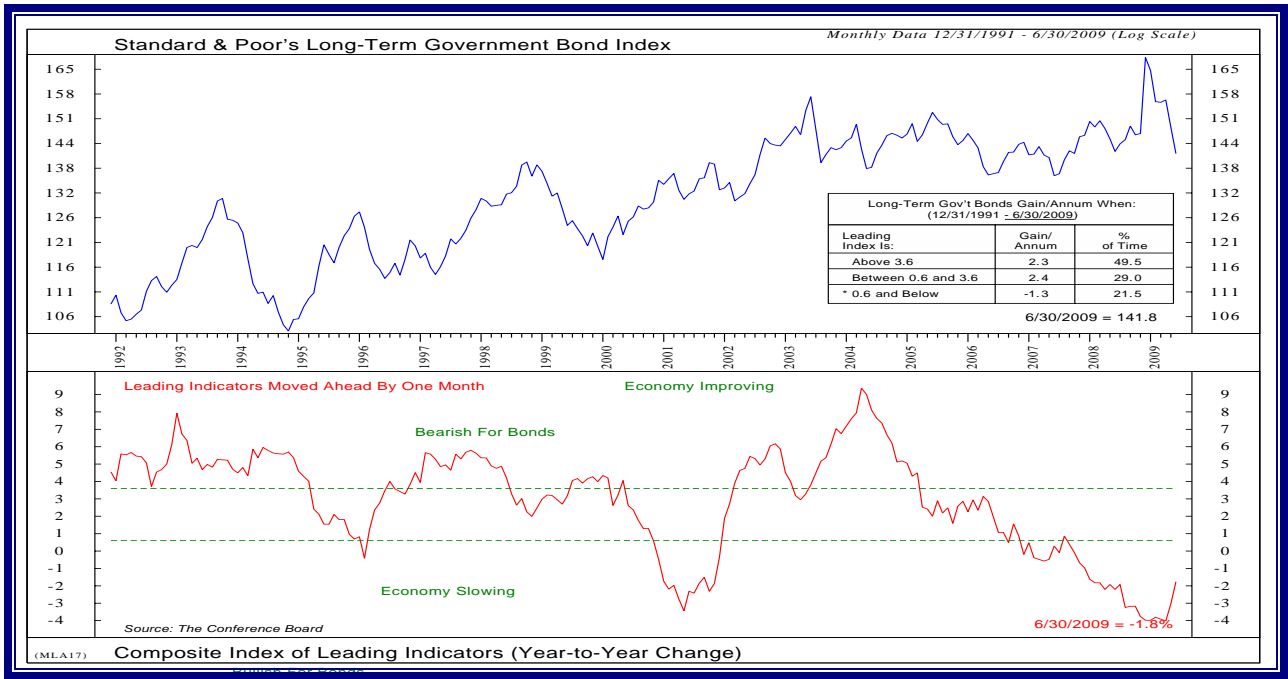
Source: Ned Davis Research

- ❖ While fears of inflation have surfaced associated with the enormous monetary response, a better case can be made for modest deflation at present with the consumer price index down 1.4% over the past year and the Producer Price Index(PPI) down 4.6%. In addition estimates of \$15 trillion of asset wealth has been removed from consumer balance sheets by the drop in both stock prices and houses. Additionally market analysts have concluded that the recent improvement in corporate business profitability was primarily caused by operating margin improvement through cost cutting and not top line growth.
- ❖ While investors have begun to modify their recession forecasts of a delayed recovery late 2010 or early 2011, our earlier expectation of an economic turnaround resulting in a positive 1% GDP growth for 2009 and corporate profits of 5.0% may be a bit too optimistic. However, we are still quite encouraged that the leading indicators have begun to reinforce our positive stance on equity participation through the spring of 2009.

An Update on the U.S. Fixed Income Markets

- Fixed income markets have been lifted by the wave of renewed confidence, led by formerly impaired consumer asset-backed securities and low quality corporate debt. Consumer ABS(credit card receivables) and High Yield, for instance, have gained more than 18% and 28%, respectively. Many high quality sectors are approaching more "normal" trading ranges, as lower volatility reflects receding uncertainties about large financial institutions. The expectation is that the recession is in the process of bottoming and the fear of renewed weakness has passed.

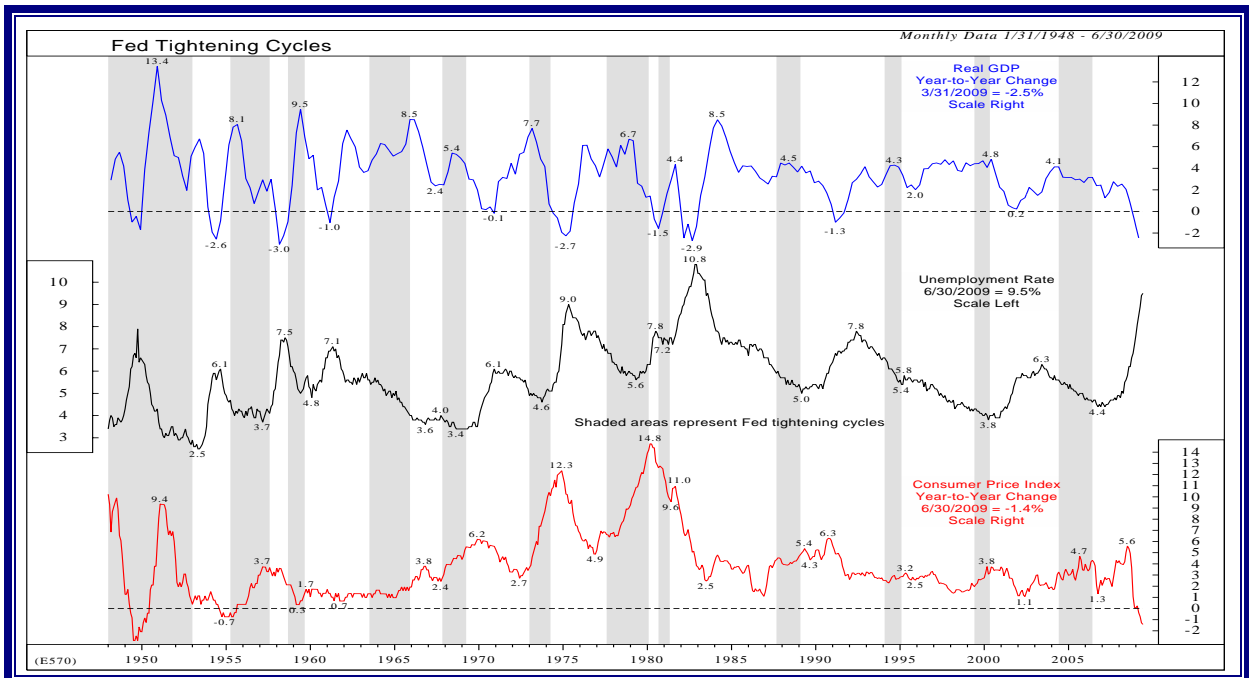
EXHIBIT II



Source: Ned Davis Research

- **The sheer magnitude of government and central bank support has been a key contributor to these trends, fueling dramatic improvements in market liquidity.** This, in turn, has bolstered risk appetites and the overall healing process. It also has allowed the 19 largest US banks to raise more than \$100 billion over the last few months and recently prompted government officials to begin scaling back some of the support programs that were initiated to stem the crisis. For instance, the nine money managers selected for the Treasury department is long-delayed Public-Private Investment Program (PPIP) will be part of an initiative that is expected to be around \$40 billion compared to the original \$1 trillion commitment.

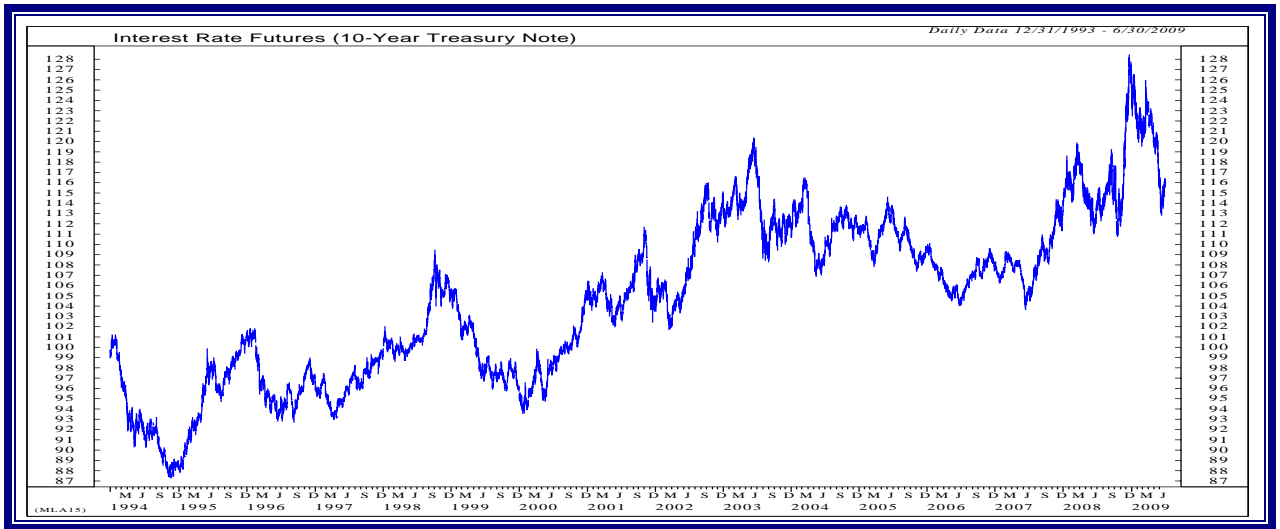
EXHIBIT III



Source: Ned Davis Research 1/31/1948 - 06/30/2009

- ❖ That said, after strong performance during the second quarter, positive momentum in the bond markets has taken a breather. Government bonds have staged a rally as futures markets reconsider likelihood of Fed tightening near-term and investors accept that economic fundamentals are clearly likely. The US labor report released on July 2nd reminded investors that the surprisingly less-weak than expected June employment numbers are likely to be an aberration at this stage of the cycle. Weaknesses in the labor markets are poised to persist in the developed economies well into next year until the private sector gets firmer footing. Additionally, with less credit available and tight lending standards still the norm, businesses and consumers still face substantial hurdles. Even if the US economy generates some modest growth during the second half of this year as we expect, the sustainability of any economic recovery will be critically tied to improved financial conditions.

EXHIBIT IV

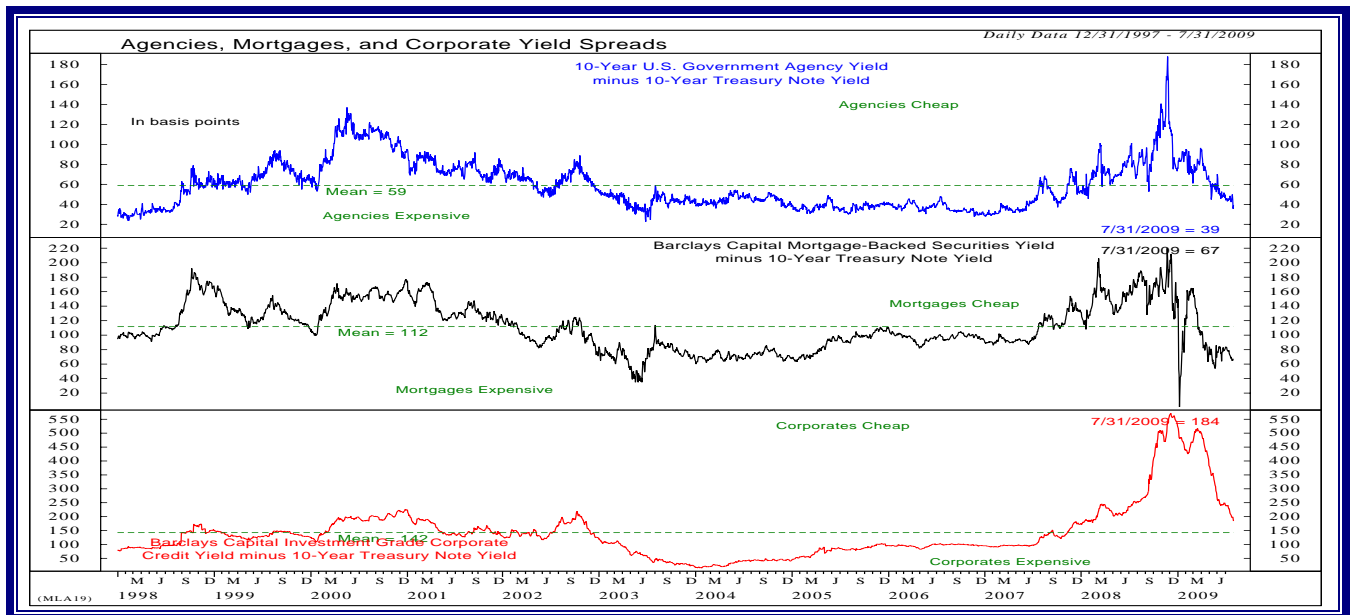


Source: Ned Davis Research

AGENCIES

- ❖ Relative to US Treasuries 5-7 year callable securities appear to be cheap versus bullets. Supranational issuers also provide a yield pick-up over Treasuries due to their similar government sponsorship.

EXHIBIT V



Source: Ned Davis Research

HIGH GRADE CORPORATES AND PREFERRED

- ❖ Long-term opportunity exists, however near term returns would appear to be somewhat attenuated as a result of extensive spread tightening in the high-grade arena. We are focusing on A/BBB rated issuers in utility/energy, and those industrial issuers with improving balance sheets. Within the financial sector we remain cautious. . In our view, the best relative values are concentrated in the 3-year to 7-year maturity range. Keep credit quality high and duration low. Difficulty in refinancing debt/loans could be a catalyst for a correction. Preferred Securities We favor issues with high liquidity from the bank/finance/insurance companies that are determined to be of systemic importance. Moreover, we recommend US-based issuers versus either UK or Euro area financial institutions. Investors should also consider diversifying with cable/media and utility issuers when possible, although these sectors trade relatively rich compared to finance-related names.

MUNICIPALS

- ❖ **The short end of the curve appears rich**, with investors better rewarded in the 15-year to 25-year range. Although long-term muni yields increased very slightly, the rest of the yield curve has remained extremely well supported over the near term. Indeed, the continuing round of negative news on budgets in a variety of states does not seem to have put a significant dent in demand.
- ❖ **Revenue Bonds versus GO's. Some investors have historically only purchased general obligation debt**, on the basis that such the credit strength of such debt tends to be better able to withstand economic downturns than single purpose revenue bonds. Recent events have suggested that this is not always the case: Many revenue bonds provide a needed service, and many revenue bond issuers have more flexibility to change revenue levels by raising fees than their General Obligation counterparts. In addition, some of the patterns that have damaged the revenue generating capacity of general obligation issuers, such as sharp declines in property values and in sales, income and/or capital gains taxes, may not have as direct an impact on essential service revenue bond issuers.

Our Positive Viewpoint on the Financial Markets Continues

- ❖ **While there are still five months left in the current decade, many investors may not fully appreciate how devastating the decade has been for market participants.** During the Great Depression stocks fell a cumulative 42%, or an estimated 5% per year. If you then added the dividends back to the total return, stocks actually appreciated by 1% per year. This study recently compiled by *Bloomberg* and *Business Week* took the current the current decade excluded the last six months of 2009, which are as of yet unknown, and calculated that the S&P 500 Index has fallen 5% per year from its Dec. 31, 1999 high of 1469. When dividends are added back, the annual decline is 3% per year or materially worse than the decade of the 1930s.
- ❖ **Admittedly, the last six months of 2009 could result in a significant rally, ameliorating the decline to some degree** Nevertheless, there is little doubt that for most investors it has been a lost decade. Looking ahead and assuming even a modest economic recovery, equities could be expected to return significantly higher returns of perhaps 7%-8% from current levels. With 10-year Treasury bonds yielding 3.5% against a background of large fiscal deficits for many years, it would be our position that equities should be favored over government bonds whose yields are not far from 60-year lows.
- ❖ **At present, yields on 30-day T-Bills are .13% versus .20% a month ago and 1.54% a year ago.** Yields on 10-year Treasury bonds are 3.48% compared to 3.53 a month ago and 4.1% a year ago. Similarly, long-term high quality corporate bond yields are 6.8% versus the same yield a month ago and 7.29% a year ago. Long-term municipal bonds currently yield 4.8% compared to 4.9% a month ago and 4.7% a year ago. 30-year mortgage bonds also at 5.60% are little changed from a month ago and compare to 6.6% a year ago. The credit markets have stabilized because of Federal Reserve monetary policy including quantitative easing and keeping short-term interest rates close to zero. With modest deflation at present and a weak economy, we expect little change in interest rates over the next few months. Looking ahead a year, we would expect interest rates to rise as the economy recovers and with the expectation that the U.S. dollar could weaken as a result of

the large fiscal deficits. At present, the U.S.dollar index is at 78.3 versus 80.13 a month ago. It has fallen a little over 10.0% since early March of this year and flat since the start of the year.

- ❖ **While commodities are down significantly from a year ago, they have generally risen in 2009.** The CRB Index (22commodities) is at 257.5 versus 250.0 a month ago but down 38.2% from 416.4 a year ago. Copper at \$2.62 per lb. is up from \$2.33 per lb. a month ago but still down from \$3.64 per lb. a year ago. A similar pattern exists with other metals and can be attributed to the economic recovery in China. Gold at \$954 per ounce on July 31st is stable with year-ago levels and up from \$926 a month ago. It tends to move inversely with the U.S. dollar and is viewed by many investors as means of maintaining purchasing power. While oil (\$69.7 per gallon) has rallied in 2009, natural gas has collapsed due to factory closings as a result of the US recession. Oil is a global commodity, helped by Asian economic recovery, whereas natural gas is a mainly domestic energy source. Overall, we believe that commodities will continue to rise based on the global recovery. The S&P 500 has had a strong rally in July and at 987 sells at 15.1 times our \$65 earnings per share estimate and at 13.8 times our \$71 per share estimate for 2010. Our view is that earnings will gain 9.0% in 2010 with real GDP growing by 2%. The above multiples appear reasonable and we would therefore continue to maintain an asset allocation of 65% in equities, 20% bonds (corporate and municipal), 5% gold and 10% cash.

IN SUMMARY

- ❖ **The S&P 500 is one of the ten components of the Index of Leading Economic Indicators.** It seems to be forecasting a robust V-shaped economic recovery. This has got to be the most contrary scenario of all right now. Everybody is hung up about the anemic outlook for employment and a compelling agument against any kind of recovery near term. So what is the S&P 500 seeing out there? Besides a classic inventory restocking are we seeing yet another global bubble developing? This one led by China, where M2 was up 28.5% y/y in June. Copper futures seem to agree with this outlook. The price of this basic metal rose to \$2.52 a pound at the end of last week, the highest since October 7, 2008. China's Dow Jones Shanghai Composite is up 53% since March 6, well ahead of the S&P 500. It actually bottomed on November 4, 2008, and is up 122% since then to 383.78. That's certainly an impressive meltup. Even more impressive would be if it recovers back to its record high of 588 on October 16, 2007. Anything is possible in a bubble.
- ❖ **While monetary stimulus is dependent upon the health of the financial sector to act as a proper transmission mechanism,** fiscal stimulus is directly in the GDP equation and thus can have effects on both the economy and the markets. While it's one thing to fade monetary policy and say the Fed is "pushing on a string", it's much harder to fade fiscal policy - even in the 1930s, once the government decides to spend money, it generally "works". That is until, of course, the bill comes due. The 1930s is again a good case in point: massive fiscal stimulus resulted in year-over-year GDP gains of 10.8%, 8.9%, and 13% in 1934, 1935, and 1936 respectively. The Dow rallied 372% during the same period, weakening only when the bill for government spending came due with higher marginal tax rates as we moved through 1937. For the time being, it might be hard to fade government spending (cyclical bounce). In the long-term however, stocks are likely to have trouble when both long-term interest rates and taxes move higher (secular problems).
- ❖ **We would continue to emphasize an asset allocation of 65% in equities, 20% in bonds (emphasizing corporates and municipals) and 10% in cash in balanced accounts.** We have reduced our cash allocation in growth accounts as the third quarter unfolds. When appropriate we might suggest 5% in gold. While gold flirts with the \$1000 per ounce level, we would advocate a hedge against an inflationary outcome of the increase in the money supply and continued geopolitical concerns. We believe that equities as well as corporate bonds are attractive based on the beginning of an economic recovery in the second half of 2009.

The opinions expressed in this commentary are those of Altman Investment Management, LLC as of the date appearing on this material only and are subject to change. The material is based upon information we consider reliable but we do not represent that it is accurate or complete and should be relied upon as such. This material does not take into account the particular investment objectives, financial situation or needs of the individual client and should not be viewed as an endorsement of any particular investment. Certain investments give rise to substantial risk and are not suitable for all investors.