JOHNSON INVESTMENT COUNSEL
e-update

# A Weak Economy and Concerns About Government Intervention Push Stocks Lower

## Why The Stock Market Has Traded Lower

Stock investors are painfully aware that 2009 has started off as another challenging year. While many stocks rallied in the last six weeks of 2008, we did not believe that the market was "out of the woods." It is normal in bear markets for the lows to be re-tested, in some cases multiple times. That scenario has played out so far this year, and with the sharp decline in February, we are now near a 12-year low for major stock market indices. While economic news continues to be discouraging, that is not unexpected. Serious doubts about the effectiveness of the United States Government's efforts to combat our nation's financial and economic crisis have led to another downturn in the stock market.

Since the collapse of Lehman Brothers in September, investors have anxiously awaited effective governmental actions to provide stability. So far, the Troubled Asset Recovery Program (TARP) is widely considered to be insufficient and the credit crisis continues to hurt the economy. Fourth quarter annualized GDP growth came in at -6.2%, the worst reading since 1982, and the current recession is now in its 15th month. As 2009 began, the realization that silver bullets do not exist for this situation has weighed upon investors. An improvement in the credit markets and economy will take time. Unwilling to repeat the mistakes of the Depression, the government is taking unprecedented actions to stabilize the financial system and spur the economy.

## Governmental Action

While there has been much governmental intervention, we believe the most important piece of all of the government programs is the **Financial Stability Act**. The Act aims to deal with the fallout from the housing and credit crisis and to re-establish the flow of credit via the following programs:

1. **Financial Stability Trust & Stress Test** – Established to strengthen our financial institutions so they have the ability to increase lending
2. **Public-Private Investment Fund** – Will purchase troubled assets from financial institutions and help re-establish a market for these securities
3. **Consumer & Business Lending Initiative** – Supports the purchase of loans by providing funding to the private sector; affects auto loans, credit cards, and other consumer and business credit
4. **Transparency, Accountability, Monitoring & Conditions** – Increases oversight of corporate activity, including dividend policy and executive compensation
5. **Housing Support & Foreclosure Prevention** – Designed to assist struggling homeowners and stop the trend of increasing foreclosures

The announcement of the Financial Stability Act was not accompanied by much detail, which clearly disappointed the markets. Lack of clarity on how banks would be stress-tested and how "toxic" assets held by banks would be valued led to a great deal of market chatter about the potential of the government's nationalizing some of our largest financial institutions. More recently, details have emerged about how banks would be stress-tested and several officials, including the President, have stated that the best interests of the U.S. are served by having the banks remain independent. A key step to recovery is developing a framework for valuing illiquid securities currently held by financial institutions that balances private sector interests and the interests of taxpayers.

Another significant piece of legislation, the American Recovery and Reinvestment Act of 2009, which is particularly politically-charged, was signed into law on February 17th. Most refer to this as the "stimulus package" and the cost is estimated at $787 billion. The majority of the items in the package fall into broad categories. The largest piece involves the purchase of goods and services, followed by tax relief and direct payments to individuals. The intent is to inject capital into the economy and create jobs. Many investors are concerned that this package will not promote long-term growth or desirable behavior, and that it dramatically increases the role of government in our economy. This plan is very complicated, and a complete description can be viewed online at www.recovery.gov.

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## Johnson Investment Counsel's View

From a capitalist and free-enterprise perspective, we are cautious about the government's playing an activist role in the economy and markets on a longer-term basis. However, given current conditions, we believe that some intervention is necessary to provide stabilization. It bears repeating that we believe the risk of the U.S. Government doing nothing is greater than the risk of doing something – even if that action is imperfect.

The Financial Stability Act has the most potential to benefit our economy in the short term, given the pivotal role that our financial and credit system plays in our economy. We do not agree with all aspects of the Act, but if toxic assets can be effectively handled, the credit freeze will begin to thaw. When there is healing in the credit markets, the economy should improve. The markets will need to see more detail on how the plans will be implemented. When the details are too vague, it only leads to more uncertainty. "Nationalizing" financial institutions would be quite negative, in our view, so we are encouraged that the latest commentary from the government downplays this troublesome option.

We believe the effects of the stimulus package will be muted. There could be some short-term benefits such as job creation in certain industries and targeted tax relief. One concern regarding the package is its impact on inflation in the coming decades. At this point, deflation is a bigger concern, and we maintain the Federal Reserve and U.S. Government have ample tools at their disposal to control inflation. We are more concerned that the package will not provide enough sustained economic impact, despite its huge price tag.

We understand that this is a stressful and troubling time for investors. No investor knows when the market will bottom, and the media certainly has a much greater effect on investor sentiment now than ever before. However, history suggests an upturn in stock prices may be near. Before this month, there were only two times in the last century when stocks revisited 12-year lows, as the market did on March 2nd. In each case, the market bottomed within 3 months of that occurrence even though economic recovery was several months away. In turbulent times, maintaining discipline is especially challenging. However, we are focused on making the appropriate investment decisions for each client and ensuring that each client's asset allocation is aligned with both their near-term and long-term objectives. We expect that quality companies will survive this tumultuous period and reward investors over the coming decade and beyond.

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