



"The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born not an infant, but a giant."

Arthur C. Pigou, Cambridge University Professor of Economics,
1920

It has been more than six months now since the market low, but many commentators suggest that this rally is not based on a genuine economic recovery. Yet as we move further away from the panic of 2008 and early 2009, it is obvious that the economy is stabilizing. The third quarter of 2009 will likely be the first three-month period to experience positive economic growth since early 2008.

It's no surprise that people are having difficulty imagining a scenario where the global economy recovers as quickly as it fell apart, but that may be the most likely outcome to this once in a generation economic downturn.

James Grant, a famously pessimistic forecaster recently observed the following:

"But it has been a generation since a business cycle downturn exacted the collective pain that this one has done. Knocked for a loop, we forget a truism. With regard to the recession that precedes the recovery, worse is subsequently better. The deeper the slump, the zippier the recovery. To quote a dissenter from the forecasting consensus, Michael T. Darda, chief economist of MKM Partners, "The most important determinant of the strength of an economy recovery is the depth of the downturn that preceded it. There are no exceptions to this rule, including the 1929-1939 period" (Wall Street Journal, September 19th, 2009).

This recession was one of the four most severe downturns since the Depression. Forecasters who are calling for a moderate recovery seem to think that this upturn will be of a similar magnitude as those that followed the recessions during the early '90s and earlier this decade. But those anemic recoveries followed two of the shallowest recessions in history. If history is any guide, based on the severity of the downturn, the next upturn is likely to be

stronger than average. Stocks do not reflect this optimistic outlook. As the economy continues to perform better than expected, stocks should continue to perform well.

For the three months ending September 30th, the growth accounts under the management of Barden Capital performed comparably to the S&P 500, which was up roughly 15 percent. Balanced accounts actually outperformed growth by a modest amount as the fixed income markets have recovered more fully than U.S. stocks. For the year, most all of the accounts under Barden Capital's management are up roughly 20 percent.

We continue to integrate companies that are leveraged to the economy into your portfolio. In 2008, companies that were most resilient to a weak economy outperformed. In 2009, the market has done a 180 degree turn, rewarding the companies that are most dependent on a strong economy. As the recovery has become more certain, we have increased your exposure to the companies that most benefit from the stronger economy.

A frequent common objection to the claim that this is a new bull market is that the market can't go up with government spending out of control. I recently put that argument to the test. I looked at the past quarters when the deficits relative to the overall economy were at their worst. In the fall of 1992, the deficit was 5% of GDP; in the winter of 1982 the deficit was 5.4% of GDP. Today, it's about 6% of GDP.

If you invested during the fall of 1992, you'd have more than tripled your investment. The total return on the S&P 500 has been 225% since the fall of 1992. If you had bought when the deficit was even worse, in the winter of 1982, you would have enjoyed an increase of 1,421%, a more than 15x increase on your investment.

Most investors assume that investing when deficits are high is dangerous. They feel more comfortable investing when the government is running a surplus. Unfortunately, it's not quite that easy. The biggest surplus we've enjoyed since the 1960's was during the spring of 2000. The NASDAQ was at 5,000. I don't think anyone needs to be reminded how that worked out. Deficits peak at the bottom of recessions and trough at the top of expansions. To sell stocks because deficits are peaking has historically meant selling stocks very near the bottom of bear markets.

I mentioned in a previous letter that my father purchased 5 oz of gold at more than \$800 an ounce in 1982. That gold today (which he still owns) is worth about \$1,050 an oz, for a total return of about 20% or less than 1% a year. Then as now, everyone was telling investors to buy gold. If Dad would have instead used that \$4,000 to buy stocks, that investment would now be worth more than \$60,000 instead of \$5,250.

Another widespread concern regarding the impact of deficit spending is how the deficit impacts the value of the dollar. International currency flows are very difficult to predict, but economics textbooks tell us that when U.S. deficit

spending increases, assuming all else is equal; the value of the dollar should decline. As the government creates debt denominated in dollars to fund deficit spending, the supply of dollars in the world increases, driving the value of the dollar down.

In reality, it's much more complicated than this. Much of international currency flows are due to investors either seeking a safe haven by owning U.S. bonds, or seeking more aggressive investments like emerging markets. As the tolerance for more aggressive investments increases, investors tend to sell dollar denominated assets in order to increase their holdings in assets like emerging markets companies and commodities.

Regardless of the cause, the dollar has been declining in value this year after appreciating through most of 2008. This appears to benefit stocks. As the dollar declines, U.S. companies doing business internationally become more competitive as the international price for their goods and services declines. A falling dollar also helps the earnings of U.S. companies, as foreign sales are worth more in dollars. For the last couple of years, dollar strength coincided with stock market weakness, while dollar weakness has correlated with stock market appreciation.

We have just completed the strongest three-month period for stocks since 1998. In spite of many concerns, this environment is very favorable for stocks. I'm still holding to my year-end target of 1200 on the S&P 500 and a complete recovery leading to new all-time highs sometime in 2010. If events unfold in this way, we could experience roughly 50% appreciation between now and the end of next year. But, given the complexity of the current crisis, we also recognize that events could deteriorate. So, it's prudent to maintain some exposure to companies that should succeed regardless of the broader economy.

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The Standard & Poor's 500 Index (S&P 500) is an unmanaged capitalization-weighted index based on the average weighted performance of 500 widely held common stocks. BCM Returns are based on a size-weighted composite of all BCM accounts under management at the end of the period.