



Client Bulletin

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PADDLING ROUGH WATERS

The first week of January was shaping up pretty well. On January 7th however, market indices and our supply-and-demand indicators began deteriorating. That is where we are as I write this on January 15, 2009.

Supply has regained control on a number of fronts and has put the defensive team back on the field. In the past couple of days, we've reduced exposure to Gold, Wal-Mart*, and the S&P index. The dollar has been showing more signs of strength over foreign currencies so we have increased our exposure to the U.S. dollar. Certain areas of the bond market are showing strength and safety also.

Utilities, consumer staples, healthcare and biotech, and the telecommunications sectors remain strong on a relative basis within the broad stock universe. In most cases, these sectors, excluding biotech, generate decent dividends while we wait for the stock market to get better.

In the January newsletter, I mentioned that the volatility, or fear factor index, had finally broken down from all-time highs in October and November of last year. That was good news, but that fear factor index still remains at higher than normal levels. These high levels go along with the bottoming process that we've been in since October 2008. We remain in that bottoming process. Also, looking at a statistical worst case, we could see a low in the S&P 500 index at a level of about 675. That is about 20% lower than where it is. Given that our technical indicators once again point to wealth preservation, and given the increased market risk, we felt it prudent to reduce our exposure to equities and to raise some cash. It is tough paddling!

While we have gone back to a defensive or wealth preservation mode, there remain several very positive facts for the longer term perspective. I've mentioned them before. There is an extraordinary amount of money in the money markets and in treasuries, much of which will eventually migrate back into equities. Many well-managed and financially strong companies' stocks remain at excellent valuations longer term (note: bank stocks would be an exception and are worrisome). The government continues to take a proactive stance to create jobs, and to fix the many problems in the credit, housing, and financial markets. Given government intervention though, there is a skeptical and healthy "show me" requirement that government policies will work. It'll take more time and discernible results to promote investor confidence.

We deal with what is and we continually assess reward and risk. When demand is in control, prices are rising and we are in wealth accumulation mode. When supply is in control, we are in wealth protection mode. Demand had the ball for a short time but in the past week turned the ball back over to supply. That puts us in a defensive posture and in wealth preservation mode. It requires that we move some of our assets to safety until the reward/risk situation again improves.

We will continue to keep you posted when significant changes occur in the investment environment. For now we continue to paddle in rough waters.

* Wal-Mart's accounting and governance rating by Audit Integrity, Inc., has fallen since last year. It is down to the mid-thirties percentile level. That suggests very aggressive accounting, and stewardship issues that we believe are best to avoid. For comparison, Family Dollar Stores, another value retail store that is somewhat recession-proof, has an excellent 88% accounting and governance rating.

