



INVESTMENT  
COUNSEL

## MARKET OUTLOOK

First Quarter 2010

The market closed strongly, posting a 23% return for the year, and up 65% from its lows in early March. The sharp swings of 2008 and 2009 were confirmation of the importance of asset allocation. Few investors were deft enough to get out at the top and back in at the bottom at each of the many intermediate peaks and troughs over the past two years. ZWJ took advantage of the market moves to make investments in stocks that had not previously met our valuation disciplines. We enjoyed the strong recovery in their share prices when it became clear the worst part of the economic decline had passed.

Like the equity market, the bond market rebounded in 2009 as corporate and municipal bonds recovered from a dreadful 2008. As bond investors demonstrated their renewed preference for riskier assets, they moved out of the U.S. Treasuries bought in a late-2008 stampede. Treasuries declined in value as interest rates increased throughout the year, particularly at the longer maturities of the yield curve. Within our bond portfolios, ZWJ selectively added corporate and municipal bonds because our research suggested risk premiums would contract from their elevated levels at the beginning of the year. Throughout the year we remained selective, adding U.S. Treasuries with inflation protection and “step-up” bonds that raise their coupon rates as they move toward maturity.

None can dispute the strong market performance since March, nor can one fail to notice the improvement in most economic indicators. The economy seems to have passed through dangerous straits like Magellan sailing around the horn of South America. Like Magellan on his circumnavigation, we have a long journey yet before we reach our goal. Instead of unpredictable forces of wind and rain, we face monetary and fiscal policy decisions. As in the case of wind for a ship, monetary and fiscal policies can

help an investor, they can be benign, and they can be a destructive force on investment portfolios.

The fiscal policies that are directly helpful include licenses or regulations that protect those who control them over their competitors who do not. Utilities and government-enabled oligopolies provide barriers to entry of new competitors, and they hobble smaller enterprises that cannot spread the costs of regulation across a sufficiently large customer base. Expansionary monetary policy provides liquidity and credit to all interested in growing through leverage. This policy remains benign as long as the rate of monetary expansion is kept at reasonably low levels. Non-monetary fiscal policies can have a benign and even beneficial effect on the private sector, with the Internet being a clear example. After years of fostering its development as a military research enabler, the government allowed its use by commercial enterprises with the result that we can “tweet” and “friend” each other from web-enabled cell phones. On the other hand, government policies can stifle entrepreneurial growth through confiscatory tax policies, excessive fiscal stimulus, or policy preferences that artificially boost demand and lead to economic misallocation.

In 2010, it is almost absurd to make a distinction between fiscal and monetary policies, so closely linked are they. The independent Federal Reserve Governor, Ben Bernanke, is in constant communication with the politically appointed Treasury Secretary, Timothy Geithner. Twice a year, Mr. Bernanke testifies before Congress on how the Fed is meeting its twin mandates of price stability and full employment. The previous Administration proposed a financial system bailout in which the Federal Reserve would buy “toxic assets” from banks and mortgage backed securities from the government-sponsored entities known as Fannie Mae and Freddie Mac. Nearly every observer concluded regretfully the bailout was necessary to preserve the

system, that the institutions were “too big to fail.” Government debt ballooned as a result of the bailout.

The elected politicians did not let the socialization of private risk through TARP and TALF and the other programs distract them from their policy preferences. We had a \$787 billion stimulus, which brought U.S. government debt to \$2.5 trillion. The Department of the Treasury continued to have successful bond sales, with the Federal Reserve Board being one of the buyers of the new issues. We seemed to have made it through the worst of the storm, with Ben Bernanke as the little Dutch boy plugging the leaky dyke with his thumb.

There remains yet a wall of water on the other side of the dyke. The massive government spending and investment in toxic assets (a contradiction in terms if ever there was one) has created what has been described as “a sugar high” by the chief investment officer of the bond management firm PIMCO. It all looks good “until the bill comes due” as the research firm Strategas Research Partners phrased it. We run the risk of letting the air from one deflating bubble in housing and mortgage derivatives become the start of another bubble if our stock markets rise too rapidly while the global economy stagnates. When the Federal Reserve works in concert with the Department of the Treasury to keep interest rates near zero, it creates an incentive to put money in almost anything but cash. Having signaled clearly that rates will remain near zero until the economy is clearly in recovery, Mr. Bernanke is enabling traders to borrow at low short-term rates and invest in longer-term higher-return securities. Currency traders have been borrowing U.S. dollars and investing in Australian dollars where the interest rates are higher. Equity investors have been pouring money into the stock markets because cash earns nothing. Most of the participants concede the quality of growth is not great. We in the U.S. are still losing jobs each month, the GDP numbers are juiced by government spending to spur automobile and home sales, and companies are meeting earnings forecasts primarily through cost controls rather than sales gains. The expectations implied by the recent market moves

may reflect an excessively sanguine economic outlook.

We have participated in this rising market, yet we remain concerned about what we might expect “when the bill comes due.” We think we will see interest rates rise, first at the longer end of the maturity curve because the government has less control over that end. The massive increase in government debt will be recognized as the inflationary force it is, and bond investors will demand a higher yield for long-dated instruments. As inflation expectations ratchet up, price-earnings multiples will ratchet down, and low p/e stocks with solid dividend programs will be the best performers in the stock market.

We have had these concerns for a year now, and the market has sloughed them off to post the strong gains of 2009. Everyone is a Keynesian, and Washington, D.C. is the place you want to be these days. Fiscal stimulus is an effective but temporary measure. We expect Gross Domestic Product (GDP) to increase in 2010, but we need to see growth in its non-government components: Consumer Consumption and Private Investment. Investors know this, too. At some point in the future, they will demand compensation. Investors will raise the discount rate they apply to future earnings streams, which means price/earnings multiples will contract. Investors will see that the need to monetize the staggering government debt load means higher inflation and a weaker U.S. dollar, and they will insist on higher bond yields as compensation.

We have been positioning our portfolios in preparation for this change in investor attitudes. We have been tilting our bond portfolios toward a shorter average maturity so we can reinvest maturing bonds at higher rates. We have been tilting our equity portfolios toward a shorter average maturity in that we have a greater weight on dividend payers and business staples. We have been positioning for faster growth outside the U.S. by adding multi-national companies that can sell in the developing economies where the growth rates are higher. Around that core we do find specific opportunities – domestic and foreign – that complement the portfolio.

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