SMS Capital Management, LLC

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A Major Mood Change

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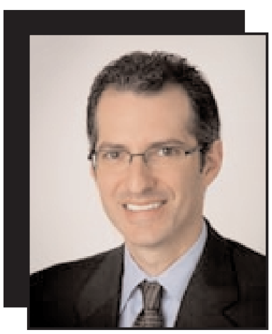
By Steven M. Sheldon, CFA

About SMS Capital Management

SMS provides investment management services to individual investors desiring to preserve and build long-term wealth. As a fee-based firm, SMS has an independent, objective and sound approach to portfolio management. The firm is a Registered Investment Adviser.



About the Author

Steven Sheldon has more than thirteen years of professional experience analyzing and managing investments. Prior to founding SMS, Mr. Sheldon worked as a senior member of a corporate principal investments group. Mr. Sheldon has an MBA from Tulane University and a BBA from The University of Texas. In addition, he is a CFA charterholder and a member of both the CFA Institute and the Houston Society of Financial Analysts (HSFA).

Not too long ago, it felt as though we were teetering on the edge of financial Armageddon. The chances for a big rally seemed about as likely as Susan Boyle's odds to win "Britain's Got Talent" (before you heard her sing). Miraculously, less than two months later, the market has rebounded, the mood has brightened, and Susan is an international sensation.

With the market having surged from its 12-year lows set in early March, the debate now is whether or not we are in the midst of yet another bear market rally (aka "head fake") or the beginning of a new, sustained bull market.

The Pendulum Swings

The optimistic view that an economic recovery is upon us in the not too distant future has started to gain favor with investors. This is a welcome change from the widespread belief that we were headed for a severe multi-year depression. Why the change in sentiment?

First of all, things were looking mighty bleak and so awful that it didn't take much to ignite a rally. Major concerns regarding the viability of the private U.S. banking sector (or what was left of it) abated with positive comments from management of some major banks. Management insisted they were making good money in this environment and that fears of "nationalization" were unjustified. Those comments seemed to be reinforced with better than expected earnings reports.

Secondly, earnings for some non-financial market bellwethers have also been a bit better than analysts' pessimistic forecasts. While the top line is down for most companies, due to the slower global economy and stronger dollar, the bottom line is holding up reasonably well because of aggressive cost cutting.

Lastly, central banks and governments around the world continue to provide historically unprecedented levels of stimulus as they attempt to pull the global economy out of this serious recession.

Off to the Races or Back to the Bottom?

It is possible that lows registered in March will prove to be the lows for this cycle, and that the market will be significantly higher in six months time. However, even if that is the case, it is unlikely that the road upward will be a smooth ride. Given the likelihood that corporate earnings will be under pressure for some time as the economy continues to shrink, there is still risk the market will fall off again or trade sideways for an extended period of time.

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In my forecast for 2008, I pointed out that it is too early to tell how this recession will play out given its severity. While the road to recovery has begun, it is clear that the economic landscape going forward will look quite different than the pre-crisis world.
I continue to believe the next few years will be marked by three themes: deleveraging (both for consumers and businesses), more regulation, and less consumer spending; hardly the backdrop for a major bull market in stocks. That does not mean stocks cannot advance (perhaps significantly) from here as sentiment improves with the recovery. It just means that I wouldn't bet on getting back to Dow 14,000 in the next 12-24 months.

Therefore, investors should maintain some exposure to stocks, but also maintain a good portion of their portfolios in areas that offer yield and an attractive risk/return profile, namely high quality corporate and municipal bonds. Some cash reserve should be maintained in the event better buying opportunities lay ahead.