



THE FOXHALL GLOBAL OUTLOOK



APRIL 30, 2009

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Dear Paul,

The stock market has rallied over the past 5 weeks. Is this the beginning of the new bull market or is this a bear market rally that will be followed by new stock market lows? When do you think this bear market recession will end?

Economists often say that the stock market always starts to go up before the “real economy” recovers and often goes up before a recession ends. That is only partially true.

First off, an investor has to make a distinction between the economy in “real time” and the time it takes the government to collect data and formally release that data. As you may recall, the government formally declared the current recession started in December 2007, but it took them until November of 2008 to report this fact.

The stock market reached its peak in October of 2007 and started to decline after that. It seems that the stock market anticipated by about two months the coming December recession. But the actual recession didn't happen overnight.

Investors started to see sales and profits weaken in October and they could see the impact the housing crisis was having on the economy.

So it might be more accurate to say that the stock market was giving us a “real time” signal that the economy was starting to decline even though it took the government some time to assess that decline and formally declare it a recession.

The same will be true in the next real bull market. Investors in the stock market, at that time, will start investing in stocks as they see companies starting to re-order raw materials and increase manufacturing and increase inventories as executives start to anticipate new sales. When many companies start to do this, the economy will start to reverse direction and that will be the start of the next real bull market.

However, until the real, underlying economy starts to expand, any short term stock market rally is by definition a BEAR MARK-

ET RALLY that will go up for a few weeks or months and then drop down reaching new lows.

This happened during the first three months in the recession year of 2002 and then the stock market dropped dramatically hitting new post-9/11 lows.

I fear that will happen again with this current bear market rally. I don't believe the rally will last and I believe the market will be 15% to 20% lower by the end of 2009.

THERE IS NO GOOD NEWS IN THE ECONOMY RIGHT NOW!

Here is my reasoning as to why this current stock market rally is not the start of a new bull market and recovery. Over the past two quarters, it felt like the U.S. and world economies were dropping off a cliff. The only good news is that the worst drops may be over and the declines have now moderated. BUT MAKE NO MISTAKE ABOUT IT, THEY ARE STILL DECLINING.

Unemployment is growing by over 600,000 people per month, but even if we go down to only 300,000 to 400,000 people being laid off each month, the economy will still be declining.

Housing foreclosures continue to spike up each month and are now not expected to peak until the first quarter of 2010. Housing prices throughout the nation continue to decline even though sales (at bargain basement prices) are starting to increase in some cities.

Manufacturing continues to decline globally and more businesses are going into bankruptcy.

The recent financial sector rally started after accounting changes were approved for the big banks. They all reported profits last quarter. But the bad news is if it were not for those accounting changes, all of the big banks would have announced significant losses. I always hate it when accounting changes try to make the banks look better than they really are.

It is hard for me to see any good news in the real, underlying economy that would herald a new bull market.

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WHAT OTHERS ARE SAYING...

Nouriel Roubini, a professor of economics at New York University who has accurately predicted almost every turn in the global economy for the past few years had the following to say earlier this week.

“The stock market's latest 'DEAD CAT BOUNCE' may last a while longer, but three factors will, in due course, lead it to turn south again. First, macroeconomic indicators will be worse than expected, with growth failing to recover as fast as the consensus expects.

Second, the profits and earnings of corporations and financial institutions will not rebound as fast as the consensus predicts, as weak economic growth, deflationary pressures and surging defaults on corporate bonds will limit firms' pricing power and keep profit margins low.

Third, financial shocks will be worse than expected.

At some point, investors will realize that bank losses are massive, and that some banks are insolvent. Deleveraging by highly leveraged firms—such as hedge funds—will lead them to sell illiquid assets in illiquid markets. And some emerging market economies—despite massive IMF support—will experience a severe financial crisis with contagious effects on other economies.

So, while this latest bear-market rally may continue for a bit longer, renewed downward pressure on stocks and other risky assets is inevitable.

To be sure, much more aggressive policy action (massive and unconventional monetary easing, larger fiscal-stimulus packages, bailouts of financial firms, individual mortgage-debt relief, and increased financial support for troubled emerging markets) in many countries in the last few months has reduced the risk of a near depression. That outcome seemed highly likely six months ago, when global financial markets nearly collapsed. Still, this global recession will continue for a longer period.

There may be light at the end of the tunnel—no depression and financial meltdown. But economic recovery everywhere will be weaker and will take longer than expected. The same is true for a sustained recovery of financial markets.”

WHEN WILL THIS RECESSION END?

I know that everyone would like to see the stock market rebound and the new bull market start as soon as possible, but looking at the economy and stock market through “ROSE COLORED GLASSES” is almost always a severe investing mistake.

At FOXHALL CAPITAL, we try to look at the U.S. and global economies as dispassionately as we can. We try to eliminate bias and emotion by using a quantitative, computer-based process of analyzing the world's stock markets.

Academic studies show that in the short-term, meaning a few weeks or months, the stock market can rally for all sorts of political or other rational or irrational reasons.





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However, over the long-term, meaning any 12-month period of time, the stock market almost always reflects the underlying direction of the economy.

OPTIMISM CONTAINS TWO TRAPS

THE ECONOMIST magazine published an article on April 23, 2009 that I think was one of the best explanations of the current situation. They said, “optimism contains two traps, one obvious, the other more subtle. The obvious trap is that confidence proves misplaced—that the glimmers of hope are misinterpreted as the beginnings of a strong recovery when all they really show is that the rate of decline is slowing. The subtler trap, particularly for politicians, is that confidence and better news create ruinous complacency. Optimism is one thing, but hubris that the world economy is returning to normal could hinder recovery and block policies to protect against a further plunge into the depths.

It is easy to read too much into the gain in share prices. Stock markets usually rally before economies improve, because investors spy the promise of fatter profits before the statisticians document a turnaround. But plenty of rallies fizzle into nothing. Between 1929 and 1932, the DOW JONES INDUSTRIAL AVERAGE soared by more than 20% four times, only to fall back below its previous lows. Today’s crisis has seen five separate rallies in which share prices rose more than 10% only to subside again.”

HERE ARE THE SIGNS TO LOOK FOR IN A “REAL RECOVERY”

THE ECONOMIST magazine article went on to look at what needs to happen for a real recovery. “The economic statistics are hard to interpret, too. The past six months have seen several slumps, each with a different trajectory. The plunge in manufacturing is in part the result of a huge global inventory adjustment. With unsold goods piling up and finance hard to come by, firms around the world have slashed production even faster than demand has fallen. Once firms have run down their stocks they will start making things again and the manufacturing recession will be past its worst.

Even if that moment is at hand, two other slumps are likely to poison the economy for much longer. The most important is the banking crisis and the purge of debt in the bubble economies, especially America and Britain. Demand has plummeted as tighter credit and sinking asset prices have exposed consumers’ excessive borrowing and scared them into saving more. History suggests that such balance-sheet recessions are long and that the recoveries which eventually follow them are feeble.

The second slump is in the emerging world, where many economies have been hit by the sudden fall in private cross-border capital flows. Emerging economies, which imported capital worth 5% of their GDP in 2007, now face a world where cautious investors keep their money at home. According to the IMF, banks, firms and governments in the emerging world have some \$1.8 trillion-worth of borrowing to roll over this year, much of that in central and eastern Europe. Even if emerging markets escape a full-blown debt crisis, investors’ confidence is unlikely to recover soon.

These crises sent the world economy into a decline that, on several measures, has been steeper than the onset of the Depression. The INTERNATIONAL MONETARY FUND’S



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(IMF) latest WORLD ECONOMIC OUTLOOK expects global output to shrink by 1.3% this year, its first fall in 60 years. But the collapse has been countered by the most ambitious policy response in history. Central banks have pumped out trillions of dollars of liquidity and, in rising numbers, have resorted to an increasingly exotic arsenal of “unconventional” firepower to ease credit markets and loosen monetary conditions even as policy rates approach zero.

Governments have battled to prop up their banks, committing trillions of dollars in the process. The IMF has new money. Every big rich country has bolstered demand with fiscal stimulus (and so have many emerging ones). The rich world’s budget deficits will, on average, reach almost 9% of GDP, six times higher than before the crisis hit.

The Depression showed how damaging it can be if governments don’t step in when the rest of the economy seizes up. Yet action on the current scale has never been tried before and nobody knows when it will have an effect—let alone how much difference it will make.

Whatever the impact, it would be a mistake to confuse the twitches of an economy on life-support with a lasting recovery. A real recovery depends on government demand being supplanted by sustainable sources of private spending. And here the news is almost uniformly grim.

SEARCHING FOR NEW DEMAND

Take the country many are pinning their hopes on: America. The adjustment in the housing market began earlier there than anywhere else. Prices peaked almost three years ago, and are now down by more than 30%. Manufacturing production has been falling at an annualized rate of more than 20% for the past three months. And the government’s offsetting policy offensive has been the rich world’s boldest.

As the inventory adjustment ends and the stimuli kick in, America’s slump is sure to ease. Cushioned by the government, the economy may even begin to grow again before too long. But it is hard to see the ingredients for a recovery that is robust enough to stop unemployment rising. Weakness abroad will crimp exports. America’s banks are propped up with public capital, but their balance-sheets are clogged with toxic assets.

Consumer spending and firms’ investment will be dragged lower by the need to pay back debt and restore savings. This will be a long slog. Private-sector leverage, which rose by 70% of GDP between 2000 and 2008, has barely begun to unwind. At 4%, the household savings rate has jumped sharply from its low of near zero, but it is still far below its post-war average of 7%. Higher unemployment and rising bankruptcies could easily cause a vicious new downward lurch.

WHAT ABOUT CHINA?

For the time being, the brightest light glows in China, where a huge inventory adjustment has exaggerated the impact of falling foreign demand, and where the government has the cash and determination to prop up domestic spending. China’s stimulus is already bearing fruit. **Loans are soaring and infrastructure investment is growing smartly.**



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The IMF's latest forecast, that China's economy will grow by 6.5% this year, may prove conservative. Yet even China has its difficulties. Perhaps three-quarters of the growth will come from government demand, particularly infrastructure spending."

CONCLUSION

Add all this up and the case for optimism in 2009 fades quickly. The worst is over only in the narrowest sense that the pace of global decline has peaked.

I still believe a case can be made that the new bull market will start in the first half of 2010. However, we at FOXHALL don't have a crystal ball and our investment process and discipline is designed to simply follow the stock market in the direction it is already going—we don't ever try to anticipate future stock market movements—we just follow them.

Right now, we continue to implement our FOXHALL DEFENSIVE STRATEGY of staying invested primarily in U.S. government treasury bonds. We will continue to track long-term stock market trends and when we see a sustainable and persistent trend toward a new "real" bull market, we will then notify our clients that we will be moving to our FOXHALL OFFENSIVE INVESTMENT STRATEGY.

But until we see those new trends, which we do not at the moment, we will maintain our FOXHALL DEFENSIVE INVESTMENT STRATEGY to try to protect our FOXHALL client's retirement capital.

UNTIL NEXT TIME...

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