



Park Piedmont Advisors LLC

Registered Investment Advisor

Helping to Achieve Clients' Goals with Indexed Investments

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MAY 2009 COMMENTS

MAY 2009 MARKET ACTIVITY (ending Friday, May 31st)

During the month of May, US and INTERNATIONAL STOCK prices showed continuing gains, are now mostly positive for 2009 (albeit with a wide range of results), and have made huge percentage gains since the March 9th lows. International and Emerging Markets continued to greatly outperform most US indexes, exactly the reverse of 2008 results. (Month and YTD figures are on page 2; figures tracking the volatility in stock prices since the end of 2006 are presented on page 5).

BOND prices of high credit quality bonds gained, except for the continuing declines in US Treasuries, as interest rates continued to move higher on the benchmark 10-year bond, which closed at 3.47%. This is up from 3.12% last month, and far higher than December's historically low close of 2.25%. (Typically, bond prices decline as interest rates rise, absent credit concerns). The high credit quality corporate bond market, as well as the low credit quality "junk bond" market, continued to post substantial gains, outperforming a mix of government-corporate bonds (month and YTD results are on page 2). This month's detailed discussion, starting on page 6, covers the subject of Interest Rates, and their huge impact and effect on the real economy and financial markets.

The rapid, significant increase in stock prices since the March 9th lows (S&P500 up 35%) presents the question of whether investors should: (1) sell some stock positions to take some of the recent gains; (2) buy more stock positions, since prices have been rising; or (3) retain their stock positions, based on previously established allocations (and the fact that the S&P 500 is still down approximately 40% from the highs of October 2007). The answer to this question is likely to depend on: (A) your view of the likelihood of an economic recovery in a reasonable time frame, without harmful inflation (see discussion on pages 6-8); and (B) whether you want to act as a short-term investor, focusing on short-term price swings, or as a long-term investor, seeking to meet established goals for your money and needing some growth potential to meet those goals. As you know, we are major proponents of the view that investing is a long-term process, that no one knows in advance when markets will enter periods of significant declines and/or significant gains, and that staying the course with an appropriately allocated, well diversified investment portfolio is the best approach, rather than trying to outguess the market's moves.

Any recommendation contained in these Comments may not be suitable for all investors. Moreover, although the information contained herein has been obtained from sources believed to be reliable, its accuracy and completeness cannot be guaranteed.

COMMENTS: INDEX RESULTS for period ending MAY 2009

	YEAR	YEAR	YEAR	YEAR	YEAR	YEAR	YTD	MAY
	<u>1999</u>	<u>2000-2</u>	<u>2003-5</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2009</u>
STOCKS								
Vanguard Total Stock Market Index Fund	23.8%	-37.2%	53.1%	15.5%	5.5%	-37.1%	4.0%	5.3%
Standard & Poor's (S&P) 500 Index	19.6%	-40.1%	41.9%	13.6%	3.5%	-38.5%	1.8%	5.2%
Vanguard S&P 500 Growth Index Fund	28.8%	-48.4%	41.8%	9.0%	12.6%	-38.4%	9.2%	4.6%
Vanguard S&P 500 Value Index Fund	12.6%	-26.2%	63.2%	22.1%	0.1%	-36.1%	-1.6%	5.6%
Dow Jones Industrial Average Index	25.2%	-27.5%	28.5%	16.3%	6.4%	-33.8%	-3.1%	3.8%
NASDAQ Composite Index	85.6%	-67.2%	65.2%	9.5%	9.8%	-40.5%	12.5%	3.6%
Vanguard Midcap US Index Fund	25.0%	-18.3%	83.9%	13.6%	6.0%	-41.8%	8.8%	4.3%
Vanguard Smallcap US Index Fund	19.6%	-24.2%	87.5%	15.6%	1.2%	-36.1%	6.1%	3.8%
Vanguard International Index Fund (EAFE)	25.3%	-45.9%	95.9%	26.6%	15.5%	-44.1%	12.2%	14.1%
Vanguard Emerging Markets Index Fund	61.6%	-29.5%	162.7%	29.4%	39.0%	-52.9%	37.2%	21.0%
Vanguard Real Estate Investment Trust Fund	-0.4%	47.5%	98.6%	35.1%	-16.5%	-37.2%	- 8.7%	5.9%
BONDS								
Vanguard Short-term Bond Index Fund	2.1%	25.8%	6.5%	4.1%	7.2%	5.4%	1.8%	0.8%
Vanguard Short-term Tax-Ex. Bond Fund	2.6%	13.8%	4.5%	3.2%	4.2%	3.7%	1.5%	0.1%
Vanguard Total Bond Market Index Fund	-0.8%	30.4%	11.1%	4.2%	6.9%	5.1%	1.5%	0.8%
Vanguard Interm-term Tax- Ex. Bond Fund	-2.9%	23.7%	10.3%	4.4%	3.4%	-0.1%	5.8%	0.9%
Vanguard High-Yield Bond Fund	NA	1.7%	30.7%	8.2%	2.0%	-21.3%	17.7%	4.9%
Vanguard High-Yield Tax-exempt Bond Fund	-3.4%	25.2%	16.5%	5.5%	1.6%	-10.5%	11.6%	3.0%
Vanguard Inflation-Protected Bond Fund	NA	25.5%	20.0%	0.4%	11.6%	-2.9%	5.1%	1.8%

NOTE 1: Current Month Results measured from beginning of year, and not beginning of prior month.

NOTE 2: Three-year results start with a base of 100, and after each year's % change, the result for that year creates a new base. So if at the end of the first year the index is up 10%, then the new base is 110%; and if down 10%, then the new base is 90%. NOTE also that a decline of 50% requires a gain of 100% to get back to the starting value, which explains why NASDAQ, down 67%, would require a gain of 200% to get back to its starting value.

- 1) Results for Vanguard funds include dividends and fund expenses but do not reflect PPA's advisory fee.
- 2) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's advisory fee.

%	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q			
		<u>1999</u>					<u>2000</u>					<u>2001</u>			
S&P 500	4.1	7.6	(7.7)	15.6	2.0	(3.0)	(1.3)	(7.8)	(12.1)	4.8	(13.8)	8.1			
NASDAQ	14.6	10.0	0.0	61.0	12.4	(14.8)	(7.2)	(29.6)	(25.5)	12.9	(26.7)	18.3			
BONDS	0.0	(0.5)	0.4	(0.7)	2.4	1.5	3.1	4.3	3.2	0.8	4.3	0.0			
		<u>2002</u>					<u>2003</u>					<u>2004</u>			
S&P 500	0.0	(13.8)	(14.1)	4.5	(1.8)	12.8	2.2	13.2	1.3	1.3	(2.4)	8.8			
NASDAQ	(5.5)	(19.5)	(13.5)	7.0	2.5	19.2	12.1	16.2	(0.5)	2.7	(7.5)	13.9			
BONDS	0.0	2.8	3.6	1.8	0.9	2.7	0.2	0.2	2.7	(2.6)	3.1	1.0			
		<u>2005</u>					<u>2006</u>					<u>2007</u>			
S&P 500	(2.6)	0.9	3.1	1.6	3.7	(1.9)	5.2	6.6	0.2	5.8	1.6	(4.1)			
NASDAQ	(8.1)	2.6	4.4	2.5	6.1	(7.6)	3.9	7.1	0.3	7.5	4.0	(2.0)			
BONDS	(0.5)	3.0	(0.7)	0.6	(0.7)	(0.2)	3.8	1.3	1.4	(0.6)	2.9	3.2			
		<u>2008</u>					<u>2009</u>					<u>2010</u>			
S&P 500	(9.9)	(2.9)	(7.9)	(17.7)	(11.7)										
NASDAQ	(14.1)	0.6	(8.0)	(19.0)	(3.1)										
BONDS	2.2	(1.1)	(0.5)	4.5	0.3										

STOCK index prices for US and International indexes showed continuing gains during May, ranging from 3.8 % (Dow Industrials) to 3.6 % (NASDAQ) to 21.0 % (Emerging Markets). YTD figures range from a still negative -3.1% for the Dow to 12.5 % for NASDAQ to 37.2% for Emerging Markets. Growth continued to outperform Value, and the REIT sector, while down YTD, also gained in May. In general, stock sectors showed major variations for the year to date, as shown by the huge 40% spread between the Dow and Emerging Markets.

BOND returns (price change plus interest) for high credit quality corporate bonds and low credit quality high yield (or “junk”) bonds were up for May and YTD, while government bonds declined (another complete reversal of last year’s performance). The benchmark 10-year US Treasury yield closed at 3.47%, up from 3.12% in April and 2.25% in December 08. (The discussion starting on page 6 focuses on the many impacts of rising interest rates). Short-term US Treasury yields remained at almost zero, as the Federal Reserve kept its short-term rates at that level. During September-November 2008, credit quality issues were the key to bond pricing, but from December through May, the more normal relationship of interest rates and bond prices has returned.

ECONOMIC NEWS continued mostly negative, with unemployment and job losses remaining high, albeit at reduced levels of decline, and GDP falling 5.7% in Q1 (revised from a 6.1% decline). Housing sales have picked up, but at very low prices, and mortgage foreclosures continue at extremely high levels. Retail sales for April were disappointing. On the positive side, corporate profits turned positive in Q1, after six straight quarterly declines (WSJ, 5/30-31, A2). Even with the current negative economic news, the key issue of the recession’s future duration and severity continues to depend on the success of governments’ efforts at economic stimulus and restoring the banking system to some degree of normalcy.

From a longer-term standpoint, the stock price declines from the October 2007 highs accelerated dramatically starting in September 2008 and reached lows in early March 2009, with the declines approaching 60% from the 2007 highs. The subsequent March-May 2009 rally has now reduced those declines to approximately 40% (see chart on pg. 5). From 2000 through May 2009, the Dow Industrials are now 27% lower, the S&P 500 40% lower, and the NASDAQ a stunning 65% lower, even as NASDAQ is the outperformer in the current stock rally. The decade of the 2000s is almost certain to be the first since the 1930s with cumulative annualized negative stock returns, making these returns obviously far lower than their positive long-term average annualized returns of 9.6% (a figure updated by Ibbotson/Morningstar to cover 1926 through 2008). Going back to the bull market that began in 1995, all three major indexes have similar (and, since September 2008, very much lower) average annual returns, ranging from 4.9% to 6.1%. The mutual fund company Vanguard notes that from 1926 through 2008, in only six of 83 years did stock prices fall within 2%, up or down, of the long-term annual average return of 9.6%.

The moral: Stock returns are truly unpredictable and volatile in short time frames, and can be over long time periods as well, even with (so far) a fairly stable very-long-term average return. Key Questions: Your relevant time frame and tolerance for risk.

	<u>S&P 500 (1)</u>		<u>DOW (1)</u>		<u>NASDAQ (1)</u>	
1st Qtr 2000 High	1,527		11,723		5,048	
Year End 2000	1,320	(13)%	10,785	(8)%	2,470	(51)%
September 21, 2001 Low	965	(37)%	8,235	(30)%	1,425	(72)%
Year End 2001	1,148	(25)%	10,020	(17)%	1,950	(61)%
October 9, 2002, Low	777	(49)%	7,286	(38)%	1,114	(78)%
Year End 2002	880	(42)%	8,342	(29)%	1,336	(73)%
Year End 2005	1,248	(18)%	10,718	(9)%	2,205	(56)%
Year End 2007	1,468	(4)%	13,265	+13%	2,652	(47)%
November 20, 2008 Low	752	(51)%	7,552	(36)%	1,316	(74)%
December 31, 2008	903	(41)%	8,776	(25)%	1,577	(69)%
March 9, 2009 Low	677	(56)%	6,547	(44)%	1,269	(75)%
May 31, 2009	919	(40)%	8,500	(27)%	1,774	(65)%

Context: Prior Five-Year Gains in Bull Market of 1995 - 1999

	<u>S&P 500 (1)</u>	<u>DOW (1)</u>	<u>NASDAQ (1)</u>
End 1994	459	3,834	752
End 1999	<u>1,470</u>	<u>11,500</u>	<u>4,070</u>
Gain	1,011	7,666	3,318
Avg. Ann. % Gain: '95-'99; 5 years	26.2%	24.6%	40.2%
May 2009	919	8,500	1,774
Gain	460	4,666	1,022
Avg. Ann. % Gain: '95-5/09; 14.42 yrs	4.9%	5.7%	6.1%

1) Results for S&P 500, Dow Jones, and NASDAQ indexes do not reflect dividends or PPA's fees.

INVESTMENT CONCEPTS

The chart below has been updated monthly to reflect the extreme stock market volatility since the summer of 2007. What appeared extreme in late 2007 and early 2008, however, has turned out to be a mild prelude to the declines of Sep.-Nov. 2008, and Jan.-Mar. 9, 2009.

	<u>S&P</u> <u>500</u>	Change from <u>YE06</u>	<u>Dow Jones</u> <u>Industrials</u>	Change from <u>YE06</u>	<u>NASDAQ</u>	Change from <u>YE06</u>
YE 2006	1,418	-	12,463	-	2,415	-
10/9/07 High	1,565	10.4%	14,165	13.7%	2,859	18.4%
12/31/07 Close	1,468	3.5%	13,265	6.4%	2,652	9.8%
1/22-23/08, and 3/17 Lows*	1,257	-11.3%	11,635	-6.6%	2,155	-10.8%
5/31/08 Close	1,400	-1.3%	12,638	1.4%	2,523	4.5%
10/10 & 24 Lows*	840	-40.7 %	7,882	-36.7%	1,494	-38.1%
10/31/08 Close	969	-31.7%	9,325	-25.2%	1,721	-28.7%
11/21/08 Low*	741	-47.7%	7,449	-40.2%	1,295	-46.4%
12/31/08	903	-36.3%	8,776	-29.6%	1,577	-34.7%
3/9/09 Low*	677	-52.2%	6,547	-47.5%	1,269	-47.5%
5/31/09	919	-35.2%	8,500	-31.8%	1,774	-26.5%

* Note – These are not closing prices, but "intra-day" lows

Some key observations from the chart:

- 1) From the October 2007 highs to the new March 9, 2009 lows, all three major US indexes were down a huge 60% to 65%, far exceeding the declines of 1973-74 and 2000-2.
- 2) October 2007, May 2008, and the last week in October 2008 were all periods of price recoveries of 10% or more. The December 2008 price recovery, measured from the November lows, ranged from 18% to 22%. The March-May 2009 recovery from the March 9th lows has been best of all, with gains ranging from 30% to 40%. These recoveries illustrate the dangers of exiting the stock market after periods of substantial declines on the assumption they will continue, and also about using periods of gain as entry points. During this bear market, and with the benefit of hindsight, no rally (until the current one, at least so far) would have been a good entry point.
- 3) Even knowing what we know now about the severity of this bear market, there is no way to determine, before the fact, at what point the lows for this market cycle will have been reached until long after the cycle has been completed.

INTEREST RATES: Their Impact on the Economy and Financial Markets

We have written extensively on interest rates in prior Monthly Comments (most recently in March 2008 and September 2007). We think an update is in order, particularly now that interest rates have begun to rise from the historically low levels that had been put into place by central banks throughout the world as one of the main policies to combat the severe economic recession that began in late 2007, and continues to this date.

Interest rates are the cost associated with the use of money. Governments, businesses, and people must pay interest when they borrow money from those who have the money to lend. Therefore what is a cost to one side of any borrowing transaction is a source of income to the other side. Interest rates are a key factor impacting economic activity and financial markets, as discussed in the front page WSJ article "Rise in Rates Jolts Markets" (5/28/09):

"Treasury yields (our note: "yields" are another term used interchangeably with "interest rates") surged Wednesday (5/27) to their highest levels since November, dealing a blow to the Federal Reserve's efforts to stimulate the economy by keeping borrowing costs low.... The Fed has made low mortgage rates a priority in its strategy to stem the US recession. To achieve that, the central bank has been buying mortgage backed securities (\$460 billion) and Treasuries (\$125 billion), and investors worry the government's approach could lead to inflation. Further, the government will sell nearly \$2 trillion in US Treasury bonds this year to fund its stimulus programs, and investors worry that insufficient demand would send bond prices down and push up the cost of raising money (that is, interest rates)."

The article continues: "Likewise, signs of recovery in the US and across the globe have prompted investors to move out of the relative safety of the Treasury market and into securities that may yield more, such as corporate bonds, stocks, and even emerging market debt. While that is overall good news for the US, it makes it harder for the Fed to help invigorate the battered housing market, seen as a linchpin of any recovery. With higher interest rates on the horizon, investors have been moving out of longer-term Treasury bonds and into shorter-term debt to avoid the risk of rising rates.... Higher interest rates make existing mortgage-backed securities less attractive because newer securities would be filled with loans that pay more interest."

The article observes that "to be sure, a 10-year Treasury interest rate at 3.7% is not historically high, and a steep yield curve (our note: the "yield curve" shows the relationship among interest rates on shorter- and longer-term Treasury bonds; a steep yield curve refers to a high differential between the shorter and longer maturities) can be seen as a sign of strength in the economy.... A steeper yield curve is also good for banks, because it allows them to borrow in the short-term at lower interest rates and lend at higher rates for longer periods. But rising yields also make the government's rescue efforts more expensive."

We have the following comments on the points raised in this article and related issues:

- 1) Rates on mortgages directly impact the prices of real estate transactions. During the current recession, both the Federal Reserve and the Treasury have instituted programs to lower interest rates, with the goal of stimulating the purchase of homes at reasonable prices and slowing the alarmingly high rate of mortgage foreclosures.

So far, neither lower interest rates nor programs to stimulate home purchases has stopped the severe decline in housing prices or the high number of foreclosures, presumably because continuing high unemployment is proving stronger than the government's programs. "More homeowners than ever are falling behind on mortgage payments and sliding into foreclosure....The number of foreclosures would probably keep rising as more people lose jobs or are forced to trade full time work for part time....More defaults could shunt more houses onto a saturated market, sending prices lower" (NYT, 5/29, B5).

- 2) Rates on credit cards directly impact the cost of borrowing; the higher these rates go, to cover the losses the credit card companies are experiencing from high levels of defaults, the less credit is available for future use. This, in turn, has a direct and negative impact on the future level of economic activity. Again, high unemployment leaves people unable to pay their credit card bills, leading to defaults and, in turn, to the credit card companies increasing their rates in an effort to recoup some of their losses. This can be self-defeating for the credit card company, since the higher rates reduce the usage of the cards.
- 3) This same negative cycle can be seen in banks' willingness to lend money. The banks raise interest rates to cover potential loan losses, but the higher rates make it unprofitable for businesses to borrow the money in the first place. This restricts economic activity, and prolongs the unemployment that is the root cause of much of the economy's current problems. There is a vicious circle at work here.
- 4) Turning to interest rates and their impact on financial markets, we see a number of interrelated effects:
 - a) In general, prices on existing bonds decline as interest rates rise. A bond investor will pay more for a newly-issued bond at 4% than an existing bond paying 3%. The 3% bond price therefore goes down to provide the equivalent value of the 4% bond. The longer the maturity of the bond, the greater the price decline, because at maturity the bond investor gets his/her money back, and can reinvest at the higher interest rates.
 - b) As a partial offset to the decline in bond prices when interest rates rise, the bond investor does at least get to earn more income.
 - c) At some point, the higher income available on bonds, especially from safe, high credit quality bonds, competes for investors' money. If high quality bonds with reasonable maturities paid 6% interest, investors might prefer to earn that return rather than risking the downside associated with investing in riskier investments such as stocks, or high-yielding low credit quality bonds.
 - d) While receiving higher interest rates may seem quite desirable for investors, the downside is that there is a strong historical correlation between rising interest rates and rising inflation. Economic theory holds that as inflation rises, fixed income bond investors demand higher interest rates to compensate them for the reduced purchasing power they will have when the bonds mature and their capital is returned.

With all the current economic turmoil, government must borrow huge amounts of new money to finance the stimulus programs and bond buybacks (see WSJ article above), and one of the goals of this government spending is to raise the prices of housing and other financial assets. Large amounts of new money pushing prices higher clearly presents the risk of inflation. Modest inflation can work favorably through an economy, but a rapid increase is bad news for investors in most financial assets. In an editorial on rising interest rates and inflation (5/28, A14), the WSJ stated: "Treasury yields leapt again (to 3.7% for the 10 year bond);... as risk aversion subsides, and investors return to corporate bonds and other assets, investors are now calculating the risks of renewed dollar inflation.... The Fed is desperate to keep mortgage rates low to reflate the housing market, and the Fed has promised to inject hundreds of billions more in this effort,... but the "bond vigilantes" are showing what they think of that offer, bidding up yields even higher." Further, the WSJ reported (5/30-31, A2) that "senior administration officials said that policy adjustments necessary to contain soaring budget deficits would be made once an economic recovery takes hold, in response to growing concerns about a run-up in long-term interest rates."

We would make the following observations to tie these ideas together:

- 1) If the rising interest rates are signaling an improving economy, that would be good news. A stronger economy should lead to more employment, fewer home foreclosures and reduced losses related to them, more tax collections to reduce the amounts government needs to borrow, and more corporate profitability to support higher stock prices. Another front page WSJ article (5/29/09) makes this point: "Federal Reserve officials believe the recent sharp rise in yields on US Treasury bonds could reflect a mending economy and a receding risk of financial catastrophe, suggesting the central bank won't rush to react – even though some investors see danger in the government's rising cost of borrowing."
- 2) If the rising interest rates instead reflect investors' reluctance to lend money to government unless they receive higher rates as compensation for rising inflation, that is bad news. The same WSJ article quoted in 1) above states: "Bond markets may be expressing worry over the government's borrowing to finance its large budget deficit," and "some Fed officials worry that ramping up Treasury purchases could be read by investors as a sign the central bank is willing to finance government budget deficits to the point where it could spark inflation or trigger a decline in the dollar."
- 3) At this time, the outcome of the two conflicting paths discussed above is very much in doubt. If at some point the financial markets become convinced of one outcome or the other, the results are likely to be either quite good or quite grim. We are unlikely to know the answer to this until long after the fact, and so continue to advocate owning a broadly diversified mix of assets, with an allocation geared to your needs, goals and risk tolerance. We avoid trying to come up with the prediction of how this all works out.



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