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1st Quarter 2009 - Market Review & Outlook

The Markets' Ills

The list of issues affecting today's investment landscape is dizzying and at the top is the dismal state of the global economy. The fundamental problems, as we have discussed in previous articles, were the amount of borrowing in the economy, the lax lending standards used by financial firms and the resulting catastrophically-designed securities (i.e. CDS, etc...) that were created to make the other two factors manageable. This trend was self-reinforcing as purchases with borrowed money drove up asset prices (such as homes) and profits, which supported even more borrowing. And lenders, in their ultimate desire to remain competitive with their peers, wanted to make the loans available. So they did. Other financial firms, the Lehmans/AIGs/Bear Stearns of the world, created products to "insure" the risk created by making those additional loans. Ultimately, the upward spiral in asset prices was unsustainable and the failure of the risk-management products created the now ubiquitous "toxic assets." Now, forced selling has created a downward spiral of falling asset prices and lower spending and profits. As the economy deteriorates, contributing factors such as rising unemployment, mortgage defaults, loan write-offs, reduced lending, and overall fear all fuel one another.

Importantly, this is not just a U.S. economic problem. It is a severe global economic slowdown - almost certainly the worst since the 1930s. It is estimated there has been roughly \$50 trillion of global wealth destruction over the last 18 months. U.S. households' net worth fell by \$11 trillion, or nearly 18%, in 2008. (By way of comparison, the entire U.S. GDP is around \$14 trillion.) So the United States and other exporting countries cannot count on export-driven growth to help stimulate their economies. Indeed, the World Trade Organization recently forecast that global export volumes would drop by 9% in 2009, "the biggest such contraction since the Second World War."

In short, we are in the midst of a global economic crisis. In such a situation, most experts agree, the government needs to step in as a consumer and lender of last resort to try to stop the downward spiral, or at least to mitigate the extent of the damage from forced selling within the private sector. In effect, the public sector (the government) must leverage up and spend in order to try to plug the gap created by the deleveraging in the private sector. The \$800 billion fiscal stimulus package and the monetary and credit policy actions undertaken by the Federal Reserve and the Treasury to support the financial and credit markets are the result so far.

But there is significant doubt and disagreement as to whether and to what extent the current crop of economic policies and programs will be successful in stopping the economic slide. The bottom line is no one really knows. Economics is an inexact science,

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to put it mildly. There are too many variables that interact in dynamic and unpredictable ways. Additionally, as globalization has led the world's economies to become even more interconnected this complexity has only increased. And when you add politics and introduce the government as a player in markets and industries where in the past they were at best only the referee, the implications and outcomes of economic policy decisions become even more uncertain. Fundamental questions about the role of government in our capitalist system - questions that were previously never taken seriously - such as the potential for major bank nationalizations and auto industry ownership have exacerbated the already-high levels of uncertainty among market participants and investors. And as the saying goes: the market hates uncertainty.

All of that said, it is worth noting that as of this writing, the previous three months of the stock market's performance has been the best 3-month period in several decades. Historically the stock market is a leading indicator of economic activity. While uncertainty still exists in the economy the stock market is presenting a signal: that better days are ahead. In the same way our Founding Fathers found hope in the most desolate of situations when our great nation was born, we must do the same in these trying economic times.



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