

April 2009

**MOODY, LYNN & CO.
INVESTMENT REVIEW AND OUTLOOK**

"I place economy among the first and most important virtues and public debt as the greatest of dangers to be feared. To preserve our independence, we must not let our rulers load us with public debt."

- Thomas Jefferson

It has been just over a year since the global financial crisis commenced with the collapse of Bear Stearns. It has certainly been an historic, traumatic and at times surreal twelve months. Is it possible, after six consecutive quarterly losses for all the major global market indices that the financial system is finally beginning to return to some state of normalcy? The recent dramatic gains in the equity markets suggest that both risk and confidence are resurfacing. ***Despite further losses recorded by the major averages during the first quarter, many sectors and geographic regions actually registered gains or only minor losses for the period.***

First Quarter 2009 Select Market and Sector Performance

S&P 500	-11.0%
NASDAQ	-3.1%
Emerging Markets	0.0%
Energy (oil service)	+1.0%
Technology	+4.0%
Healthcare	-8.5%
Basic Materials	-2.8%
Gold Bullion	+4.0%

The world economy continues to struggle with a severely over leveraged financial system and an over extended consumer. According to the Bank Credit Analyst, in 1991 it took \$2.60 in debt to produce \$1.00 of GDP. By the end of 2007, the debt level had increased to more than \$6.00. In the current year, the Congressional Budget Office projects the federal budget deficit will approach \$2 trillion, or 13% of GDP (vs. 3% in 2008).

Notwithstanding the work that still needs to be done, it is encouraging to note that the aggressive "quantitative easing" measures and the historic interest rate cuts currently being employed by many of the world's central banks are beginning to bear fruit. Bank lending has been restored while existing home and retail sales have stabilized. Consumer consumption appears to be benefiting from lower energy prices and lower mortgage rates as well as temporary tax cuts. In short, the *pace* of economic contraction is slowing.

Despite rising unemployment (8.5%) and declining real estate prices in many regions, recent economic data suggest that the worst of the economic news may now be behind us.

While outright bullishness is hard to justify, there are more reasons to be positive than there were six months ago. Across the globe, there is evidence of possible recovery. China implemented a multi-hundred billion dollar stimulus plan that has led to the country's official purchasing managers' index moving back into positive territory. China has also become more assertive, exploiting its unusual position as a country with huge cash reserves (est. \$2 trillion of foreign reserves) and a strong banking system to acquire natural resource and infrastructure companies. In the U.S. financial arena, Wells Fargo Bank recently reported record earnings. Concurrently, word circulated that all nineteen "large" banks were expected to pass the Treasury's "stress test." The confluence of these noteworthy events provoked one of the biggest stock market rallies in a century. This rally, in contrast to the prior two, was accompanied by both impressive breadth and lower volatility.

With the unprecedented flooding of the money supply, the Federal Reserve has essentially declared an all-out war against the prevailing trend of deflation. We are witnessing new and very creative policy action. Federal Reserve Chairman, Ben Bernanke (a recognized scholar of the Great Depression) is desperately afraid that the United States runs the risk of entering a prolonged period of deflation similar to what has plagued the Japanese economy for two decades. It is believed that should deflation take hold, job losses would accelerate, personal consumption (70% of U.S. economy) would collapse and the economy could potentially spiral into a depression. Hence, regardless of the longer term implications of creating trillions of new dollars, policy makers believe that eventual inflation will be much easier to manage than deflation.

The unusual depth and breadth of this recession means that we cannot expect a "normal" cyclical recovery. Any economic upturn is likely to be slow and painful. Unlike most postwar recessions, this "balance sheet" recession was caused by a decline in asset values and excessive leverage. It is likely to take some time for consumers to repair household balance sheets and return savings rates to more normal levels (6-8%). Furthermore, once a recovery is in sight, the outcome will be complicated by the implications of the aforementioned historic monetary and fiscal policy initiatives. Rising concerns over budget deficits and inflation will eventually lead to a hike in both interest rates and tax rates by the Fed and Congress, respectively.

Economists and CEO's currently have little confidence in their earnings forecasts or any clear idea of what the drivers for a resumption in domestic growth might be. On the other hand, we believe the best leading indicator of future business prospects remains the stock market. History shows that even during the dreadful decades of the 1930's and 1970's, the equity market generated numerous rallies that lasted many months and provided returns in excess of 25-50%. Although no one can precisely time these intermediate moves, we are confident that Moody Lynn's disciplined yet flexible investment approach will allow our clients to meaningfully participate in such opportunities.

In view of these positive elements, our investment strategy has recently become more offensive with respect to of our sector weightings, while remaining defensive in our overall asset allocation Specifically, we have increased the equity holdings in the technology, commodity, energy, and financial sectors while reducing positions in the more defensive health care and consumer non-durable areas. We continue to hold cash and gold reserves as a hedge against longer term inflation concerns.

Despite the recent encouraging news and very positive global market reaction, the economic outlook remains quite uncertain. Though abating, volatility may continue at elevated levels. *Since much of what we are experiencing has no precedent in the post-World War II period, economic policy makers, business leaders and investors will need to develop a new playbook, if not a new set of rules.* New “norms” will need to be established, and this will take time. In the interim, economic decision making in general and portfolio allocation in particular will remain tricky and subject to change. Once again, *flexibility will be key.* With respect to individual client portfolios, there will be no one answer or formula that is right for everyone. We encourage you to contact us should you feel the risk level in your portfolios is not commensurate with your current financial circumstances and/or comfort level.