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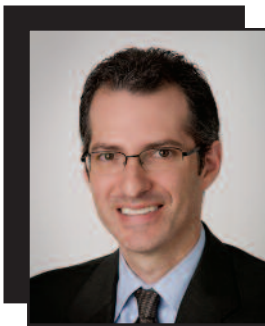
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September 2009

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).

Economic Alphabet Soup

Like a Jedi warrior using his power of suggestion and mind control over an adversary, Ben Bernanke recently declared that the recession is “very likely over”. With this simple qualified statement, the Fed chairman is hoping to restore shaken consumer and business confidence. Mr. Bernanke is not alone in his view that the recession has indeed ended.

Most economists now believe that this brutal recession concluded in the third quarter. The great economic debate has shifted from “when” we are going to have a recovery to “what kind” of recovery it will be.

Pick a Letter

Apparently, all economists take a mandatory course that teaches them how to make economic forecasts armed with nothing more than four letters (not to be confused with a four letter word forecast). Those four letters are “V”, “W”, “L” and “U”.

Those economists suggesting that the recession has ended and the recovery is going to be “V-shaped” believe that economy will rebound with as much force as what brought us into recession. On the surface, the “V” shape of the stock market over the last year would support the theory that we are on the cusp of a “V-shaped” robust economic recovery as has been the case with many recessions and recoveries in the past. However, Mr. Market and the economists might have it wrong.

Perhaps the economy expands in the third quarter only to slip back into recession again by the beginning of next year as the economic stimulus wears off. Then, additional stimulus might be required to push the economy back into a more sustained growth mode. This scenario is known as the “W” or “double-dip” recession. Some pundits argue that we might even have an “extended W” where short stimulus-led stretches of economic growth are followed by repeated economic weakness over the course of years. As noted economist Gary Shilling points out, there have been positive quarters of GDP growth in 8 of 11 recessions since WW2.

There is also the possibility of a “U” shaped recovery where there is light at the end of the tunnel, but it just takes a lot longer to get there than expected.

Finally, we may be destined for something much worse than any of the above – the dreaded “L”. This is where economic activity drops down to a new lower level and essentially stagnates for several years. Think Japan.



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Market Ramifications

After nearly a 60% bounce off the March bottom, investors continue to place their bets on the “V” recovery. Investors are extrapolating early signs of stability and growth into full fledged recovery. As has been the case with many prior recessions, this scenario is certainly possible, but far from certain. If we do have a stronger than expected recovery, the market will likely hold gains and could go up another 20% or so in the next year. However, there are some major components that are missing from this recovery that could impede forward progress – easy credit and job growth.

Even though interest rates are low, credit is not flowing to consumers and small businesses. In fact, consumers are shunning debt at a record pace. Easy credit led the U.S. economy out of the 2000-2002 recession, but won’t this time around. This recovery is being fueled by government stimulus programs (i.e. “cash for clunkers”, first time homebuyers credit, etc.). The hope is that the government gets the motor running again and consumers start spending as the mood brightens.

Furthermore, companies continue to eliminate jobs not create them. Until jobs are created, consumer spending (which makes up 2/3 of our economy) will be curtailed. While there have been clear signs that the pace of job cuts has slowed, job hiring remains very precarious. Undoubtedly, consumers will remain reluctant to spend in this type of environment.

At this point, anything other than a robust recovery will likely be met with investor disappointment since global stock market valuations are already baking in a healthy rebound in corporate profits. If corporations fail to deliver those earnings, the market will be a lot less forgiving than Taylor Swift. High levels of insider selling and stock issuances from corporations as well as declining short interest are also yellow flags.

Investors should be more cautious about adding to stock holdings at these levels and wait for firmer signs that the economy is catching up with the market.

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