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DON'T HANG YOUR HAT ON IT

06/09/2009

	Value	YTD %
Dow Jones Industrial Avg	8764	-.1%
Vanguard 500 Index	\$ 86.9	5.3%
Vanguard Total Bond Index	\$ 10.0	.1%

As you can see on **GRAPH 1**, the S&P 500 stock market index has given us a profound rebound.

After hitting a low in early March, the S&P 500 Index, as represented by the Vanguard Index 500 fund, has gone up at least 25%. The more volatile NASDAQ index has gone up as well. Meanwhile bonds have continued on their somnolent, steady path.

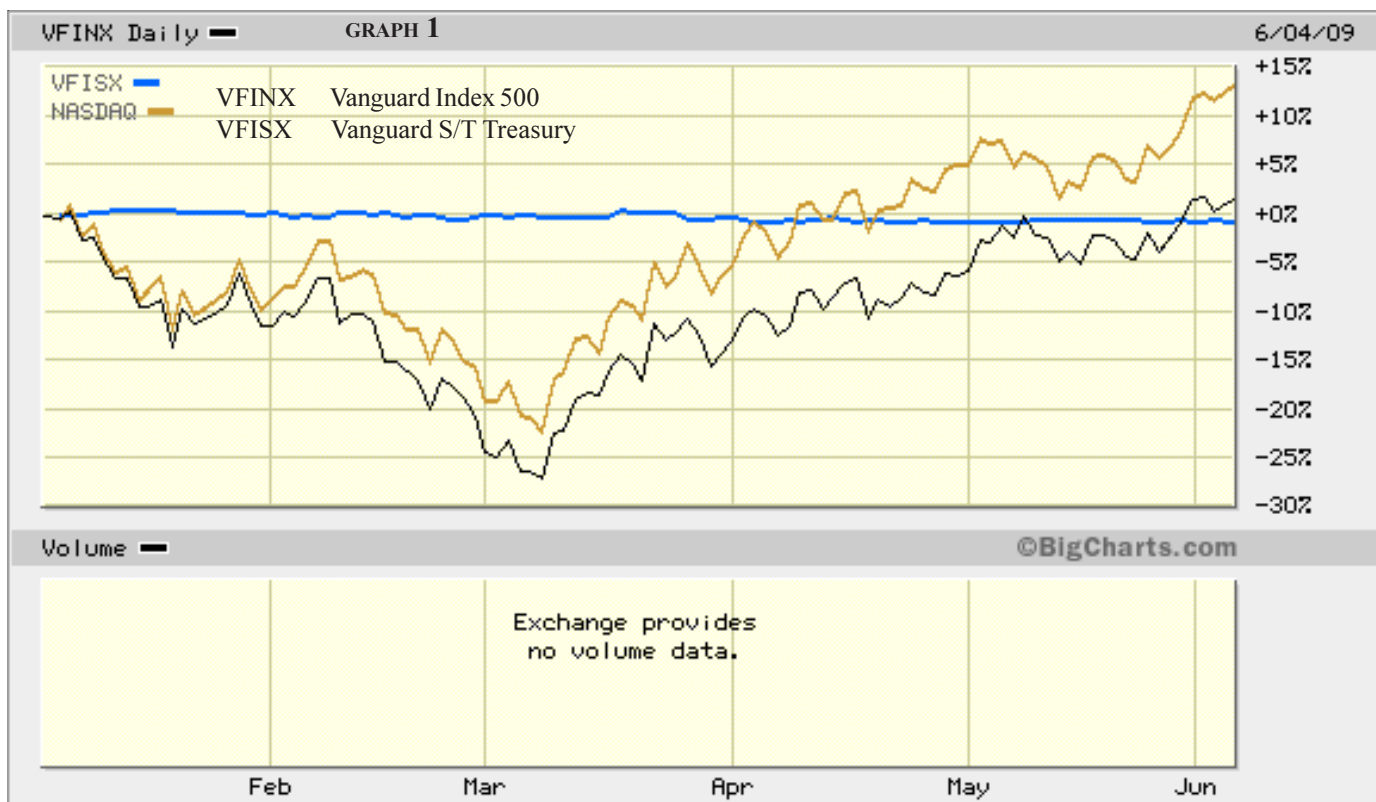
I have been writing about the possibility of a rapid recovery since the Financial Panic of 2008 began. We have gradually

invested small portions of your money in sectors which we believed would rise when the recovery began to emerge. Since March, these investments have done well.

Still, as is my tendency, I see the possibility of a gray lining inside this silver cloud. In other words, don't hang your hat on this flawless rebound.

It is natural for the stock market to proceed through time in a never-ending wrestling match between fear and greed. A healthy stock market looks like a saw-blade with the right side higher than the left. In other words, uncertainty is normal.

When we see such a smooth line as we have witnessed since March, we know that part of the engine of this recovery is irrational optimism. Investors in the stock market are feeling inappropriately secure.



When I wrote about a rapid stock market recovery, I did so because history tells us that such a rebound is statistically probable. But that doesn't mean that it is assured. Meanwhile, people who sold out near the bottom are faced with the unanswerable question: will this rally stick or not?

There is no easy answer in the short run. In the long run, the economy is self-healing, so it will inevitably stagger to its feet. When it will gallop again is a good question. Staying invested in a diversified portfolio of mutual funds has remained the best of a plethora of hard choices.

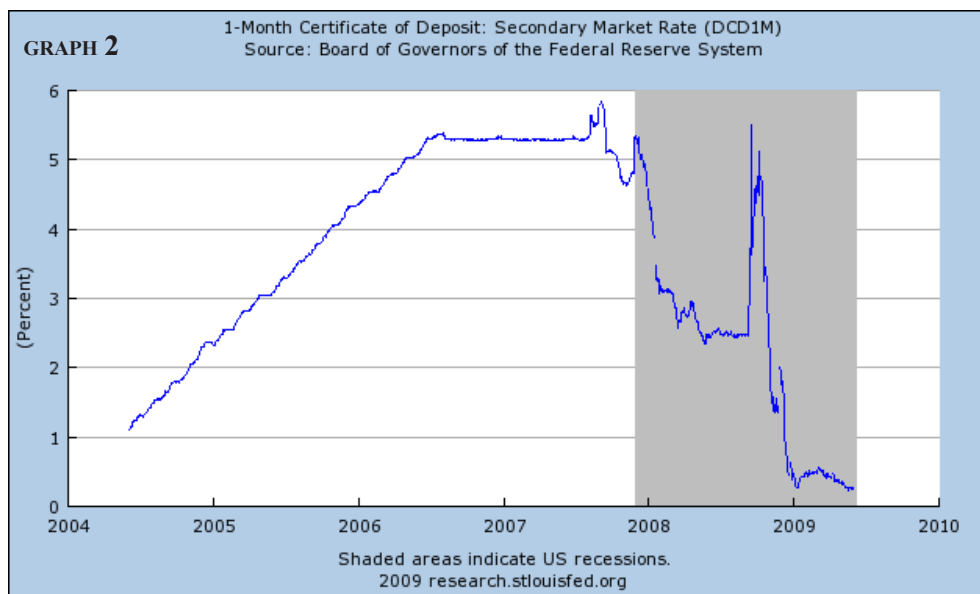
Even in a genuine recovery it would be normal to see this stock market endure a bout of profit-taking, which would pull the market down somewhat. Then the market would crawl back up and keep going.

On the other hand, another wave of bad economic news could knock the legs out of this recovery within a few weeks. We just don't know, and we don't want to guess.

So, instead of guessing, we have focused on re-balancing and diversifying. Recently we have done lots of trading to reduce the amounts we have in our favorite mutual funds so that we aren't relying excessively on a few hero mutual fund managers.

In the process, we bought several very independent small stock mutual funds. Small stocks should do well in the inevitable rebound, even if it doesn't happen now.

We are also watching interest rates closely. GRAPH 2 shows the one-month CD rate for the past five years. The rate was rising in 2005 when the Federal Reserve was seeking to slow the explosion in values in the housing markets. This created the implosion which we now know as the Financial Panic of 2008.



I am trying to show you that interest rates are now so low that they can only go sideways or up. There isn't much more downside available. I have been wondering... and we have been researching... what may happen as a glut of new US debt hits the bond markets in the next few years.

We don't know what will happen. Normally, such a massive increase in the supply of Treasury bonds results in declining bond prices and increasing interest rates.

This would mean that traditional bonds and bond mutual funds would decline in value. Short-term bond funds would be least affected while long-term bond funds might be noticeably injured.

The stock markets can stand such an uptick if the interest rate rise is small and the economy grows faster than interest rates. But both bond and stock markets may falter if interest rates soar.

To counteract this, we took small positions in inflation-resistant natural resources funds several months ago. Physical commodities of all kinds will rise in an inflationary environment when interest rates rise.

Our most recent purchases included floating-rate bank note funds which should see increased income if interest rates rise. In other words, they should be able to protect principal by simply changing their interest rates to current levels. The downside of these is that when rates fall, their rates re-adjust downwards. Since declining interest rates are arithmetically near-impossible, I don't regard this as a problem.

Given our inability to see the future, all these purchases in your accounts have been relatively small.

In the bigger picture, the stock market remains a buy. I remain confident that a recovery is inevitable within 3 years. Meanwhile, the potential for unwanted excitement remains high. We could see a bumpy ride as we continue on with our long-term agenda.

Note: Pete will be out of the office June 15- June 23. Please call the office immediately if you foresee cash needs in the near future. Laurie will be in the office daily 9-3 to receive your calls.