

Lighthouse Beacon

A Guide in the 21st Century

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Lighthouse Investment Commentary

Recession is Past; Invest for Your Future

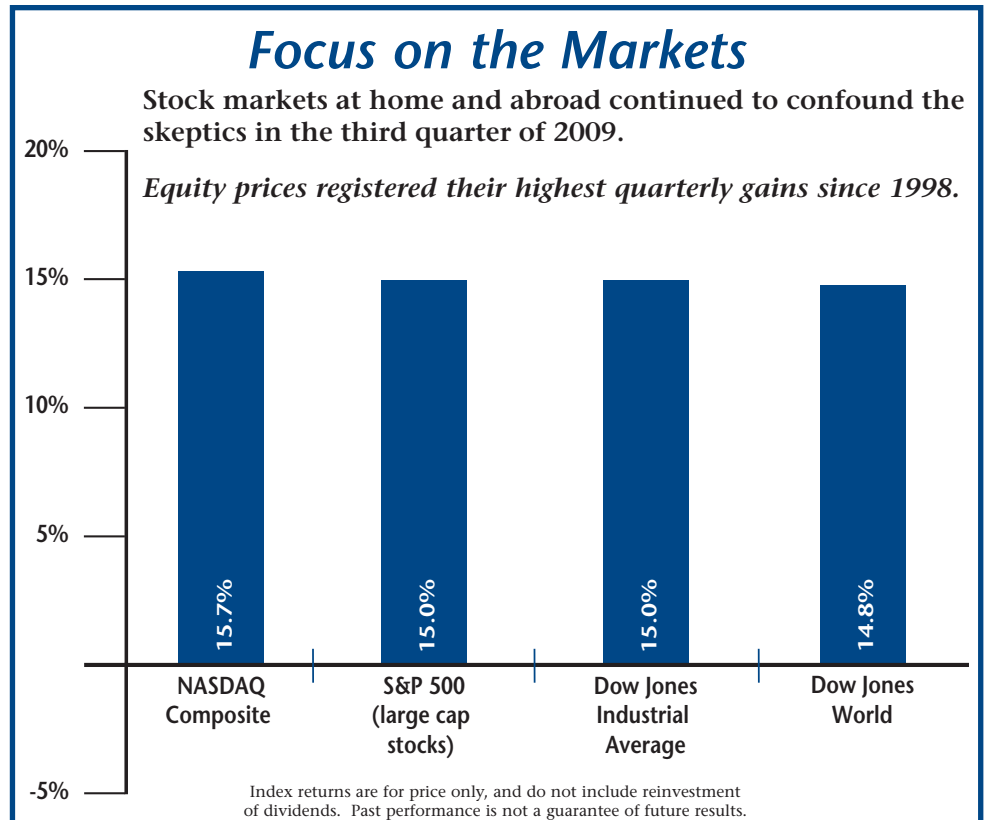
Don't let the past constrict your thinking about the future.

We need to leave behind memories of the market collapse that started a year ago. That is over. The stock market has been on the rise after bottoming out on March 9, 2009. Since then, stock prices have risen by 50% as many investors have recognized that the worst recession since the 1930s' Great Depression is behind us.

Evidence of economic stabilization and the beginning of a recovery is pervasive. In fact, we have been witnessing signs of economic recovery both in the domestic and world economies for several months.

In the United States, the economy grew at an annual 3.5% rate in the third quarter of 2009 as consumer confidence improved, housing stabilized and industry production picked up. During the three months ending September 30, orders for durable goods increased at a 22.3% annual rate, while housing sales rose by 23.4%. Little wonder that U.S. factories increased their output in October—for the third consecutive month—and manufacturers even have started rehiring. At the same time, more corporations are reporting improvements in their earnings.

Meanwhile, the world economy is showing new energy, led by China and other emerging markets. The



Asian Development Bank projects that GDP growth in China will rise by 8.2% for all of 2009 and the European Commission predicts that the European economy will return to positive growth in 2010.

Witnessing these trends, many investors have allocated more of their assets to equities, as evidenced by the second consecutive quarter of strong increases in stock markets throughout the world. (See accompanying chart.) Nevertheless, some market observers don't believe in the rally and have remained stuck

in the mindset that emerged during the bear market of late 2008 and early 2009. Evidence of this persistence of fear and pessimism can be found in the astounding \$3.6 trillion that remains parked in money market funds earning less than 1% a year.

We continue to hear the doomsayers warn that the market has come back too far and too fast and that a big correction is imminent. Ignoring the bulk of the evidence, they point to one factor that stands out as the

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exception: unemployment continues to rise. And yet, even this is consistent with the historical lessons learned from past recoveries.

Employment historically has lagged in economic revivals as companies cautiously postpone their hiring plans to see how much of their earnings growth is sustainable. That is why employment is called a “lagging statistic”—a phenomenon stubbornly resisted by the economic pessimists who cling to high unemployment as evidence that the economic recovery is not real.

To be sure, the recession was real—and terrible for the toll it took on many families. Virtually everyone has been affected by the widespread economic downturn that appeared to threaten the underpinnings of the global economy. But the U.S. government and the national governments and central banks of other major industrialized and developing nations responded with massive stimulus programs that helped avert the threatened worldwide global depression.

Many of the pessimists may be guilty of wishful thinking. After all, they were on the sidelines as stock prices rose steadily since March. Their continued warnings may be in hopes that the market will give them a second chance to get back in at the bargain-basement prices that existed early this year.

Make no mistake. There always is the possibility of a correction at any time after a bear market has ended and a new bull market has begun. The modest slippage in stock prices this October may be a good example of this natural phenomenon. Nevertheless, history has shown that meaningful price corrections in the stock market are rare

in the early stages of a bull market and economic recovery.

Now that economies have stabilized and once again started to expand, it is time to look ahead. The economic recovery is real, even though it is likely to proceed in fits and starts, as have earlier recoveries.

In the months ahead, we should expect to see mixed reports on the economy and on corporate earnings, with some evidence exceeding expectations and others falling short of what had been anticipated. We also should expect to see the capital markets over-react to these mixed reports, both on the upside and on the downside. As we see these events unfold, we should keep in mind that expectations only affect markets in the short run and that it is very difficult to forecast long-term trends with weekly

or monthly data. Over the longer term, economic fundamentals will be the deciding factors.

The major factor on which to focus is the long-term TREND. And, as we have already seen, the underlying trend for the economy and for corporate earnings has turned positive.

The robust market rally that began in March has only started to recoup the enormous losses suffered in the preceding months. We still have a long way to go, as the accompanying Lighthouse Guides question-and-answer outlines. The healing process has begun and investors should be concentrating on the task of rebuilding wealth. .

As always, we need to be disciplined. The long-term trend is clear: Things are getting better.

Lighthouse Guides

Q: I am told that the stock market declined by 60% in late 2008 and early 2009 before rising again by 50% since March.

Why, then, does the stock market remain far below its peak level?

A: You are not alone in the confusion. It's true that we have had a strong rally since March, but it's also true that most equity investors haven't come close to recovering from their earlier losses. Why? It's all in the way percentages are calculated. You can call it “the tyranny of numbers.”

Let's illustrate with a very simple example. Let's say you had \$100 in the market, but then lost 60% of it. That would

mean you were down to \$40. Then, you had a 50% gain. That would only bring you up to \$60, which is 50% more than the \$40. You still have a long way to go to bet back to the original \$100. To get to that level, your investment will need to climb by 150%.

As we write, the stock market still has far to go. The Dow Jones Industrial Average, for example, had hit a high of 14,164 before plummeting all the way to 6,547 on March 9. Since then, it has climbed back to more than 10,000. That's a great start, even if it is still distant from where we started.

Reaching the 14,164 level is going to take time—and patience.

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