

March 23, 2009 Stick to the Simple Truths

Dear CFG Clients,

This week we'll answer the question we all care about: What's going to happen in the coming weeks?

The answer has three parts:

- 1) the first part is the charts, the technical and the internal market momentum that's not related to the economy or fundamentals.
- 2) The second part is Treasury Secretary Tim Geithner's toxic asset disposal plan.
- 3) And the third part is the new General Motors bankruptcy aversion (or bankruptcy management) plan.

So, what are the current fundamentals? Is the market turning up for real or is this a rally in an ongoing bear market?

INTERNAL MARKET MOMENTUM

Housing

Recent headlines said that the February housing starts were up, but once you sifted through the numbers, you could see that the number was driven by new starts in apartment buildings and the milder-than-usual February weather.

At February's sales rate, it would take more than 13 months to sell-off existing inventory, twice the historical average. Excess inventory drives home prices, so look for prices to continue to decline.

Plus, when you look at the numbers, February's single family starts may have been up 1% over January, but they were down almost 5% from February 2008.

Meredith Whitney, housing analyst also sees more declines in home prices -- on the order of 15%-25% -- on top of the 27% drop we've already seen. If she's right (and during the last few years she has been spot-on about the economy) then all the bank estimates for write-downs in the future are very wrong.

Banks

Everyone is waiting for Secretary Geithner to reveal the details of his plan to rid the banks of toxic assets.

The wildcard now is that Congress and the public are so outraged over American International Group and the continuing arrogance of bank CEOs, that Congress may not fund Geithner's plan. On top of that, the credit markets are freezing up again and the economy is worsening.

Basically, the banks are broke. Forget the comments by CEO Ken Lewis at Bank of America about paying back TARP money. He's assuming a second-half turnaround in the economy and no

pun intended, but I wouldn't bank on that happening.

The bottom line in my opinion is that there is no bottom, yet.

Consumer Spending

Based on the most recent Alliance Research Network consumer spending survey showed that the slight pause in the decline that we saw earlier in the year is over, and consumers are, once again, pulling back.

The recession and headline scares have conspired to reduce income and spending power for many millions of households, and create a "new frugal" among consumers who aren't even touched by the recession, yet.

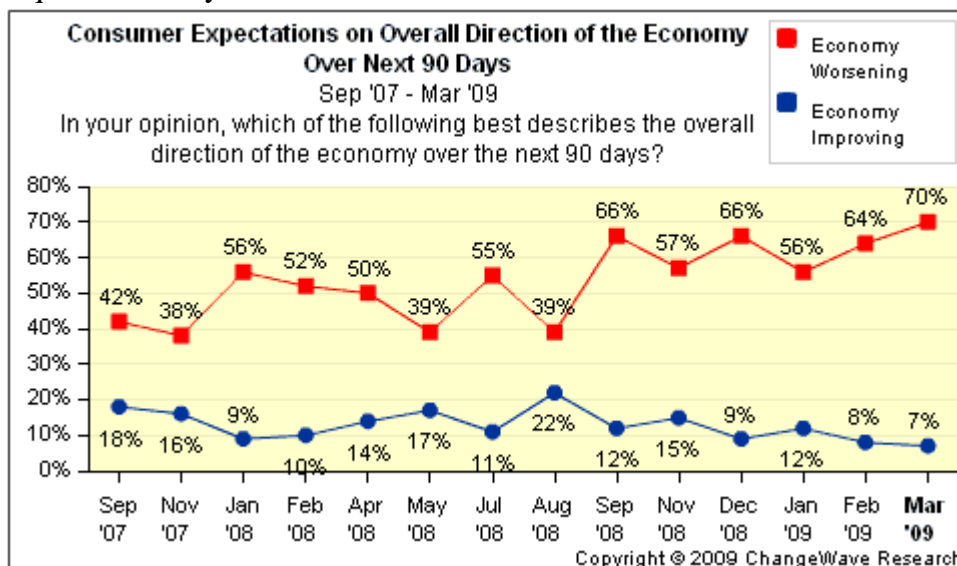
The nation's households lost 18% of their wealth last year, now more than 20% of all mortgages are higher than the value of the homes they are backed by, and credit card lines are being pulled back at a furious pace -- in fact, at a rate of more than \$1 trillion last year and \$2 trillion this year.

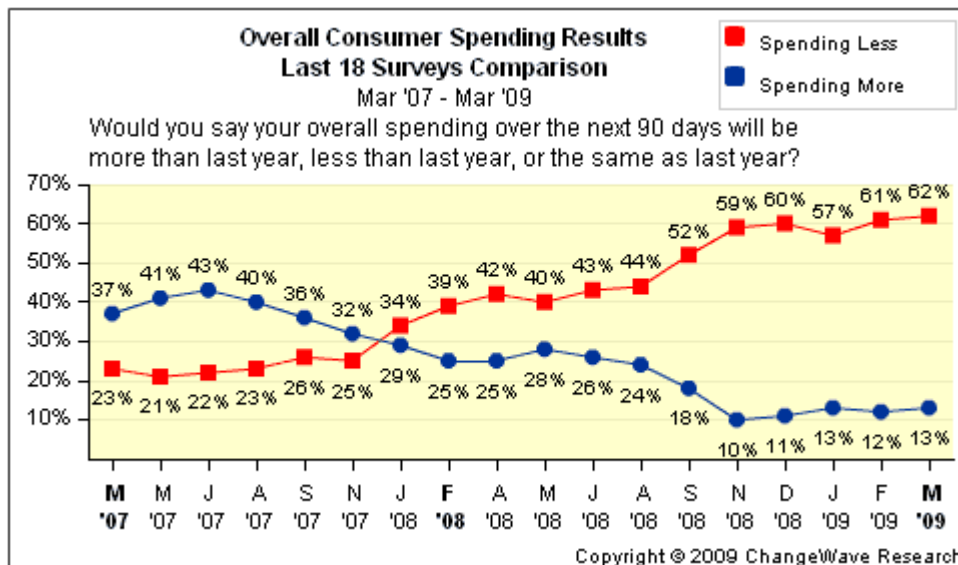
Put it all together and many folks are out of work, more people will be and everyone is worried so they're now frugal.

In simple math, we are losing more than 600,000 jobs per month. If you add the unemployment rate to the number of workers who have stopped trying to find a job, plus the number who are working part-time (but want to work full time), and we are near an eye popping 20% unemployment rate.

This percentage affects everyone -- whether unemployed, having an unemployed family member or knowing people in your office, neighborhood or church who are now unemployed.

Alliance Research Network survey respondents understand what's happening and the charts say it quite concisely:





Tech

Tech is the safe haven for many traders, as many tech companies are debt free and generate cash even when they're not growing.

That being said, this is still a fundamentally weak sector of the economy. Tech is a derivative of overall business capital spending and the Street's belief is that the critical sectors, semiconductors (the bedrock) and wireless (the growth area), are at bottom.

Alliance Research Network recent surveys tell us differently. The first half of 2009 will be weak or worse, and the second half will tell the tale when (as I believe) tech companies will miss estimates and guide down.

Summing it up, from a fundamental point of view we are not at a bottom, and I believe all investors will come to understand this, eventually.

THE GEITHNER PLAN

The broad outlines of the plan -- a key being the public and private funds used to buy toxic assets -- should be revealed in the coming days.

The goal is to resurrect what is known as the "shadow banking system." It's the market for securitized assets such as bonds backed by mortgages, credit cards and auto loans. The U.S. Treasury and/or the Federal Reserve will provide loans to these new funds and (in some form) the Treasury will guarantee the toxic assets they buy. The Federal Reserve is trying to do the same thing with the TALF program.

Secretary Geithner's plan will use the remaining \$250 billion in TARP funds and is rumored to require another \$750 billion in funding -- which will have to come from an angry Congress.

But, there is very strong skepticism about the ability of the plan to work for the same reason the TARP program didn't work -- and quickly shifted from buying toxic assets to re-capitalizing banks.

The overlying problem remains how to price the toxic assets. If they're priced too low, the banks will not sell, and if they do sell they will be insolvent. If priced too high taxpayers get creamed.

GENERAL MOTORS

GM is, effectively, bankrupt. It's at a stage where it's bluffing its way through the mess day by day.

I believe the Obama administration will adjust the initial rules regarding the government loans to GM and provide another round of cash to get the company through a "non-bankruptcy bankruptcy." It will hit junior bond holders and probably wipe out most of the shareholder equity. My thought now would be to sell GM stock if you still are holding it. It has went up a little this passed week and I think that I would be careful if I were you. At the very lease, I would put in a tight stop lost.

If President Obama does let GM go through this process it may be seen as a positive by the market -- some sort of proof that the administration will not bail out everything.

MARKET OUTLOOK

There's a split opinion right now about the market outlook.

The rally could be out of gas or could gather internal momentum and continue longer -- based on technical factors and short covering. But, the rally has nothing to do with the real economy and is really a bear market rally.

The rally seems to like Dow 7,200 as a place to pit the bulls against the bears -- it did this a few weeks ago -- and from here it could run out of steam and begin to reverse before the end of the quarter, as funds pull out profits. This is what I feel will happen. I do not think that you would be able to get a Small Investor back into this market right now no matter how much sugar coating our government or anyone else wants to put on it. The other problem is that the Mutual Fund Companies and large Pension Funds may be too weak at this point to have resources to gain enough strength to go much higher. They want to for sure. The end of the quarter is almost here and the S&P 500 is down YTD 13.13%, the Dow is negative 16.56% and the Nasdaq is off 3.64%. These losses in addition to the losses in 2008 won't go over well for the traditional mutual fund companies. Many Investors are not opening their statements as it is.

By the way: OUR CLIENTS HAVE MADE MONEY THIS QUARTER.

The other scenario is that it could continue with less and less intensity until it simply reverses, based on the same technical and momentum indicators that pushed it up in the first place.

The 7,200 level does seem to be an inflection point, and the coming days will decide if we turn or take another leg up. Right now there is no firm direction and everything is trading with the market, which means most stocks will also trade down when the market turns.

The coming weeks have several key events that are all based in Washington, D.C.

The United States and Europe

If you think it is bad in the United States; wait until you see what happens in Europe during the

coming months. European banks continuing to use the cover story that things are just fine is failing.

German, Austrian and Swedish banks have gargantuan exposure to failing eastern European banks and economies. Where many people took out foreign currency-denominated loans, their own currency is falling and their economies are failing.

The Fed has already provided \$500 billion, plus or minus, in "swap" agreements that function as loans to many of Europe's central banks. Mostly by funneling it through AIG.

If there is even the appearance of another crisis of some kind; the credit markets will tighten up again and the U.S. market could take a big hit as well.

Rule Changes

Modifications to the existing financial rules could include splitting assets into two classes -- one of them being a class that would be for illiquid assets that could then be valued based on some internal metric used by a bank.

Investors are smarter than that and the potential buyers of these assets are certainly smarter than that. They will value those assets their own way based on their own metrics.

At this point it's more headline risk than anything else, but I also sense these changes are being timed to coincide with the "stress tests." The devil will be in the details of both the final market rule changes and the final stress tests and their results.

Stress Tests

These tests of the books and assets of 19 major banks are supposed to tell the Treasury which companies deserves more capital and which do not.

This crisis is so big I don't believe we can discount the possibility that the Treasury will try to make the banks look somewhat better than they really are. This could fuel another rally in financials like we saw this pass week. If they don't do that, and the results are negative, the entire financial sector will take a hit led by the banks with the worst problems. That will enable investors to better pick the winners and losers. Stay tuned.

The AIG mess may have emboldened Treasury to do the stress test right, maybe. It may also mean that Secretary Geithner may not get the capital he wants from Congress -- so the stress tests may become a little more "rosy" for that reason. Again, we will have to stay tuned. Are you starting to get why things are never just black and white when it comes to dealing with messes like this?

The bottom line here is that the results are due out at the end of April, they are a major event and I will watch for signs of how they are going to turn out and affect us.

Managing Through the Rally

How does one manage through a blind rally that lifts lousy companies and dying companies -- even AIG doubled last week?

There are several ways:

* Go cash. This rally is for people who have stayed in the market a chance to get out. It is most definitely not a signal to get back into the market.

* If you do not want to jump out totally, then depending on your stress level move some out.

* Average down. Buy more of what you are holding as they become cheaper. I usually eschew this strategy, but a few more days of this rally and it may become a viable way to regain some ground quickly. That being said, you need to be a very good market timer to make this work consistently. It's never been our game.

* Add inverse Exchange Traded Fund (ETF) to your portfolio. This is a way to hedge your positions. There are inverse ETFs for every index.

This strategy will reduce your overall return to that component of your portfolio. Using a variation with much higher risk, would be to buy a double inverse ETF -- an ETF that goes down or up twice as fast as the market goes up or down.

What I recommend right now is to have some patience and wait for the turn.

We'll wait a few more days to see if the rally begins another leg up, before making any modifications to our strategy.

WEDNESDAY'S FED ANNOUNCEMENT

The Federal Reserve announced a surprise to some on Wednesday. Not to us though. We were prepared and had purchased for clients that we knew could handle the risk an ETF with the symbol TLT. This ETF will go up when bonds go up.

The Federal Reserve is making a gigantic expansion of its balance sheet -- about 50% -- with more than \$1 trillion more to buy more agency debt of Freddie and Fannie, and more Treasuries.

As a result of this announcement the market ended Wednesday up 90 and changes at the close -- because this will make banks more profitable and give them more ability to write-off assets. However, that didn't last long and on both Thursday and Friday the markets fell back.

Why?

Because the opposite is true about the economy. The Fed is saying the economy still needs massive stimulus because the credit markets are still somewhere between frozen and a wreck.

One of my favorite bond and credit market gurus is Bill Gross, and he said this announcement means to him that the Fed is very worried about credit markets and the economy. I agree.

SECTOR REVIEW

Homebuilders and Cousins

Single family starts increased only 1.1% last month and are off more than 50% from February 2008, when things were already so low that many analysts screamed "we are at the bottom." It's worth noting that when new home starts have, historically, fallen to one million, the market says

we have a bottom, but February's number was 375,000, so we are in dismal and uncharted territory.

Consumer Spending

The earnings announcement by Darden Restaurants Thursday says it all. Its high-end chain, Capitol Grille, had a revenue fall of 20%, while Olive Garden fell just 1%. It's a perfect metaphor for consumer spending -- everyone is spending less and trading down. When this rally subsides, high-end companies stock like Coach, Tiffany, and Nordstrom will probably fall like a rock. Luxury goods are dead and even the optimists on Wall Street realize the AIG guys are not flocking to Tiffany's to spend their bonuses, if they keep them.

Tech and Biotech

One piece of hard news -- Sun Microsystems reports of buyout talks with IBM.

Apple announces a much more robust development environment for the iPhone, which should put a dent in the new smart phone from Palm that's to be shipped this summer.

Friday, we saw shares of Alibaba.com, operator of an online merchandise trading site for businesses fall as much as 10%. Also, Xerox slashed its first-quarter earnings target by 80% Friday.

Financials

Regardless of the potential for this rally to continue a while longer, Goldman Sachs Morgan Stanley and Capital One are companies to stay away from. They will come down hard and fast when this rally runs out of steam I am afraid.

Until next time.

Val and Shari

Sources: Paul Carton & Jean Crumrine ChangeWave, www.changewave.com, IBD, Wall Street Journal, Kiplinger's

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