

### 2009 FIRST QUARTER COMMENTARY



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## The Financial Markets

- ◆ During the first quarter of 2009, major global markets continued to shudder from the effects of credit deleveraging, major threats of bankruptcies and structural financial uncertainties. Towards the close of the quarter, scattered rays of hope were emerging, as several large financial institutions reported improved business conditions in January and February, and some economic series provided slightly more encouraging data points. Only the passage of time and more evidence will tell if this is the proverbial “head fake” or the beginning of a real change in market and business conditions.
- ◆ Domestic equity markets declined for the sixth straight quarter, with the S&P 500 Index retreating 11.0%, and the Dow Jones Industrial Index falling 12.4%. The Russell Small Cap Index fell 14.9%. Major international markets followed suit, with the MSCI EAFE Index declining 13.9%. Within the domestic S&P 500 Index, the only sector to show positive returns was Information Technology, while the Financial and Industrial sectors declined in excess of 20%.
- ◆ The Federal Reserve maintained the federal funds rate near zero percent and commenced a new policy of quantitative easing, in which it will buy vast amounts of Treasury debt and Agency mortgage-backed securities. This unprecedented expansion of the central bank’s balance sheet is merely offsetting the decline in credit available from the private sector.
- ◆ Treasury bond yields rose during the first quarter in a partial reversal of the flight to safety that pushed yields down at the end of fourth quarter. The yield on the 2-year Treasury Note was barely changed at 0.80%, while the 10-year yield climbed to 2.66%. Yield spreads on investment grade corporate bonds remain at historically wide levels. Industrial credits saw some narrowing of yield spreads, while financial companies widened as their stock prices tumbled. Investors were receptive to new debt issues offered by nonfinancial companies, while most financial sector issuance required government backing. During the quarter the Barclays Capital U.S. Aggregate Index returned 0.12%.
- ◆ The municipal bond market resumed the rally that started in December after yields reached very attractive levels for retail investors. Strategies that emphasized the longest maturities, which were drubbed in 2008, rebounded in the first quarter. After seeing \$11 billion in outflows during the fourth quarter, tax exempt bond mutual funds enjoyed inflows during the first quarter as municipal bonds were seen as a relatively stable investment compared to the equity market.

## The Economy

- ◆ Many economic indicators declined to historically low levels as the first quarter of 2009 unfolded. Now, some of these indicators are showing a moderation in the rate of decline. GDP in the fourth quarter of 2008 contracted at a rate of 6.3%, the weakest showing since 1982. Profits fell 16.5%, the worst since 1953. First quarter 2009 GDP is currently forecast to be as poor as or worse than the fourth quarter of 2008. This should be followed by a lower negative rate of growth in the second quarter, with improvement in the third and fourth quarters of this year as comparisons get easier.
- ◆ Weakness abounds throughout the manufacturing sector. Although the free-fall seems to have subsided, declines are still prevalent as a base is being sought. The March ISM New Orders Index for goods weakened again slightly. Capacity utilization declined with over one third of capacity now shut down. Evidence of improvement could be found in better than expected durable goods orders for February, although January orders were revised downward. Inventories are being drawn down to lower levels than forecast, which should provide for increased output in the coming quarters.
- ◆ Consumer spending, representing 70% of the economy, fell 4.3% in the fourth quarter of 2008, the biggest decrease since 1947. Firmer sales greeted the new year, as retail sales enjoyed the largest January increase in three years and February retail sales declined less than expected. Weekly retail store sales improved further during the last week of March. The Conference Board's Consumer Confidence Index was little changed in March, with a slight improvement in the expectation index from very low levels. In February, consumers pared back on the use of credit cards by \$7.79 billion, resulting in a decline in consumer credit at an annual rate of 3.5%.
- ◆ The S&P/Case Shiller Index of home prices continued to slide in January, declining 19.0% from last year. On the plus side, new home starts by contractors have declined to very low levels, allowing existing inventory to contract. New home sales were up 4.7% in February to the highest level in 10 months, and sales in each of previous three months were revised upward. The level of home sales and mortgage activity is finally showing signs of life, stimulated by lower interest rates, foreclosure sales, improved affordability and re-finance activity.
- ◆ The Unemployment Rate rose to 8.5% in March, as employers cut 663,000 jobs. 5.1 million jobs have now been lost since the recession officially began in December of 2007. The Labor Department reports that workers out of a job for over six months now comprise 24.2% of the unemployed, the largest percentage since they started keeping records in 1948. Temporary help indices, which typically lead unemployment data, are still in a steep decline. Small business surveys continue to suggest that they plan to add fewer people in the future. Even the government sector is witnessing net job losses. A recovery in employment will likely lag a recovery in the overall economy by several months or more.
- ◆ According to Standard & Poor, the decline in 2009 earnings estimates for companies in the S&P 500 since last December is the largest for a like period in 50 years. This decline has been led by companies in the Financial sector, with the "top down" estimate (based on macro economic inputs) falling 15%, and the "bottom up" estimate (based on the sum of analysts individual company estimates) falling 24%. Forecasts by many company executives have been very cautious given little or no business visibility for the remainder of 2009.

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- ◆ Low commodity prices, global excess capacity in manufacturing, and the widespread slack in labor markets should keep inflation low for the near-term. Currently, deflationary pressures resulting from the global downturn are more worrisome than the potential for future inflation resulting from monetary and fiscal policy responses to combat the recession. Overall commodity prices are down 4.0% so far this year. Energy prices have diverged significantly, with natural gas prices declining 34% and oil prices up 12%.
- ◆ Global trade is down 32% over last six months and is still in steep decline. China is a bright spot, with last month's Purchasing Managers Indices for both manufacturing and non-manufacturing sectors indicating economic expansion after months of contraction. In Japan, economic indicators remain in decline across the board, as manufactured exports have stalled. The rest of Asia, built primarily on exports, awaits a recovery in major importers. Europe continues to experience deep cuts in economic forecasts, as falling exports (down 35% since last year) and lower personal consumption aggravate persistent unemployment. UK is now in the worst recession since WWII. Emerging economies in Eastern Europe face banking crises as the global slowdown caught them in the early stages of building their economic bases. Latin America, primarily resource and commodity based, held up for most of last year but now is feeling the effects of the global recession.

### Future Prospects and Portfolio Strategy

- ◆ Another quarter is history, but the broad trends continue: the severe recession persists with scattered signs of improvement, millions of jobs have been eliminated, and companies have cut production to meet lower levels of demand. Conversely, the rate of decline in earnings estimates is slowing, credit is becoming more available, and the financial system is pumped full of liquidity. Housing and retail sales, as well as some global indicators, are becoming less negative. But, improvements in these indicators have not yet been sustainable or of significant size to declare a turning point. More time and evidence is needed to make such a declaration.
- ◆ Equity markets will move before a change in these trends is broadly accepted. Recently, these markets rallied significantly off the 'panic' levels seen in February and early March, and now will likely pause to assess first quarter corporate earnings, possible auto manufacturer bankruptcies, and further evidence as to the direction of the economy. Stocks have become more attractive relative to cash and fixed income as structural problems are being addressed and future earnings prospects slowly come into focus. Our portfolios remain invested in the stocks of companies that have relatively strong earnings and attractive valuations. As the markets evolve from the early cycle recovery stage, we expect companies with more stable earnings patterns to benefit.
- ◆ Fixed income markets should benefit from narrowing spreads for investment grade corporate bonds, though that could be tempered by the effect of defaults in several economically-sensitive sectors. Municipal credit quality will be pressured as state and local governments experience tax revenue shortfalls; diligence on credit risk is more important than ever. The Federal Reserve has indicated it will keep interest rates low until there are broad signs of recovery. Traditionally, prospective fixed income returns from low interest rate levels are elusive. Our risk-averse, higher quality, intermediate bond strategy should help us retain flexibility in this changing atmosphere.

### Inflation or Deflation?

With all of the recent actions implemented by the Federal Reserve, the U.S. Treasury, and other similar global institutions to fight the specter of broad-based deflation, one of the most common questions we get from clients is the impact of these actions on future levels of inflation. Since inflation has a tremendous influence on the performance of various asset classes, we felt it important to communicate to our clients our thinking on this issue. In this quarterly review, with the caveat that we are clearly in uncharted waters, we discuss our thoughts and the implications for managing our clients' portfolios.

The deflationary forces in the global economy have come about as a result of global efforts to deleverage balance sheets and the efforts of consumers in developed economies to increase their savings. These are normal responses to the current economic environment. However, the problem becomes apparent when everyone around the globe is trying to increase savings and reduce debt at the same time. The situation requires governments and central banks to act in the exact opposite fashion, spending more than the private sector is trying to save to maintain aggregate nominal demand, and becoming the buyer of last resort for the levered private sector's attempts to deleverage through the sale of assets and equity. The efforts to deleverage are probably the more difficult to combat due to the lack of political will to essentially nationalize the losses of the banking system. In fact, Ben Bernanke discussed this on his recent appearance on *60 Minutes*, when he said he believed the most severe risk we face in solving this crisis is the lack of political will.

In an effort to combat the deflationary forces that have accompanied the global economic recession, interest rates have been slashed to historically low levels, fiscal stimulus packages have been initiated in every corner of the globe, and various debt guarantee programs have been put in place to help cleanse banks of troubled assets. The most recent measure to be instituted is the process of quantitative easing recently started by the Federal Reserve and several other global central banks. Under this program, the Federal Reserve will buy \$300 billion in US Treasury bonds (primarily 2-10 year maturities) and over \$1 Trillion in mortgage securities. This effectively lets the Federal Reserve work with the Treasury to monetize long-dated Treasury securities, facilitating a huge expansion in Treasury debt at low interest rate levels. The IMF projects a sharp rise in government debt in the developed world (from 80% of current GDP currently to an estimated 104% in 2014) as governments take over private sector leverage by financing bank bailouts or by injecting cash onto consumer balance sheets.

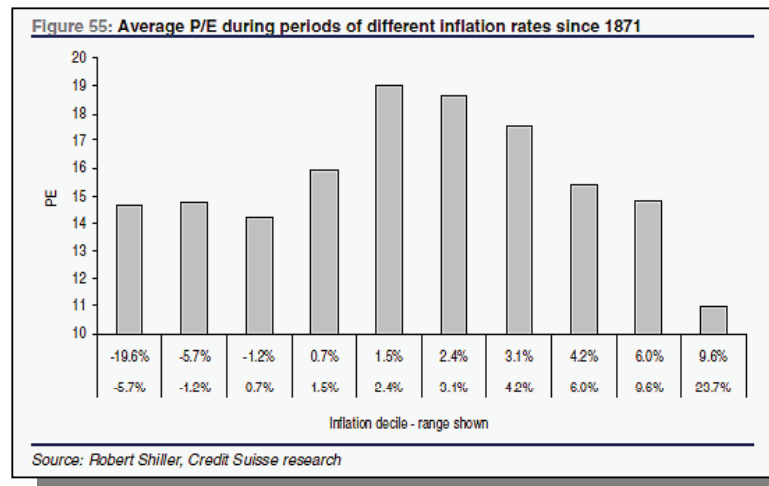
Further steps will likely be taken to combat global deflationary risks. This will mean more global quantitative easing, with the Europeans eventually joining the ranks. Countries with excess savings will unveil more fiscal stimulus plans. And ultimately, the collective political will of all involved governments will be required to execute a plan to purge the toxic assets from bank balance sheets.

In any normal time, and maybe even in these times, these operations would in the long run be inflationary. Those most worried about inflation see inflation in purely monetary terms – that it is the result of too much money chasing too few goods. The concern is that inflation will quickly result when the money supply grows at a rapid rate.

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The Federal Reserve is walking a fine line between trying to stimulate aggregate demand without creating significant inflationary pressures. As the balance sheet of the Federal Reserve approaches \$4 trillion, they are proceeding on the assumption that, once the crisis fades and the economy enters a recovery phase, they can absorb excess liquidity and avoid a significant breakout of inflation. There are a number of tools at their disposal, but history suggests the ability to time everything right is very difficult. Richmond Federal Reserve President Jeffrey Lacker, a strong anti-inflation hawk, summed up the potential quandary facing the Fed with his recent statement that the inflationary impact of the Fed's actions "depends on our skill at the Federal Reserve in withdrawing the stimulus in a timely way. This is very delicate, very hard policy."

If the Fed gets it wrong and higher global inflation emerges in the near term, how should portfolios be positioned? Looking at how various asset classes performed in previous periods of inflation in the U.S. provides cloudy conclusions. In the 1970s, gold and commodities led the way while equities and bonds were the laggards. However, the 1970s is somewhat of an outlier as, at the time of the oil shock in 1973, equities were richly valued (20X earnings) and there was a dislocation owing to the response by policy makers to inflation in the form of price controls. In the 1970s, the supply shock of higher oil prices caused the recession and inflation. With the current gap between existing economic conditions and potential non-inflationary growth so wide, unless there is an external shock, inflation is likely to be caused by an improving economy. During most previous periods of inflation (excluding the 1970s), cash and equities were the top performers, with gold and commodities trailing. In the current environment, we believe a modest increase in inflation would be positive for equities, as indicated in the chart below which shows average earnings multiples for various levels of inflation.



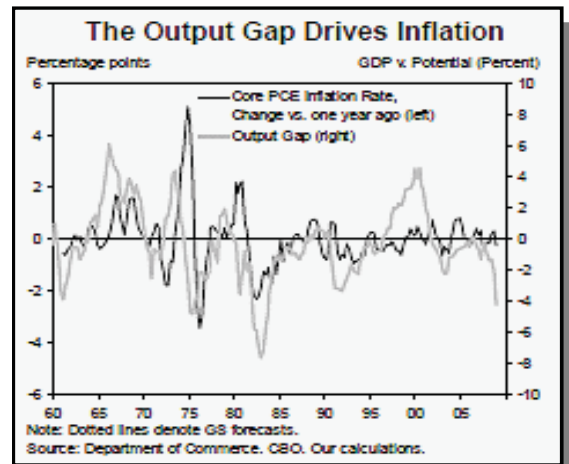
Index-linked bonds are likely to be the best vehicle in the fixed income arena, while commodities are likely to be decent performers if higher inflation is coupled with faster economic growth. Certainly, the worst outcome for most asset classes is if the Fed has to confront higher inflation before the markets stabilize and the economy has emerged from recession. In this case, the Fed will have to tolerate higher inflation for some period or tighten its policy in the face of significant economic and market weakness.

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However, we differ from the current consensus belief that now is the time to position for extremely high inflation. While the recent sharp rally in equities off the March lows - lead by inflation plays, cyclical shares that benefit from faster economic growth, and the depressed Finance sector - is based on the belief that economic conditions are slowly becoming "less bad", the recovery is likely to be modest reflecting the largest output gap in the last 75 years.

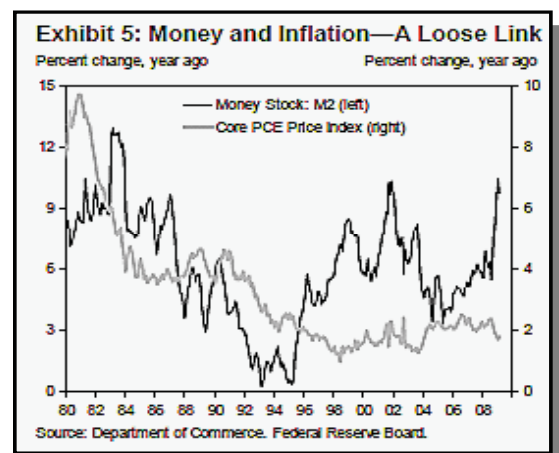
The output gap measures the difference between current economic activity and its long term non-inflationary potential. The projected gap shortfall is likely heading to nearly a 10% real GDP level by the end of next year, the largest in the post WWII period. Global spare capacity is also likely to rise to a post-war high. As seen on the chart to the right, changes in inflation are strongly correlated with the output gap.

As reflected on the chart, it took two years to close an output gap half this size coming out of the recession in 1974. It took 5 years of 5% economic growth to close the gap coming out of the 1982 recession, and during that period inflation did not accelerate significantly. While the monetary base has grown significantly, broader measures of money supply have risen much more slowly as a result of banks keeping reserves at the Fed. Therefore, the velocity of money and the money multiplier have collapsed, short-circuiting inflation for now. The correlation between the economic output gap and inflation has historically been much closer than inflation's correlation to the growth in money supply that many are concerned about today (see chart below right).



Historically, as recessions come to an end, it takes at least two years to close the output gap, with the average time closer to four years. If historical precedent holds, it is unlikely that an inflation problem will arise before 2011 at the earliest, even if the current recession were to end today.

While significant inflation does not appear to us to represent an immediate threat, modest inflationary expectations seem imbedded in recent market moves as some economic indicators suggest a slowing in downward economic momentum. Commodities have outperformed recently, more cyclical stocks have returned to favor, and breakeven rates on TIPS and GIPS (Treasury & Global Inflation-Protected Securities) have moved up. However, in the modest recovery that we expect, we believe that eventually the equity market will place a premium on companies that are able to deliver earnings growth in this challenging period of below trend economic growth - something not evident today.



In short, our answer to the question of whether the explosive growth in the monetary base implies significant inflationary pressure is: "No, not yet, but stay tuned." We believe there will be more opportune times to add more inflation protection to clients' portfolios.