



Client Bulletin

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MOVING AHEAD!

To put things in perspective, the major indices are still down drastically from their October and November 2007 highs. The S&P, DJIA, and international indices are still down more than 34% to 40% from those highs.

Since the market lows of early March this year, 2009, the indices have risen 45% or more. Year to date though, from January 1, 2009, the DJIA and S&P are up only about five and ten per cent. July threw us a curveball. Since June and into July, supply-and-demand indicators were giving us multiple signals to be on the defensive. Those indicators in June and July indicated that the risk was very high (after the run up from early March to June) suggesting that we could see a 15% drop or more in the market. In July the indices actually did break down thru a floor. Then in a matter of a few days the indices reversed up and rocketed through their technical ceilings. Exuberance is now in the air!



That whipsaw move was enough to switch us from a defensive, wealth preservation mode, to an offensive, wealth accumulation mode. The market whipsawed on us. We lost some opportunity but we believe it's easier to make up lost opportunity than it is to make up lost money. For those who may have already forgotten, not paying attention to market, sector, and individual security risk can cost a great deal more in lost assets, than protecting against that risk and temporarily losing out on some opportunity. The market can turn on a dime either way as we have just seen. We feel comfortable that by sticking to our discipline we will continue to do very well over an entire market cycle.

Where do we stand from a fundamental and technical standpoint and what's our investment game plan?

First, some fundamentals:

The general consensus is that we have avoided a second great depression and we are on a slow road to recovery. There are a lot of problems that will need to be addressed in the future. In the very near future we have another wave of mortgage debt coming due, unemployment will continue to worsen, credit card defaults and home foreclosures will worsen, commercial real estate and commercial debt will pose more problems, and rising interest rates to fight inflation are on the horizon. Corporate profits have improved but the point here is that most of those improved profits have resulted from cutting costs (e.g. laying off employees), not by bringing in more top line revenue. About 65% of our economy is driven by consumer spending. Unemployment, consumer debt, stringent credit requirements, and no longer being able to use home value as a way to borrow money, will keep consumer spending anemic. Therefore, can government and corporate spending pull us out and if so how soon?

Our economy will grow slowly until the unemployment picture begins to turn around. That will in part be a result of government spending effectively priming the pumps, the corporate sector rebuilding and creating new industries and technologies, escalating health care costs being brought under control, and the financial system continuing to get back on track. Also, we have to keep in mind that the dollar continues to weaken.

The stock market is a forward looking indicator and typically leads the economy. The July run up was in part, in my judgment, a reaction to an improvement in leading economic indicators (one of which is stock market performance itself), positive corporate profits (a result of cost cutting and perhaps not sustainable without a consumer spending comeback), and news that the housing market was showing some signs of bottoming (which could be negatively affected by a future surge in unemployment-driven foreclosures, rising interest rates, and by a lack of credit worthy buyers). In addition, there is a great deal of money earning very little return in money markets that is beginning to move back into the stock market. (continued)

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Let's now look at the supply-and-demand (technical) indicators.

With the sharp run up in the market at the end of July our supply-and-demand indicators moved from a defensive (wealth preservation) to an offensive (wealth accumulation) position. Without getting into details, **demand took control back from supply**, not only that, the July move up was very strong and rapid. That move also took the indices up through a ceiling of technical resistance. That break out is another positive technical indicator for better market performance ahead. From this point up to higher levels we do have additional levels of resistance, one immediately ahead. In general though, it's not strong technical resistance on the upside. "Not strong technical resistance" means that when the market tumbled down late last year and into March of this year, it did so precipitously and not on a great deal of volume. With no guarantees, that means it could move up easier (if market sentiment continues to improve) than if that downside volume had been greater.

In the here and now from a technical standpoint, the field position or level of risk has risen. In other words the recent move up has been so fast and strong that it has created an overbought situation. A pullback from these levels, or a consolidation period, is probable. Given a pullback, initial floors of support would be 5% to 15% on the downside.

In summary, the fundamental economic situation in the near term is very uncertain and definitely has its headwinds. The technical or supply-and-demand research has us on the offense or in a wealth accumulation mode. However, because of the strength of the July move, the technical field position is not great and we find ourselves in an overbought situation.

Given the above fundamental and technical picture, what's our investment game plan?

Given our concerns about the sustainability of the exuberant economic news of recent weeks, offset against a generally positive technical picture (though near-term overbought) here are some of the things we've been doing. We are keeping some cash on the sidelines and/or in fixed income, while increasing our exposure to equities, and increasing our exposure to assets that do not correlate to equities. The latter includes precious metals and commodities the prices of which are being aided by a weakening dollar. We're placing emphasis on using exchange traded funds and mutual funds that have built-in diversification. In the few instances that we buy individual stocks, we limit the percentage amount of the stock in a portfolio, and typically buy on a pullback.. When investing in stocks we try to keep the reward to risk at 2 to 1 or higher. That means a \$2.00 or higher upside potential versus \$1.00 downside if the risk goes against us and we stop out of the investment. We also have an exit strategy or stop loss in place for every investment that we have.

No one knows what the stock market will do in the short term. We do know that in the short term there's always lots of up-and-down noise. Measuring performance is best done over an entire market cycle (trough-to-trough or peak-to-peak). We also know that investors get hurt the most when they get caught up in the enthusiasm of the upside and ignore the risk of the downside. Since March the market has had a dramatic move up and of late a great deal of stock market enthusiasm is in the air. That in itself is a good reason to exercise caution.

Having disciplined entry points and an exit strategy for every investment is inherent to our methodology. Both the up- and the down- sides have to be managed so as to Do No Harm and Make Money** (please read the footnote)

I hope this bulletin has shed some light for you on the current investment picture! Please look for our regular monthly newsletter later this month.

**There is no risk-free investment! Investment portfolio values fluctuate and past performance is never a guarantee of future results. "Do no harm" translates into structuring and managing an investment portfolio to conform to a client's risk tolerance and time horizon. Proactive asset allocation, diversification within asset classes, and continual monitoring and risk management of each position are methods we use in structuring and managing portfolios. Our approach includes corroborating fundamental research, with capital markets supply-and-demand research, also called technical research. At times we will use conservative hedging techniques to limit downside risk.