



Baker Avenue Asset Management Third Quarter 2009 Commentary

Charles Dickens wrote in *A Tale of Two Cities*, “It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness...” This describes the roller coaster ride of the stock market over the past 21 months. After plunging -37% in 2008, the S&P has gained 58.25% since the March 9, 2009 low through the end of the third quarter. While investors were expecting a financial apocalypse at the beginning of the year, the third quarter was characterized by cautious optimism of a sustained economic recovery.

In the quarter the Federal Reserve maintained its target for the federal funds rate at 0%-0.25% citing that economic conditions are likely to remain tepid for some time. Despite this outlook, most economists estimate that GDP actually rose 2.9% in the third quarter after 3 consecutive quarters of GDP declines. If this recent quarter’s GDP shows growth, it would mark the official end of “The Great Recession”. The Bureau of Economic Analysis will officially release the quarter’s GDP figures in late October.

The national unemployment rate remained elevated in the quarter rising 0.1% to 9.8% in September, which is the highest it has been since 1983. Although these figures are alarming, the rate at which the unemployment rate is climbing has decelerated, suggesting that perhaps the worst is behind us in terms of mounting unemployment (Figure 1). It is important to point out that despite high unemployment, the stock market can still move higher. In fact, in the 2000-2002 bear market, unemployment did not peak until June 2003 – after the market had gained 21% from the Fall 2002 bottom. Between June 2003 and December 2003, the market rallied another 15%, but the unemployment rate did not decline until 2004.

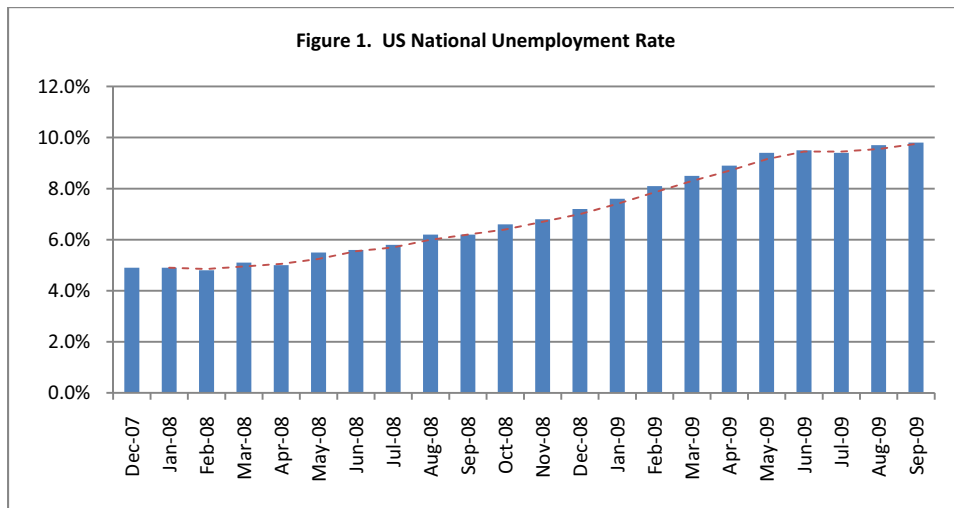


Figure 1 - Source: Bureau of Labor Statistics

Although the stock market recovered sharply from the March lows, the market is still off -42.86% from the October 9, 2007 high of the S&P 500 at 1,565. *In fact, to breakeven for the decade, the S&P 500 Index needs to advance another 39% from this recent quarter's close!* These dismal numbers call attention to two critical issues. First, it is just as important to play defense as it is to play offense in the stock market. Traditional “buy-and-hold” investment managers have failed to play defense and did not adequately protect investors against an economic climate that was worsening in the final quarter of 2007 and a horrendous bear market in 2008. Second, investors face a serious dilemma going forward which is *how to invest their hard earned capital while avoiding another catastrophic loss akin to 2008?*

Using our Baker Avenue Market Sentiment Indicator, we measure the momentum and risk of the market to decide when to invest our clients’ capital (BAMSI > 50%) or when to play defense when market conditions are volatile and intolerant of risk (BAMSI < 50%). Our sentiment index was negative for a record ten months before finally turning positive at the close of the first quarter in 2009. Since our indicators turned positive, the S&P 500 has gained 34.02% through the end of the third quarter. As such, we were able to minimize the downside volatility of our portfolios in 2008 while participating in the market upside at significantly lower risk levels in 2009 (Figure 2).

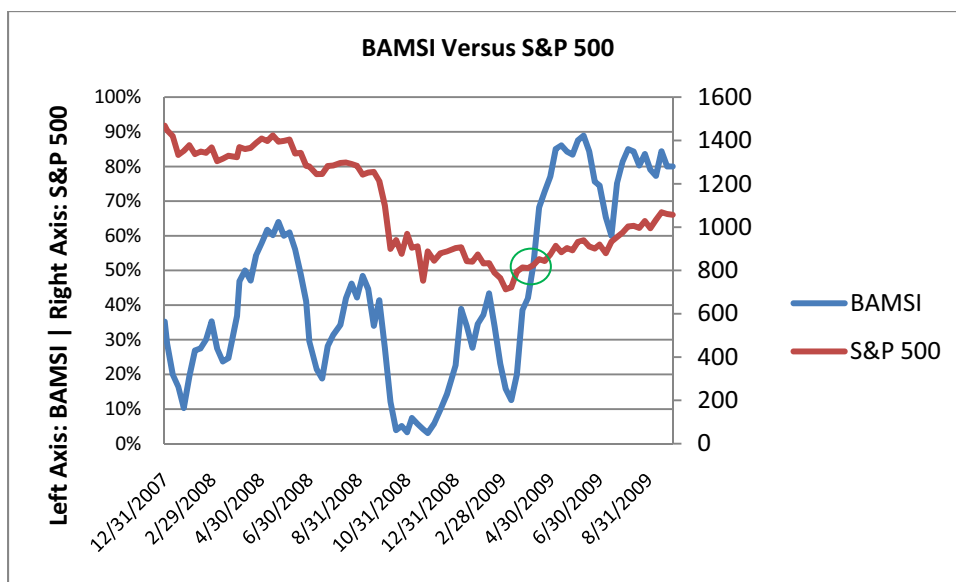


Figure 2 – Source: Baker Avenue Market Sentiment Indicator / Bloomberg, LP

While we are delighted at the success of our market sentiment indicator highlighting the need to minimize market risk for clients, high relative strength stocks have been laggards so far this year versus the major indices. Reasons include an initial surge in stocks in the second quarter that was fueled by short covering into the most battered stocks and a lack of consistent sector leadership. We believe this is a temporary phenomenon that will be followed by performance resurgence in high relative strength names.

As we conclude this letter, it may be interesting to note that it has been twelve months since our Baker Avenue Market Sentiment Indicator signaled a *Blue Buy* on October 15, 2008. When our market sentiment indicator drops below 10%, it signals what has historically been a rare and good entry point

into the market. Since we announced our Blue Buy, the market has gained 23.62% in a span of twelve months. Over the past 35 years, the only instance that resulted in a market loss twelve months after a Blue Buy signal was the aftermath of the 9/11 attacks that put the US economy deeper into recession. Nevertheless, an investor who bought into the market on the Blue Buy signal after 9/11 would have generated 11.10% returns in the market six months later. Overall, the track record of the Blue Buy has been very compelling in the past 35 years, generating returns on average of 24.57% twelve months after a Blue Buy signal (Figure 3).

Blue Buy Signals in the Past Thirty Five Years	Return 12 Months After Blue Buy
July 15, 1974 – 1973-1974 Oil Embargo	14.12%
March 17, 1980 – US Savings & Loan Crisis	30.17%
October 22, 1987 – October Stock Market Crash	14.26%
August 30, 1990 – First Iraq War	28.48%
September 3, 1998 – Asian Financial Crisis	40.07%
September 28, 2001 – 9/11 Terrorist Attacks	-19.31%
July 25, 2002 – Tech Bubble Bear Market	21.26%
October 15, 2008 – Subprime Mortgage Crisis	23.62%
Average Blue Buy Return	24.57%

Figure 3 - Source: Baker Avenue Market Sentiment Indicator / Bloomberg, LP

In summary, our outlook remains cautiously optimistic for the remainder of the year. Our market sentiment indicator remains in bullish territory at the end of the third quarter. There are early signs of an economic recovery and corporations are reporting better than expected growth on bottom line earnings as well as stabilization on earnings outlooks. While there will be the inevitable pullbacks in the market, we believe the primary upward trend in the market remains intact. However, if market sentiment should turn negative, we will play defense to protect capital and move assets to cash in the All Cap Core strategy. Although high relative strength stocks have lagged the market this year, recently they have shown signs of resurgence in performance which is in line with their historical outperformance versus the market.

We thank you for your continued confidence in us as stewards of your investment capital. We look forward to continue providing you a smarter and safer approach to growing and preserving your wealth.

Sincerely,

Baker Avenue Asset Management, LP

Data Sources: The Wall Street Journal; US Dept of Commerce – Bureau of Economic Analysis; Bureau of Labor Statistics; Bloomberg LP, Standard and Poors.com

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