

# Market Review

## September 30, 2009

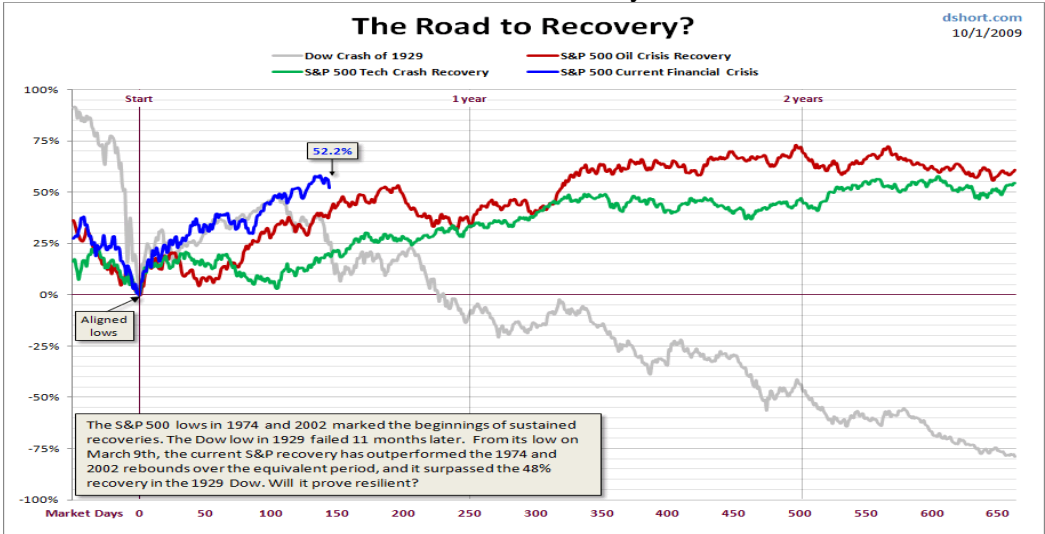
**Dear Clients & Friends,**

U.S. stock markets continued their rally in the third quarter, with the S&P 500 gaining over 15% in its best quarter since 1998. The index is now up 19% for 2009 and over 50% from early March but remains 32% lower than its peak in October 2007. The rally in 2009 has now erased about half of the decline from the financial crisis and recession. Foreign stock markets are up more for the year, with the MSCI EAFE index gaining 30%. The chart below shows the path of the S&P 500 since its March lows relative to other recoveries from deep recessions.

The strength of the rally since March indicates investors believe a robust economic recovery and improvement in stocks' earnings is probable. As we discuss further, the pace of the rally may be too fast given that corporate profits are not improving significantly and that cost cutting is still predominant over revenue gains. Also, it is not evident to us that consumers' financial situations have improved after years of excessive borrowing. The key will be how well the economy and earnings improve. The market has priced in that both will grow quickly and has transitioned from relief that the worst is over to certainty that profits will quickly rebound toward prior levels.

Meanwhile, bond and cash yields have been disappointing as alternatives to stocks. Risk appetites have returned to their highs seen before the fall of Lehman Brothers one year ago, as is evident by the increase in demand for low quality junk bonds, which drove down their yield. Because of the negative rate of inflation and low likelihood that the Fed will raise rates soon, yields on most bonds fell in the quarter. However, relative to money markets and our view of an over-valued stock market, bonds remain a necessary destination for cash for now.

<i>Market Statistics</i>		
<i>September 30, 2009</i>		
	Level	2009%
Dow Jones	9,712	+13.5%
S&P 500	1,057	+19.3%
NASDAQ	2,122	+35.8%
MSCI EAFE	1,553	+29.6%
Oil (WTI)	\$70.61/bbl	
Barclays Capital U.S. Agg Bond Index	+5.7%	
Federal Funds Rate	0%-0.25%	
6 Mos Treasury Bill	0.17%	
2 Year Treasury Note	0.95%	
5 Year Treasury Note	2.31%	
10 Year Treasury Note	3.30%	



**U.S. Economic Review – Get Ready for the “Clunker” Bounce**

The U.S. economy is likely to reflect solid growth for the third quarter when the Gross Domestic Product (GDP) data is released in October. The growth will be heavily influenced by the effect of the cash for clunkers program, related increases in inventory building and manufacturing activity in response. Auto sales in July and August rose quickly to over 700,000 per month, the highest levels since 2008. Auto-related activity will account for most of the economic growth in the quarter and we believe that the pace of growth will be fleeting, particularly with the end of other government stimulus programs. Already data for September showed a decline in U.S. auto sales of 23% after the trade in incentives ended. Primary beneficiaries of the clunkers program were the dealers, who will have pocketed nearly all of the \$3 billion program's funds. Auto sales in the future quarters will undoubtedly be lower as a result of the program.

**How the government and Fed will be able to reduce the economy's dependence on these incentive programs and other forms of fiscal and monetary stimulus without risking a return to recession is a big question.**

Housing data in the quarter reflected an improvement from their lows. After declining to levels not seen in decades, July new home sales gained nearly 10% from June, the fourth month of increases. Inventories of unsold homes also declined and price declines are slowing, although are still nearly 20% lower than one year ago.

Despite some signals of a willingness to buy at lower prices, we question whether the consumer can yet carry the weight of the economy. Can other economies such as China grow quickly enough to support a global recovery? U.S. consumers account for over 70% of U.S. economic activity and are an important piece to that puzzle. Data in the second quarter continued to show that they were saving more and lowering their use of debt, from mortgages to credit cards. Such thrift will be a drag on the pace of economic growth coming out of the recession.

The employment outlook continues to be sobering for those out of work or in part-time jobs but wanting full time jobs. According to the U.S. Department of Labor the number of job openings has fallen 50% in the past two years. The “job opening” rate now stands at 1.8% and is consistent with the high rate of unemployment of 9.8%. There are over six unemployed people for every job opening. Underemployment (officially called U-6), which includes unemployed workers, those wanting to work full time but working part-time, and those discouraged from looking is at a record 16.8%. If past recessions are a guide, employers could be hesitant to re-hire workers and that a recovery could be “jobless” for a while. However, clear signs of robust economic growth require that the U.S. economy would need to be adding over 350,000 jobs per month for a full year to have the unemployment rate drop by one percent, and even at that level the unemployment rate would still be nearly 9%. The chart below reflects both the standard rate of unemployment and the official rate of underemployment (U-6).



Source: Bureau of Labor Statistics

Along with the current reluctance of consumers to borrow and spend, there has also been a hesitance of banks to lend despite many of them receiving government assistance to help encourage lending. Standards for all types of loans are much higher than in the past few years, cutting off even those with good credit ratings.

A final issue of concern is that more trouble is emerging in the commercial real estate market for developers, investors and banks. The latest data on the commercial side show that one of six construction loans in the U.S. has become troubled. A big part of the distress nationally comes in markets where condominium development reached bubble levels, such as Florida. Overall 38% of all condominium related construction loans are troubled according to the New York Times. The problem in commercial mortgages goes beyond condominiums, with many building prices declining as much as 50%, giving some at the Federal Reserve worry that losses realized by investors and banks could be equally high. Some estimate that as many as two thirds of commercial mortgages currently under water would not qualify for refinancing because of the decline in the properties' market values and the tighter lending standards. So far this year 98 banks have failed.

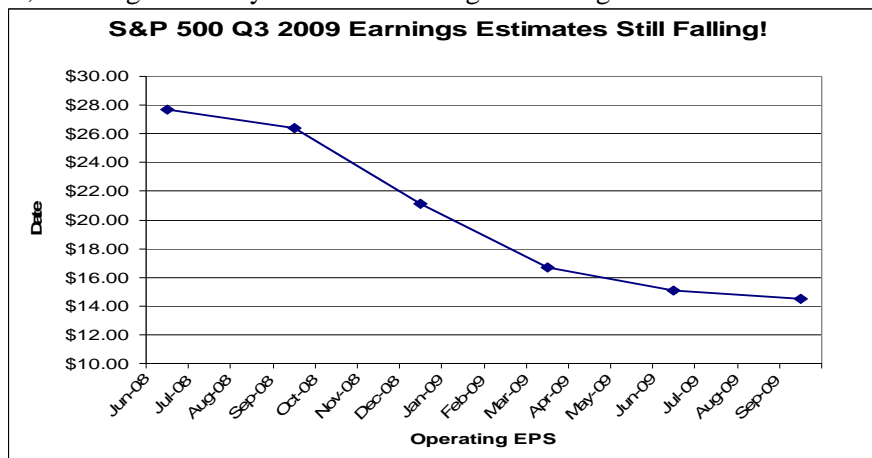
***A risk to the market and economy is the potential for a return to recession after the removal of stimulus such as the clunkers program, the end of the first time home buyer credit, further banking problems, or the removal of Federal Reserve's assistance in the financial markets. Consumers will be challenged more than the past recessions. Should growth falter, there will be pressure on the government to extend or renew stimulus efforts. Whether such assistance occurs could be a key to whether the economy can avoid the "double dip" recession.***

## Equity Markets – Still Missing a Meaningful Increase in Sales and Earnings

Gains in stocks in the third quarter were primarily in financial, technology and consumer discretionary issues, while other sectors were more moderate. Lower quality stocks continued to rise more than higher quality peers.

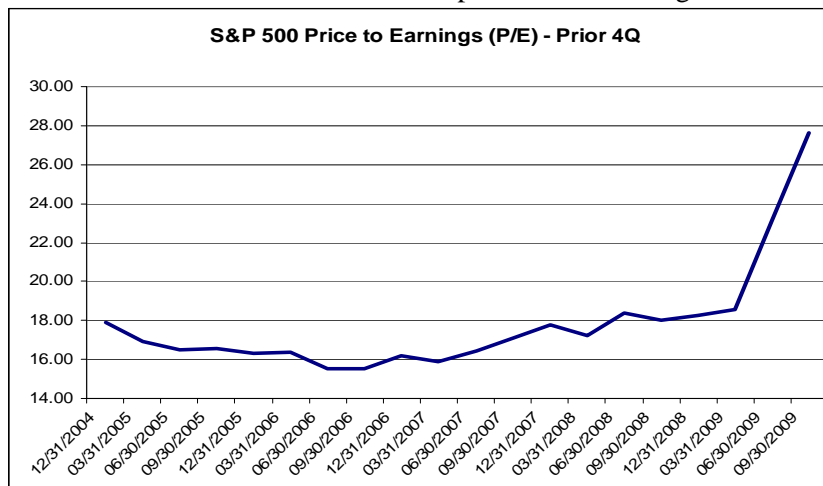
Although the market gained 15% in the quarter and over 50% since the low on March 9<sup>th</sup>, the rally has occurred without a significant increase in earnings estimates by companies. However, Wall Street is calling for as much as 25-30% improvement in earnings in 2010. Companies themselves and “bottom-up” analysts like us see less growth or even flat levels, which is more in line with consensus economic forecasts of slow growth. Wall Street’s targets for earnings, compared with their own projections for economic growth, are at their greatest difference in sixty years, implying overly-optimistic earnings numbers. The chart below shows the trend in projected third quarter 2009 earnings since 2008. For the third quarter, estimates call for a drop of 22% compared to a year ago.

For companies to meet the optimistic growth estimates and avoid future quarters like the one below, revenues will have to grow more than cost cutting, which cannot remain the lever companies use to beat estimates forever. For S&P 500 companies, year-to-date revenues through the first two quarters were down almost 10%, yet 75% of companies reported earnings above their (lowered) targets. However, only 50% of such companies beat estimates for revenue growth, showing that many are still achieving above target results from unsustainable cost cutting.



Source: S&P

The next chart shows one measure of the valuation level of stocks, with the price of the market relative to the prior four quarters of earnings, or its “P/E” ratio, at an expensive level of nearly 28. Another measure of valuation uses consensus estimates for the full year of 2009 earnings. Under that measure the stock market is trading at a 19 P/E ratio, still well above its historical average level of 16. A final measure of how expensive the market is would consider estimates of future earnings. Wall Street analysts polled by Bloomberg forecast that profits next year will rise 25% from 2009, after declining for two years, resulting in a P/E of 15 and justifying their forward looking assessment of a stock market that is cheap. Historically such estimates prove to be overly-optimistic. Our own estimate still has the market more expensive than average on a forward four quarter basis.

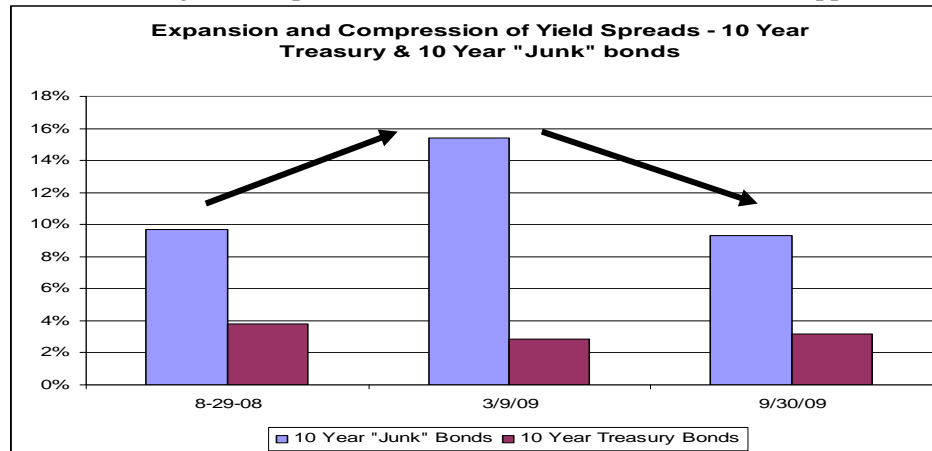


Source: S&P

Forecasts of future earnings and market returns for the next year are as wide as ever. With the consumer saving more, going to discount stores when shopping, or continuing to experience job losses, it seems improbable that earnings growth will be as high as forecast by some, yet the high expectations are already priced into the market.

### **Fixed Income – Bond Yields Remain Low and Could Go Lower in the Near-Term**

The investing environment for bonds became even less attractive than in the second quarter, with yields on most bonds generally declining. As the chart below shows, Treasury bond yields are low and even lower quality “junk” bond yields are declining back to pre-recession levels, indicative of how risk appetites have increased.



Source: Bloomberg

Given the ongoing challenges to the U.S. economy and consumers specifically, the bond market is behaving as though near-term inflation worries are non-existent. Inflation should not be a concern unless a large pick-up in employment and spending occurs. It's unlikely the Fed will need to increase rates in 2010, with some Fed Committee members more recently expressing concern that deflation is a greater near-term risk. Meanwhile, the Fed continues to keep rates low with its trillion dollar program to buy government and mortgage bonds.

### **The Negative Wealth Effect and the Recovery**

The current rise in the stock market has sometimes been defended by analysts citing that in the past the steeper the decline, the faster markets and the economy have gained on the way back up. While at other times sharp recessions have been followed by equally rapid growth cycles, there are notable exceptions including the Great Depression. The government has not been as involved in the future direction of the economy or the functioning of the financial markets for a very long time and we have not had a downturn in the housing market and the stock market that have been simultaneously as bad for decades. Despite the government stimulus, the negative joint “wealth effect” of housing and stock market declines has been affecting consumer spending and investing. We expect the recovery to be slower than normal as consumers deleverage and chastened lenders are slow to lend.

### **Investment Strategy – Remaining Attentive to Earnings Details**

This year's positive equity returns are certainly welcome, but our research has not yet identified further fundamental catalysts in stocks or the economy to see that revenue growth will be robust. As such, managed portfolios remain more defensively positioned against the threat of a faltering recovery. The market has favored lower quality stocks and more cyclical categories over higher quality stocks since March. We see headwinds for the economy and revenue growth as we apply our discipline in seeking quality stocks with potential for appreciation. Stock prices at current levels make that search difficult. The need for active management of existing holdings is as critical as ever, too. The unknown timing and level of future government spending adds complexity and uncertainty to fundamental analysis but in the past the fundamental side returns to relevance.

As always, we look forward to our next opportunity to visit with you and we appreciate your support and referrals to our company.

Christopher H. Lyford, CFA  
Managing Director & Chief Investment Officer