



INVESTMENT
COUNSEL

MARKET OUTLOOK

Third Quarter 2010

Fear has returned to the market, but we find ourselves growing in confidence for the future.

The global stock markets, which looked richly valued at the beginning of the second quarter, look fairly valued now. We find pockets of attractive valuations in the market despite the frustration of investors who participated in the market's 11.5 percent decline during the quarter. The market processed disappointing results on employment growth and home valuation improvement. It processed the dawning revelation that the hope for change in Washington two years ago was misspent in expensive yet ineffective fiscal stimuli. Tea parties rose up in response. Congressional approval is at all-time lows, a remarkable fact considering how the previous Congress dissipated political capital on bridges to nowhere and other activities. With the housing boom fully busted, mortgages difficult to obtain, jobs scarce, the government having no more spending power, how, one might ask, can ZWI be so confident of a brighter future?

We own the stocks of strong companies. We own companies with pricing power. We own companies with exposure to the faster growing geographies and market niches. In a market forecast of lower-than-average economic growth, we own what we believe will be the winners. These quality companies have not enjoyed investor favor because monetary policy was directing investors toward riskier investments by keeping cash and Treasury yields historically low. We are believers in averages, and averages are obtained by taking into account all the observations — including the extreme observations. Treasuries are at historically low levels, and we think they cannot remain there indefinitely. The S&P 500, a leading equity index, has had two periods where it produced a negative compound rate of return for a ten-year period. One time was in the late 1930s, a decade of government participation in the economy to a degree previously unknown in times

of peace. The other is today, which has likewise seen a decade of government participation at historically high levels. Businesses, having seen what happens to companies and industries under the government's visible hand, defer investments when they fear they might become the next target of government action. Their reluctance further dampens economic activity. History is replete with instances when the government rushed in only to make the situation worse, delaying economic recovery until after the government intervention eased. We have witnessed a decade of the government crowding into spheres of private activity on rationales from "too big to fail" to "never let a crisis go to waste."

The people, as measured by opinion polls, recorded their dissatisfaction with Congress and the Administration, leaving the current President with approval numbers comparable to those of his predecessor near the end of his term. Candidates promoting fiscal austerity are trouncing those promising continuation of current policies. Polling data suggest the House of Representatives could move from majority Democrat to majority Republican. A split government would make it quite difficult to continue the current policies of spending now and paying later. A split government would make it harder to progress further down the road of government involvement in business management. It could mark an inflection point that augurs well for private enterprises like the companies whose stocks we own.

We think the stock market currently offers attractive companies with attractive valuations on their shares. Many of those quality companies provide a dividend yield greater than three percent, which is the current yield on the ten-year U.S. Treasury bond. As investors have run for the apparent safety of the U.S. Treasury, they have pushed down its yield to levels not regularly seen since the late 1950s. The financial position of

the U.S. is not quite what it was in the 1950s vis-a-vis the rest of the world. Comparing the fiscal position of twelve sovereign issuers rated AAA, the United States has gross debt that is 90 percent of gross domestic product (GDP), a level matched by France and not far above those of the United Kingdom, Canada, Germany, Austria and the Netherlands, but significantly higher than those of Sweden, Finland, Switzerland and Denmark, which are clustered around the 50 percent level. The structural deficit, the annual spending over tax receipts, is no better. The United States and the United Kingdom are running structural deficits at nearly 10 percent of GDP, which compares unfavorably to most of the other AAA-rated governments' rates of between zero and four percent. We think the U.S. will raise taxes – or allow them to rise when the Bush cuts expire next year – and try to engineer an increase in inflation rates to let it repay debts with depreciated dollars. We are reluctant as bond investors to make a fixed income investment at three percent for ten years when we think the purchasing power of our investment will erode over that span. Stocks, on the other hand, have the ability to accommodate rising prices, which means the three percent dividend yield we might get from a quality company like Proctor & Gamble or Johnson & Johnson could be matched with rising stock prices to keep pace with inflation.

The outlook for economic growth is mixed, so one must be careful in security selection. Broad measures of domestic consumer strength – private payroll growth and home values – are no longer bottoming but neither are they showing a sharp turn upward. Credit continues to contract, and credit is the fertilizer for a blooming economy. We remain under-exposed to the pockets of our economy whose product for sale depends on credit availability. Big-ticket consumer goods and the banking industry that finances their purchase are two such areas. We continue to think businesses will deploy some of their accumulated cash reserves in capital projects they believe will improve productivity, and we remain exposed to those industrials and technology companies that will participate in a capital expenditure phase of

the economy. Employment will pick up in part because companies have squeezed so much from their cost structures already. The path from here is upward sloped, though the slope may not be as steep as we would like. At reasonable valuations with conservative estimates for earnings growth, we have the opportunity to own solid enterprises on which we expect to earn a decent return.

Our outlook for fixed income is less positive because the financial arrangement made when one buys a bond is fixed to maturity. Buying bonds at the low interest rates of today locks us in to low rates until we either sell them or wait for maturity. Since we expect inflation to tick up in the next few years, we are reluctant to make fixed income investments of long duration. Our approach has been to look for special features that protect us from a rising yield curve. Among the safest bonds, we continue to favor U.S. Treasury bonds that provide an inflation protection feature. We have been able to find bonds issued by U.S. Agencies and some private issuers that have a “step-up” feature by which the coupon rate on the bond steps up at certain dates. These bonds will hold their value better in the event of rising inflation.

The temptation is to fly to safety after watching the stock markets decline sharply, but this is the time to see that the future is becoming more positive. The stop-gap measures of 2008 designed to forestall a banking system collapse were just that. The unhealthy consequences of the housing bubble were moved from private balance sheets to the public's balance sheet, and that wound will leak for years to come because we chose not to take the write-down all at once. On the other hand, we have already seen two years pass, and housing prices are not dropping as fast as they were a year ago. They may not go up much for awhile, but sideways is certainly better than dropping. Likewise, payrolls have probably bottomed. Anemic private payroll gains are by definition gains, which is significantly better than the alternative. We think this is what an economic trough feels like. This is the time to be looking to make long-term investments in the market.

Charles L. Abney III, CFA ▪ Tres R. Carpenter, CFA ▪ Krista L. Cosgrove, CFA ▪ Stacey D. Ewing, CFA
Clayton F. Jackson, CFA ▪ John B. Shepard, CFA ▪ Kevin C.H. Yang ▪ Bradford S. J. Young, CFA

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