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# Are We There Yet ?

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One of the most pressing questions facing stock market investors is the following: “Can the current rally from the March lows continue?” Because the future is of course uncertain, those who are bearish on the economy tend to believe that we “have come too far, too fast,” while those with a bullish economic outlook support the idea that the current trend is intact and will continue.

As always, the market outlook is cloudy. We believe the recession has ended and is merely a formality for the National Bureau of Economic Research (NBER) to make the same conclusion official. Unfortunately, we must be quite patient in waiting for this event given the NBER’s track record for moving at a snail’s pace. According to Dr. Mark Perry, if we use prior recessions as a guide and presume that this most recent recession ended in June, it is not unreasonable to expect the NBER to wait until February or March of 2011, for the prior two recessions in 2001 and 1990-1991 were not acknowledged as complete until 20 and 21 months, respectively, had passed. Needless to say, we expect the economy and stock market to have advanced substantively between now and the first quarter of 2011.

Negative economic headlines continue to be plentiful as employment continues to hamper the current recovery. Likewise, a handful of nontraditional challenges loom in the face of economic growth, specifically the inability for a zero interest rate Fed policy to ignite expansion and the failure of municipalities to replace slack private demand because of a rapid decline in tax revenue. Though these are irrefutable challenges, we believe they will be addressed and overcome in time.

In fact, in analyzing the current challenges we face, we are reminded of some prescient words written by famed Fidelity Magellan fund manager Peter Lynch. In his much heralded book Beating the Street, Lynch discussed the following obstacles facing the market during his career: “When we make the mistake of letting the news out of the bag, we are confronted with the latest reasons that mankind is doomed: global warming, global cooling, the evil Soviet empire, the collapse of the evil Soviet empire, recession, inflation, illiteracy, the high cost of health care, fundamentalist Muslims, the budget deficit, the brain drain, tribal warfare, organized crime, disorganized crime, sex scandals, money scandals, sex and money scandals. Even the sports pages can make you sick.” We believe that if one substitutes Russia for the Soviet empire and swaps following the Red Sox in the Boston Globe, Lynch’s home team, for the Orioles in the Baltimore Sun, this paragraph mirrors the current news despite being written over 15 years ago. The S&P 500 closed 1993, when this was written, at 466 and has more than doubled since to over 1,000. We admit that these issues are all quite serious but as Lynch writes and as we have quoted Warren Buffet many times in the past, there are always problems to face and always will be, but these do not prevent the economy and stock markets from eventually moving forward and making new highs.



So, in the face of numerous headwinds, can the market continue to go higher? If history is our guide, the answer is yes. According to Mizuho Securities USA chief investment strategist Carmine Grigoli, “meaningful corrections in the early stages of a bull market are infrequent events that usually occur one or more years after the markets turn up.” In eight of the twelve bull markets since 1949, the S&P 500 did not correct by 10% until 12 months or more had passed. Grigoli’s research found that in those 12 bulls markets, the S&P 500 posted average gains of 64% before a 10% drop.

Currently, the market appears fairly valued by most metrics and we find the recent surge in merger and acquisition activity encouraging. Often, it is easy to overlook the fact that corporate managers are in a position to have far greater knowledge about how their industry is fairing than any other group of investors. When companies from a variety of industries suddenly begin acquiring their peers it signals that executives believe opportunities exists to grow by purchasing undervalued assets and investors should take note. Deals like Dell’s purchase of Perot Systems in technology, Baker Hughes buying BJ Services in energy, Disney acquiring Marvel Entertainment in media, and Kraft’s current effort to gain Cadbury are great examples of this phenomenon.

As discussed in our last quarterly newsletter, we believe that market participation via companies with solid balance sheets and a focus on returning cash to shareholders via dividends remains an attractive approach to navigating the current environment. We continue to expect markets will climb the current wall of worry and though the recovery will not occur in a linear fashion, the curative process of capitalism shall indeed occur, as it always has, and we shall eventually return to a growing and robust economic state.