

2009 SECOND QUARTER COMMENTARY



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The Financial Markets

- ◆ Led by the financial sector, the global equity markets snapped back strongly in the second quarter. The S&P 500 and the Dow Jones Industrial Average rose 15.9% and 12.0%, respectively, while the NASDAQ jumped 22.5%. Likewise, international markets rallied in the second quarter, with the MSCI EAFE Index up 25.4% and the MSCI Emerging Markets Index soaring 34.7%. Despite these big moves during the quarter, most indices were flat to slightly down in June, suggesting that investors are waiting for more evidence of sustainability of the recent rally.
- ◆ Rebounding from the extreme levels of pessimism that accompanied the market lows on March 9th, investors poured back into cyclical and other beaten down sectors during the second quarter, notably financial stocks. The Financial sector rose 36% for the quarter, followed by the Technology and Industrial sectors. The more defensive Telecom, Healthcare and Consumer Staples sectors all lagged the market. Value stocks modestly outperformed growth stocks, while small cap stocks broadly outperformed large caps.
- ◆ The Federal Reserve Bank maintained the fed funds rate near zero percent, while continuing to purchase vast quantities of Treasury debt and Agency mortgage-backed securities. This unprecedented quantitative easing has now expanded the central bank's balance sheet to nearly \$2 trillion, merely offsetting the decline in credit available from the private sector. The Fed reiterated its pledge to keep short rates low for an extended period.
- ◆ Despite support from the central bank, Treasury bond yields rose sharply during the second quarter. Bond investors demanded higher yields to take down the huge amount of newly issued government debt. Also weighing on bond prices were investor worries about the potential for higher inflation resulting from overly accommodative monetary policy. The yield on the 2-year Treasury Note increased to 1.11%; the 10-year yield climbed to 3.53%, having briefly touched 4.00% in early June. The yield curve steepened as yields moved higher for longer maturity Treasuries.
- ◆ Corporate bonds rallied as yield spreads narrowed from historically wide levels. Investors shrugged off the gloomy economic data in the second quarter and embraced riskier assets. Investment-grade corporate bonds posted a 10.8% total return for the quarter, as measured by the Merrill Lynch index, led by a rebound in the lowest quality credits that had performed poorly last year. Junk bonds fared even better, with Merrill's high-yield index posting a total return of 23% for the quarter. The exuberance for riskier assets may prove short-lived if default rates on below investment-grade credits soar as predicted.
- ◆ The municipal bond market continued to benefit from strong demand. Tax-exempt bond mutual funds enjoyed robust inflows of \$28 billion year-to-date. Prices generally rose in the first half of the quarter, and then displayed weakness into the middle of June. For the quarter, the strongest returns were again achieved by bonds with the longest maturities – 15 years and longer, sustaining the trend of the first quarter. The new Build America Bonds (taxable to investors) are reducing the supply of longer maturity tax-exempt bonds, thus helping support prices in that sector. Intermediate maturities posted the weakest performance of the quarter.

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The Economy

- ◆ The economy seems to have passed the most severe stage of the contraction, though sustained improvement may prove elusive for a while. Federal stimulus spending should have a positive impact in the second half of 2009. Labor markets, usually a lagging indicator, will likely see the unemployment rate rise into 2010. Housing may be nearing a bottom, though foreclosures are expected to keep pressure on home prices. Credit conditions remain tight, though they have loosened somewhat since early spring.
- ◆ The unemployment rate rose to 9.5% in June from April's 8.9%, reaching its highest level since August 1983. Non-farm payrolls shrank by 467,000 versus expectations of 350,000. The economy has now lost 6.5 million jobs since the beginning of the recession. The average work week fell 0.1 hours in June to a record low of 33 hours. Aggregate hours worked have now fallen more than either the 1973-75 or the 1981-83 recessions.
- ◆ The ISM Manufacturing Composite rose 2 points to 44.8 in June. While a reading below 50 indicates that the Manufacturing sector continues to contract, the index has recovered from the low 30s in the fourth quarter. This index is a composite of five components that reflect: production, employment, deliveries, new orders and inventory liquidation. Though production showed an encouraging increase, new orders fell.
- ◆ Home prices in 20 major US metropolitan areas continued to fall in the most recent S&P/Case-Shiller Index. In April the index dropped 18.1% from a year earlier. Housing starts jumped 17.2% in May but remain 45.2% below the previous year's level. Some of the improvement in housing may be due to the U.S. Government's \$8,000 first time homebuyer credit and the California new home buyer credit of \$10,000. Following the recent jump in mortgage interest rates, mortgage application activity dropped in the last week of June for the fifth time in six weeks.

Future Prospects and Portfolio Strategy

- ◆ Second quarter corporate earnings are expected to decline approximately 34% from a year ago, in line with the first quarter. In the second half of 2009, earnings comparisons will be easier, setting the stage for actual earnings growth by the end of year, and continued positive comparisons into 2010.
- ◆ A decline in commodity prices, global excess capacity in manufacturing, and enormous slack in labor markets should keep inflation in check in the near-term. At this point in time, the deflationary pressures resulting from the global downturn are more worrisome than the potential for inflation resulting from accommodative monetary policy.
- ◆ Equity markets in the second quarter were led by a rebound in lower quality companies with less visible earnings growth prospects. Given the significant bounce off the March lows, investors will now demand signs of actual economic and corporate earnings growth before bidding equity prices meaningfully higher. We believe this growth will begin to materialize in the coming quarters, but further equity market advances are likely to be modest. This environment should favor companies with demonstrated earnings growth and reasonable valuations.
- ◆ Fixed income investors continue to weigh the effects of extended economic weakness (downward pressure on interest rates) and the surging supply of government borrowing (upward pressure on rates). With money market yields expected to remain near zero for an extended time, there is incentive to take on more risk, in the form of credit risk and/or interest rate risk, to capture incremental yield. Investors may continue to direct cash toward corporate bond and other credit strategies. Meanwhile, the supply of corporate bonds has been reduced by the reluctance of companies to borrow given the uncertainty over the direction of the economy. This supply/demand imbalance could continue the trend of narrowing credit spreads.
- ◆ 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 budget woes of California may be repeated in other states, leading to debt rating downgrades. To date, the demand for tax-free bonds has been robust, and prices have largely been unaffected by the California crisis.

Between a Rock and a Hard Place

Sound uncomfortable? It is. The severity of the current recession unleashed massive fiscal stimulus plans by our Government and other governments around the world. Our fiscal situation is deteriorating as the Government spends hundreds of billions of dollars on various programs – some of the funds have helped stabilize the economy, while some have disappeared into the abyss. The continued acceleration in spending and deceleration in revenues have caused an eruption of government borrowing. On May 14th President Obama said that the current level of deficit spending was “unsustainable”. Then, one week later, a flood of new programs were introduced for healthcare and other entitlements costing billions if not trillions of dollars, extending the current deficit to \$1.8 trillion or more for the next several years. Is the growing level of Federal debt a real problem or a “straw man” that is being mostly ignored by policy makers? If it is a problem, how can we contain the increasing level of debt relative to our capacity to fund it? Let’s take a step back, ignore the endless political rhetoric, stick to the facts, and see if articles by two well respected individuals in the field will help answer these questions.

A recent piece, “Staying Rich in the New Normal” by Bill Gross, the renowned Managing Director and co-Chief Investment Officer of PIMCO, states the current annual deficit level of \$1.5 trillion is now 10% of our Gross Domestic Product (GDP - the sum of all goods and services produced). This is the highest annual ratio we have seen since the 1930’s Depression. When the U. S. entered what he calls the current Great Recession, the ratio of Federal Government Debt to GDP stood at 45%, an attractive amount relative to other countries. But, with just 5 more years of deficits like the current amount, the ratio of Federal Government debt to GDP will be close to 100%. More disturbing is that this deficit level does not include the enormous looming Social Security and Medicare entitlement spending for the “baby boomers”. (On June 1st, subsequent to this piece being written, the Congressional Budget Office raised the annual deficit rate to \$1.8 trillion for this year, before any proposed new spending or stimulus programs are initiated if passed by Congress and signed into law.)

Mr. Gross contends that the 100% level for the Federal Government Debt/GDP Ratio is a “point of no return” as the interest on the debt would consume at least 5 to 6% of the economic growth and the interest would soon begin feeding on itself. He conservatively guesstimates that the added impact of current committed entitlements for Social Security, Medicare and Medicaid further increases debt ratios to levels normally seen in “banana republics” and other third world countries. Moreover, who will have the capacity or desire to buy that debt? And, how high will interest rates have to climb to make it attractive? The higher cost of financing may also stifle economic growth and increase the possibility of stimulating inflation. Mr. Gross’s recommendation is that we move rapidly to balance the budget once a recovery is in place. He also says we should not fall into the trap of believing that continuing to lower taxes is a cure-all. He states that lower taxes do “incentivize productive investment and entrepreneurial risk-taking”, but a certain level of taxes is necessary to stabilize the country’s financial condition and not just “pad the pockets of the rich.”

H. “Woody” Brock, PhD, president of Strategic Economic Decisions recently wrote a very insightful essay entitled “End Game Draws Nigh-The Future Evolution of the Debt-to-GDP Ratio”. Dr. Brock first discusses studies that show over longer periods that governments using large amounts of debt to finance stimulus sharply increase the real rate of interest (rate above the levels of inflation) on their long term debt. The additional cost of debt offsets the positive GDP impact of the stimulus. Next, Dr. Brock focuses on the causes of the current recession and the rise in Federal debt. He projects total Federal debt to increase \$3 trillion by the end of next year, adding to the current \$10 trillion. He also uses the very straightforward analytical tool – Total Government Debt/GDP ratio - to measure the severity of debt levels. For the next 10 years, using current forecasts of program expenditures, ensuing tax collections and a 2% per annum real growth in GDP, the Debt/GDP ratio will stand close to 118%. Dr. Brock then goes on to say “this does not represent the disaster many observers assume.” Over the years, the U.S. has endured very high Debt/GDP ratios during wars, disasters or other shocks. Historically in this country, peaks in debt have been followed by multi-year periods where the Debt/GDP ratio was reduced over time. The key is the response – stimulating higher real GDP growth and “vigorous fiscal discipline.”

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Countries that did not take action to lower the ratio have experienced hyperinflation, stymied growth, outright default and a myriad of other critical problems. Federal officials must be made to understand the simple basic tenet of this relationship – over time the denominator (GDP) must grow faster than the numerator (Federal Government debt).

Stimulating the real growth rate of the economy should be at the forefront of policy, which will generate higher tax revenues and lower the need for and cost of Federal programs, thereby reducing annual deficits. Dr. Brock separates growth strategies into two primary areas – productivity growth and workforce growth. To stimulate productivity growth, he stresses that a very large part of the stimulus package should be infrastructure-related - spending that helps employment and productivity now and continues to help productivity in the future. His discussions on productivity emphasize innovation and venture capital, education (particularly for the very gifted), taxes that reward success and innovation, investment incentives, and “smart” regulation. Stronger workforce growth, he points out, is anchored by GDP growth, infrastructure spending, deregulation of labor markets, the lowering of taxes on labor, and the rationalization of demographic changes, i.e. the continuation in the work force of the “baby boomers.”

Fiscal discipline is more straightforward - simply avoiding unnecessary spending while finding ways to mitigate the cost of existing necessary programs. Spending should be redirected to “investments” that build the basis to drive growth. Dr. Brock recommends that necessary counter-cyclical spending (i.e., extended unemployment or retraining programs) should be temporary in nature, mandated to expire on a specific date when better times return, without regard to a Congressional vote.

Mr. Gross and Dr. Brock both state that we are at a critical point in the relationship of the level of Debt/GDP, where we need leadership and governance that is straightforward, and alerts the nation to the ill effects of burgeoning debt ratios. Mr. Gross concludes that we need to move “to a more balanced budget once a sustained recovery is assured, but don’t count on the former or the latter.” Dr. Brock says that we need leadership in the White House and the Congress “to confront the problems lying ahead, and that is tone deaf to philosophical issues...”

Included among the possible investment ramifications of not taking the needed actions are slower long term real growth, inflation, higher interest rates, the “crowding out” effect, a steepening in the yield curve and higher risk premiums, which will lower equity returns. Historically, after shocks to our economic system, the built-in flexibility has allowed us to make changes, some painful at times, then recover and restore growth. We will continue to closely monitor future progress on these critical issues.

References:

“Staying Rich in the New Normal”, by Bill Gross. This article was posted on Alliazinvestors.com, June 1, 2009.

“End Game Draws Nigh – The Future Evolution of the Debt-to-GDP Ratio”, by Horace W. Brock, Ph.D. This article was posted on InvestorsInsight.com by John Mauldin, May 18, 2009.