ZWJ INVESTMENT COUNSEL

MARKET OUTLOOK

Second Quarter 2010

What drives one's market outlook often includes one's outlook on changes in interest rates. We incorporate our interest rate expectations in our asset allocation work as well as our stock-picking work, for the stock and bond markets work together. Sometimes the two markets are moving against each other while at other times they operate in harmony. Both respond to changes in expectations. Our expectation is that interest rates will rise over the next few years, and we are positioning our stock and bond portfolios accordingly. The challenge with the interest rate expectation business is the same challenge with every expectation business: one can be right but too early, which makes one look wrong.

We have been consistent in our focus on quality and consistent growth in our stock selection, which has meant our clients enjoyed solid equity returns over the last 12 months. We would have done even better if we had been willing to buy more of the stocks hit hardest in the decline of 2008 and early 2009. Our attention to quality limited our exposure to those kinds of companies, which protected our clients through this tumultuous time in the equity market. We continue to think quality is the right call on stock selection. Quality, in our view, is marked by financial strength, strong cash flow generation, a stable and rising revenue profile, and prudent management teams. These characteristics were not prevalent among the firms that went to Washington, D.C., last year looking for a bailout to rescue them. Being unwilling to take on such risk characteristics in our equity holdings, we did not enjoy the outsized returns of those stocks when such risk was rewarded with government intervention and support.

Bond investors who remained safely invested in U.S. Government issues suffered through 2009, as that sector of the bond market was down for the year. We recognized a "fear bubble," and moved into some other sectors of the bond market to take advantage of excellent values at reasonable quality levels. As it became clear the economy was going to survive, corporate bonds moved up in price and risk premiums narrowed. As we move through 2010, interest rates remain very low and risk premiums are not wide. We recently saw them invert on the shorter end of the yield curve when Berkshire Hathaway bonds yielded slightly less than U.S. Treasuries with similar maturities. Yields are at 50-year lows. The yield on a 10-year U.S. Treasury in 1962 was 3.95 percent; it was more than 13 percent in 1982, and it was 3.26 percent at the end of 2009. Since the start of the year, the 10-year yield has moved up a little, to 3.88%. On the basis of nothing more than reversion to the mean, it is hard to see how interest rates will not continue to move up.

The unprecedented level of government intervention and support is a significant component of our interest rate expectations. Grounded in knowledge of the core economic truth that all government revenues come from taxing the productive private sector, we confidently forecast there will be an end to prodigal government spending. We cannot say when it will return to a normal level, but we understand it must. The world is watching Greece accept that economic reality, and nobody in power wants to be in the position of the Greek government today as it tells the Greek people they must endure austerity or go bankrupt. Governments around the globe are working on how best to get government revenues in line with government expenditures so as to reduce structural deficits. Those governments are racing against time, for they are adding debt at a low point in the history of interest rates. U.S. government debt as a percentage of Gross Domestic Product is at a 50-year high. In 1962, gross government debt was 53.4 percent of GDP; it receded to a generational low of 32.5 percent in 1982, and it reached 69.3 percent as of 2009.

In periods of declining interest rates, as we enjoyed for the past twenty years, an investor wants long-dated bonds. In such an environment, the coupon rate on the bond currently owned is probably higher than the coupon rate on a similar bond being offered in the market, and the bonds being offered in the future will feature even lower coupon rates. A savvy bond

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investor will pursue a "long duration" strategy, preferring the longer maturities over the shorter maturities as expectations for lower interest rates create a tailwind for his bond portfolio. The inverse is true when interest rates are rising. A short duration strategy works better because the bond investor gets his money back sooner to re-invest in higher-coupon bonds of similar quality.

As we expect bond rates to rise over the next few years, we have positioned our bond holdings generally to have a shorter average maturity or some kind of interest rate protection feature. Beyond simple reversion to the mean, why would we expect interest rates to rise? At the risk of oversimplification, there will be too much supply and the price will have to drop to meet demand. Declining bond prices mean rising bond yields. This repricing has been delayed due to coordinated and extraordinary measures taken by the Federal Reserve Board and its peers around the world, but it cannot be put off forever. The flexibility enjoyed by central bankers of the developed economies is powerful, but it is not infinite. Unlike a municipality or a private enterprise, sovereign governments can inject new money into the financial system. The U.S. Government did just that in response to the financial meltdown of 2008. Reacting to a liquidity crisis, it flooded the financial system with liquidity. Reacting to a capitalization crisis, it flooded the system with capital. The financial system stabilized thanks to these declarations of support by the U.S. Government. Sovereign nations around the world responded in kind, and the stronger economies helped the weaker as we saw in Iceland, Dubai, and most recently, Greece.

We seem to be through the financial system crisis, but the residue of our housing debt extravaganza remains. We added further to the national debt through a large stimulus bill passed in 2009, bringing further pressure on an economy still working through the housing debt challenge. Our interest rate forecast is that with debt at a 50-year high as a percentage of GDP and interest rates on the 10-year U.S. Treasury near a 50-year low, rates will likely begin to revert towards the 50-year average of 6.9 percent. Rates may not reach that average level because the governments around the world are committed to keeping rates low. At some point, the producers of real wealth will lose some faith in the creditworthiness of public issuers, and interest rates will creep up in response to reduced buyer interest. Taxes are also likely to rise. Some tax increases are already legislated, as the Bush tax cuts reach their sunset year and rates revert to their previous levels. The recently signed health care bill includes several new taxes, many of which do not kick in immediately.

We are looking at an investment environment featuring rising taxes, rising interest rates, elevated government spending, mountainous sovereign debt levels, and expansionary monetary policies. Taken together, these suggest investors will be less willing to bid for long duration investments. The value of cash flows in the near term will be higher than the promise of capital appreciation in the long term. Investors will demand higher cash flow rates as compensation for the uncertainty of the future.

Our shorter duration strategy also plays out on the equity side. In an uncertain future, price/earnings multiples generally contract as investors further discount future earnings streams. Stock dividends will be an important component of investor returns, as they always have been. Only during the decade of the 1990s did dividends contribute less than one-third of the total return of the S&P 500 index. In the 1930s and the 2000s, the dividend stream was an offset to ten-year negative price returns of -41.9% and -24.1%, respectively. Stocks performed in the 1970s, up 76.4% for the decade, but dividends accounted for three quarters of that total return.

Like a car that took a mountain highway curve a touch too fast, our global financial system is too close for comfort to the precipice of insolvency. We have experienced hands at the wheel, however, and we will right the car and avoid disaster. There are curves ahead, but we will approach them with more caution, chastened by our most recent experience. Our financial system went too fast, and we will have to work through the consequences, which include higher taxes and higher interest rates. The stocks and bonds in our client portfolios are positioned to navigate the winding path safely. We will get through these tremulous markets in fine shape.

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