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2010 SECOND QUARTER COMMENTARY



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The Financial Markets

- ◆ As concerns of a waning global recovery mounted at the close of the second quarter, financial markets weakened. All sectors declined in Q2 with the defensive Utilities, Telecom and Consumer Staples falling the least. The S&P 500 finished the quarter down 11.4%, while the Dow Jones Industrial Average declined 9.4% and the Nasdaq dropped 11.8%. International markets were also weak with the MSCI EAFE Index falling 13.7% and the MSCI Emerging Markets index down 8.2%.
- ◆ On May 6, US equity markets experienced a “flash crash” with stocks dropping almost 9% during the afternoon - 7% in just 15 minutes - on no specific news. Several large blue chip stocks fell precipitously (30-99%), only to recover by the end of the day. The market ended the day down 3%. Lightning fast trading programs are suspected as part of the cause. Exchange officials moved quickly to cancel the most erratic trades and introduced new circuit breakers that should halt trading in stocks that move more than 10.0% in a 5 minute period.
- ◆ Many commodity prices declined in the second quarter, though most commodity indices still remain in an upward long term trend. The Dow Jones UBS Futures Commodities Index declined 5.0% during the second quarter. Fears of a global slowdown contributed to weaker metals prices. Copper prices fell 18.0% in Q2 and Aluminum fell 16.0%. Crude oil declined 11.0% in the second quarter. Corn declined a modest 1.0%, while gold rose 12.0% in the quarter.
- ◆ The Federal Reserve Bank maintained its pledge to keep short rates low for an extended period as the economic recovery downshifted to a slower pace.
- ◆ Treasury bond yields declined sharply as equity markets tumbled. The 10-year Treasury note yield ended the quarter below 3.0%. Corporate bonds lagged as yield spreads widened, ending the dramatic recovery from the late 2008 lows.
- ◆ The municipal bond market ended the quarter with price momentum but lagged the rally seen in Treasuries. Credit concerns and low absolute yields remain a challenge.
- ◆ Concerns about European sovereign debt and growth led the Euro to depreciate 9.0% and the US Dollar to appreciate 6.0% in Q2.

The Arrington Building
1802 Bayberry Court
Suite 400
Richmond, Virginia 23226

804.288.0404
800.787.7414
FAX 804.288.7872
www.lowebrockenbrough.com

The Economy

- ◆ On April 20, the Deepwater Horizon oil platform in the Gulf of Mexico exploded and resulted in oil gushing into the ocean from more than a mile below the surface. The resulting oil spill has caused the biggest environmental disaster in US history and has significantly impaired the economy in the Gulf region.
- ◆ In June, non-farm payrolls fell by 125,000 due to the layoffs of temporary census workers. Ex-census workers, government payrolls expanded by 17,000. Private service payrolls are up compared to a year ago for the first time in two years. The unemployment rate fell to 9.5% from 9.7% in Q1.
- ◆ Following the expiration of the Federal first time home buyers tax credit in April, the National Association of Realtors reported that May's index of pending home re-sales plunged a record 30.0% from April, more than twice as bad as economists had forecast. Lower Treasury interest rates drove a 7.0% surge in mortgage refinancing at the end of Q2.
- ◆ Retail sales picked up in June. June sales at 30 chains rose 3.1% after a 2.7% gain in May, the 10th consecutive increase in monthly sales, according to Retail Metrics. The International Council of Shopping Centers trade group reported that the monthly average gain through June of 3.8% was slightly below forecast but the highest level since 2006.
- ◆ Light vehicle sales were down in June to 11.4 million from May's level of 11.6 million. Yet, first half 2010 sales were roughly equivalent to the sales in the second half of 2009, which included the federal "cash for clunkers" subsidies.
- ◆ The June ISM Service Index (which covers about 90.0% of the economy) fell to a four month low of 53.8 from 55.4 in May, but still shows growth. At the end of June, the Conference Board's Consumer Confidence index fell sharply to 52.9 from 62.7 in May.
- ◆ Factory orders declined 1.4% in May, down for the first time in nine months, the largest decline since March 2009.
- ◆ The Commerce department reported that wholesale inventories in May rose for a fifth month. Inventories remain below normal levels, reflecting the weakness in the economy. Yet, growth in inventories demonstrates growing confidence among manufacturers.

Future Prospects and Portfolio Strategy

- ◆ Market sentiment has become more pessimistic in recent weeks. As a contrarian indicator, it reflects a more favorable near-term outlook for the equity market. As well, the equity markets are more oversold than at any time since March of 2009.
- ◆ The market's current valuation of roughly 12.5x next year's corporate earnings compares very well to the longer term average valuation range of 15-16x. European and emerging market valuations are even more attractive than US valuations currently.
- ◆ Recent mixed economic signals have raised fears of a double dip recession, but support our view that we are seeing evidence of a continuing modest global recovery.
- ◆ With bond yields at the lowest levels in over a year, caution is warranted in fixed income portfolios. Any increase in the overnight interest rate by the Fed has probably been postponed to 2011, yet markets will discount such moves well in advance if the economic recovery proves sustainable.
- ◆ We maintain our overweight stance on corporate bonds, though credit spreads have already normalized for many segments of the high grade corporate market. Prospects for short and intermediate municipal bonds continue to be challenged by low absolute yields and concerns over municipal credit conditions. Expectations of higher income tax rates should boost demand for tax-free income.

Home Stretch for Financial Regulation? Almost – Not Quite! The Dodd-Frank Wall Street Reform and Consumer Protection Act

The move to write a new financial regulatory bill formally began with the 88 page comprehensive Treasury Department proposal introduced by President Obama in a news conference on June 17, 2009. Since that time, with the help of costly lobbying efforts by a multitude of interested parties, fiery partisan political debate and the normal Washington demagoguery, the end product is being painfully squeezed out of the other end of the “sausage machine.” The 2,300+ page bill, which has passed a House vote but still has to pass in the Senate, is still fluid at this time, but seems to be mostly, if not completely finalized.

In its description of the processes instituted by the bill, the Treasury Department lists ten things that Financial Reform should accomplish:

- ◆ End “Too-Big-To-Fail”
- ◆ Close Loopholes in Regulation of Major Financial Firms
- ◆ Bring Transparency to Hedge Funds
- ◆ Constrain the Size of the Largest Firms
- ◆ Reform Executive Pay and Strengthen Shareholder Protections
- ◆ Separate Banking and Speculative Trading (The Volker Rule)
- ◆ Strongest Consumer Protections Ever
- ◆ Crack Down on the Abuses in the Mortgage Markets at the Center of the Crisis
- ◆ Safer, More Transparent Derivatives Market to Help Main Street Businesses
- ◆ Support Long Term Job Growth by Helping Prevent Future Crises

The rhetoric describing each of these aspects is many pages long and includes new agencies, studies and oversight committees. Senator Chris Dodd (D.-Conn.) stated “This is about as important as it gets, because it deals with every single aspect of our lives.”

The operating details of the bill’s legislative-speak and the associated costs will become clearer as ensuing regulations are written by the various controlling agencies. The bill does accomplish some of its goals as it attempts to control abuse in the system, but also is an aggressive extension of regulatory reach, bureaucratic rulemaking and Governmental control. Lobbying by some focused groups, especially the larger banks, has muted the possible beneficial effects in some areas. Growing bi-partisan opposition is making a last ditch effort before the bill is passed by the Senate, and the list is growing of “fixes” that will need to be addressed soon after passage. Following are some of the concerns voiced by a number of prominent financial publications and experts regarding the bill:

- ◆ On June 25th the New York Times Business Day section reported that the new bill was “awash in so much minutiae that its impact on the financial services industry was still unclear.” It went on to say that when it is signed into law, “the financial industry will still be dominated by a handful of institutions that are too large, too interconnected and too politically powerful to be allowed to go bankrupt if they make unwise decisions or make huge wrong-way bets.” It also pointed out that Fannie Mae and Freddie Mac are back to growing their balance sheets, and not part of the reform bill. The Treasury Secretary stated afterwards that the Fannie and Freddie resolution was too complex to be a part of this bill but will be addressed separately at a later time.

- ◆ In an opinion piece on June 24th, Arthur Levitt, the former chairman of the Securities and Exchange Commission, wrote that “The bill, already weakened by deal-making as it emerged from the Senate, has been bled dry of nearly every meaningful protection of investors.” Levitt goes on to focus on investor safeguards by saying that the bill will allow more public companies to avoid doing internal audits and expands the number of smaller companies exempt from Sarbanes-Oxley audit requirements. The bill also failed to revoke the 1975 law that prevents municipal bond issuers from being subject to the same kind of regulation and scrutiny required of corporate bond issuers. In addition, proxy access was tightened, favoring larger groups such as labor unions. The bill also leaves the SEC and the Commodity Futures Trading Commission as two separately regulated entities, with confusing differences in operating rules and on-going turf battles.
- ◆ The Wall Street Journal on June 26th stated that in the final bill, the biggest banks “appeared to have dodged some of the harshest provisions of the Senate version....adopted in May.” The “Volker Rule,” which would have prohibited banks investing their own capital in riskier assets, was neutered to the degree that banks can now invest 3% of their assets in risky hedge or private equity funds and continue to manage them as they generate hefty fees. The banks are allowed seven years to phase out excess risky holdings that are liquid, and even longer for more illiquid investments. Provisions of the Volker Rule barring proprietary trading in derivatives ended up not requiring banks to provide more collateral for “less risky” interest rate and foreign exchange based derivatives. Derivative trading in “riskier” commodities, stocks and credit default swaps on non-investment grade debt will have to be moved to separate subsidiaries, along with newly regulated levels of collateral that will be raised in most cases from the bank’s balance sheet. The good news to banks was that the new bill’s definition of “risky derivatives” only affects 10%-20% of the banks’ derivatives, and they again have a several year grace period to spin off or sell the subsidiary. The big banks echoed that this was “better than expected.”
- ◆ As more of the bill is understood, unintended consequences are beginning to rise to the surface. One is the requirement that all corporations purchasing and holding commodity derivatives will have to collateralize them, even if they are used to reduce business and pricing risk. This means that companies who use commodity derivatives in the normal course of business - i.e. agricultural, energy, manufacturing companies, etc. – will now have to set aside liquid assets as collateral instead of using them to grow or finance their business. The International Swaps and Derivative Association estimates this will require close to one trillion dollars of liquid assets be escrowed by American corporations, lowering returns and making them less competitive internationally.

This legislation will hopefully begin to address some of the loopholes and regulatory shortfalls that led to the recent financial crisis. The Wall Street Journal says the bill will redraw how money flows through our system, and touch every company and person who has a bank account or credit card. A consumer protection agency in the Federal Reserve will monitor financial products and a new council of regulators will monitor broader systemic risk. Derivatives will be pushed to trade on exchanges and be scrutinized by regulators. Much of this could be positive, helping to rebuild confidence in the system and ensure integrity. As some of the aforementioned omissions are addressed and “fixes” enacted, the system could be even stronger. However, the creeping bureaucracy has to guard against the negative feedback loop of over-regulation. In the midst of this evolution, the financial sector will again gradually begin to modify its operations and offer new products to seek greater profitability outside of the slow-moving regulatory net. Historically, that is the cycle our system has typically experienced over and over again. Will this time be different?