# Second Quarter 2009 Market Report

*Friday, July 31, 2009*

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## Is the Great Recession Over?

During the second quarter the stock market continued its brisk recovery off the March lows, enabling stock indices to reverse earlier losses and notch positive returns at the year's halfway mark. As of June 30th, the large company S&P 500 index had gained 1.8%. The small company Russell 2000 index was also modestly positive, gaining 2.6%. Developed international markets, as measured by the EAFE index, were ahead 5.6%, aided by dollar weakness. Interest rates rose gently on the 10-year US Treasury, to 3.5% as of June 30th. Shorter term interest rates, anchored by Fed policy, remained at trifling levels.

The acute, panic phase of the global financial crisis has passed. Capital markets have stabilized, as policy measures from both the Fed and Treasury have bolstered confidence in the financial system. The nation's banks, many having raised additional capital following their stress tests, are slowly healing themselves with strong margins on new lending, although lending volumes and the performance of existing loans remain areas of concern. The nation's housing market is continuing to show improvement as well, particularly on the lower end. Sales volumes are perking up and helping to improve the inventory imbalance. Although prices are still softening, they are doing so at a less rapid clip.

Corporate earnings reports from the second quarter indicate that continued cost-cutting has helped companies to sustain profitability amidst a weak top-line environment. A typical S&P 500 company has reported sharply reduced sales and profits from the year-ago period, with sales falling short of analyst expectations, and earnings only "beating" expectations on the back of cost cuts and lower reported tax rates. We can surmise that many companies, having shed costs so aggressively, are primed for a healthy profits recovery when sales volumes return.

As the world economy begins to cycle the bad economic news and numbers from last year, we expect a modest return to positive economic growth for the current third quarter. Across a host of industries, inventories have been drawn down and new production will be required to meet customer demand. The world economy is actually smaller, in the absolute, than at this time last year, but we are increasingly stabilized, and again moving tentatively in the right direction, toward expansion.

## Discussion: The Jobs Problem

The Great Recession put the lie to the myth of decoupling – namely, that other of the globe's economic blocs, such as Asia, could sustain themselves despite a falloff in the US economy. The global economy remains intertwined, as ever, and the US consumer remains the engine of world growth, as ever. Over time, these relationships will change, as consumer-centric economies will eventually emerge in China, India and Brazil, among others, but at present, US consumption is the centerpiece of the global economic stage.

The consumer sector, however, remains challenged from unemployment and the continued housing malaise. (Even if the latter is getting less bad, it's still bad.) Unemployment figures are often dismissed as a lagging economic indicator, but we believe the unemployment situation is of particular significance in this economic cycle. Specifically, we have not witnessed the scale and duration of joblessness since at least the 1980-82 recession. It is expected that the labor market conditions will continue to worsen, likely into 2010, before unemployment begins to improve.

There is profound slack in labor markets at present beyond the 9.5% headline unemployment rate; the broader "U-6" measure, which counts those discouraged workers who have stopped looking for jobs, and also accounts for part-time workers who desire full-time employment, stands at 15.9%. *Almost one in six workers is in some degree of economic displacement*, either without a job, or with less of a job than is wanted. Even for the 90% of the workforce that is employed, the tale is a challenged one. The national average work week, the government tells us, is 33.0 hours, the lowest reading since recordkeeping began in 1964.

In addition to the present difficulties in the nation's jobs market, we have a nagging concern that, more than usual for a downturn, many lost jobs will be forever lost, such as in the auto industry as it sizes itself for significantly lower volumes. Yes, the US remains a very dynamic economy, and even today is generating millions of jobs on an annual basis, as others are lost to economic conditions and global competition. However, we expect the damage to the fabric of the job market to be long-lasting, given the deep cuts in payrolls, and the rising likelihood of skills mismatches within the workforce. Many of the nation's current jobless may not have the skill sets required for the jobs that a recovering economy may otherwise create.

## Investment Outlook

The strength of the present market rally is impressive. Investor capital is returning to equities as investors, small and large alike, fear being left behind during the current rally. Nearly one year into its all-in efforts, the Fed and its easy money are helping to push investors away from low-yielding cash and government securities, and into risky assets.

There are also fundamental factors in play as well helping to undergird market strength: for example, reported inflation is virtually non-existent, and many commodity-based input costs for firms are lower for companies. Combined with reductions in their payrolls, corporations are quite possibly "spring-loaded" for sharp earnings gains when demand recovers. As it usually does, the market is anticipating and discounting a profits recovery in advance of its arrival.

The market is pricing in a solid recovery that normally issues from a traditional, inventory-led business recession. We maintain, however, that this recession is one *primarily* drawn from an overburdened consumer carrying too much debt; essentially, living beyond one's means and replacing income shortfalls with borrowing. With access to credit tighter, and asset prices such as houses lower, the borrowing game is on hold indefinitely. End consumer demand, by necessity, will need to come from a smaller, healthier base of organic growth, led by real productivity gains within the broad economy. Absent these cues, we continue to eye the market's ascent somewhat warily, as we continue to believe the household sector has further to adjust on its journey to a "new normal."

## Equity Investment Strategy

We continued to invest available cash to both equity strategies during the second quarter. Consistent with our view of a nascent recovery, we have positioned our **Quality Core** strategy for renewed economic growth, much

of it away from the US, along with expectations for a weak dollar. Our recent purchases have added capital to basic materials, technology, and energy names. We reduced our overall holdings of defensively-tilted consumer staples names during the quarter. We remain underweight the financial sector, as we expect more loan-related stresses to pressure that industry.

We also boosted the economic sensitivity of our value-oriented **Equity Income** stock strategy. While maintaining an overweight position in several attractive, high-dividend consumer staples names, we have added capital to the industrial and energy sectors, and to select technology issues. We have taken profits and trimmed our position holdings in the utility sector. The portfolio's average dividend yield of 3.8% is roughly double that of the broad S&P 500 index.

## Fixed Income Strategy

Credit market conditions continue their mend from last year's crisis and are increasingly normalized. Worthy corporate borrowers can access the capital markets readily, and spreads over Treasurys have tightened from earlier wide crisis levels.

The Fed continues to hold short-term rates at zero, or thereabouts, to promote the flow of credit to the economy, and also to afford the banking system a source of inexpensive funding. Shorter-term debt instruments that price as a spread to Treasury rates are comparably low-yielding in absolute terms. Bank CDs with FDIC protection have been a relatively attractive investment for accounts desiring a short term structure.

We continue to purchase high-grade corporate debt, although financial companies are almost entirely absent from new investments. (Goldman Sachs was a recent exception.) Other recent corporate purchases have included Boeing, Haliburton, and Oracle, all of intermediate term.

Among tax-free municipal bonds, we remain steadfast in owning high-grade General Obligation bonds that are supported by taxing jurisdictions, or other essential service revenue bonds. Supplies remain tight, due to high demand from investors like ourselves.

We expect Treasurys to continue their weakness as the fight-to-safety trade unwinds in the bond market. Treasurys are also vulnerable to a reset down (i.e., higher rates) if investor appetite for unprecedented levels of US borrowings should wane.

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