



INVESTMENT  
COUNSEL

## MARKET OUTLOOK

First Quarter 2009

To state the obvious, 2008 was a terrible year for investors. One must go back more than a generation for a comparable year of market performance. For much of the year, only one investment worked: the price of oil continued to rise from its elevated level on January 1st. Then nothing worked: oil, financials, industrials, consumer, materials, technology all were down sharply from June through October. There seemed nowhere to hide in the equity markets, as foreign markets, emerging markets, and small-caps offered no sanctuary. The flight to safety did make U.S. Treasury bonds perform relatively well, but Treasury yields slid to near-zero levels over the course of the year. In 2008, we saw a massive policy response to the financial turmoil. Again, one would have to go back more than a generation for a comparable policy response. The full extent of that response is as yet undetermined, and that is one of the items we are watching in 2009.

Rather than make specific forecasts, we are sharing with you some of the key questions for the coming year. In addition, we want you to know which signals we think will be indicative of new trends in the economy and the investment markets. One thing is certain after the Emergency Economic Stabilization Act of 2008: government and the economy are deeply entwined. One of our first questions for 2009 is what more will the government do to spur lending activity? Given the breadth of the application of Troubled Asset Relief Program (TARP) funds, it seems the government will stop at nothing to re-ignite lending activity. The Federal Reserve has lowered its target rate to nearly zero, and that move renders moot the most traditional lever of monetary policy.

The next most traditional tool in monetary policy is open market activity, in which the Fed buys or sells bonds – and now other assets – to pump money into or out of the financial industry. Chairman Bernanke has committed to using this tool aggressively. Fiscal policy, in the form of tax cuts or spending programs, will likely play a part. President Bush pushed through Congress a consumer stimulus, though the impact was not as significant as he hoped. President-elect Obama seems committed to more stimulus, though the nature of his plans have not been fully fleshed out. Others in Washington, D.C., would like stimulus through tax cuts for the consumer or for corporations. Another tool available is somewhat technical: changes in the mark-to-market accounting rules could improve the balance sheets of banks and other financial institutions. Such changes could be legislated by Congress or implemented by the Securities Exchange Commission.

All of these monetary and fiscal policy options will be considered, and we expect most to be tried. Some are longer-lived than others. A \$500 check or a payroll tax rebate will have a fleeting impact, while an infrastructure rebuilding program will reverberate more broadly through the economy and last longer. To the extent that Democrats stimulate through spending and Republicans stimulate through tax cuts, we would expect more spending rather than more tax cuts. President-elect Obama certainly said during his campaign, however, that he would cut our taxes. How he and the Congress choose to follow through on that rhetoric is one of the items we will be watching.

Washington will not be our only focus, however. We will look at the spreads between various lending

rates, and a narrowing of certain spreads will suggest an increase on the part of the private sector to extend credit. The spread between government bond yields and corporate bond yields is at its widest point in the past 10 years. A narrowing of this spread would be a positive indicator of increased business credit activity. Somewhat similar to the spread between bond sectors, we will keep an eye on the spread between jumbo mortgages and conventional mortgages. (Simply put, jumbo mortgages are those that are too large for Fannie Mae and Freddie Mac to buy from the mortgage originators.) Since jumbo mortgages are much harder to move off the originating bank's ledger, the spread between jumbos and conventional mortgages is another indicator of the private market's willingness to extend credit.

A more confident banking sector is only one side of a lending transaction. We need a more confident consumer, too. We will be looking for a recovery in employment. The past year has been a drumbeat of significant job losses every month, and the consumer's confidence is tied to his sense that his job is safe. When the monthly payroll employment figures show fewer jobs lost and perhaps even turn positive, the consumer sentiment will improve. The second most significant indicator of consumer sentiment will be a similar change in the direction of home prices. As with employment reports, 2008 has seen a steady decline in the average price of homes. When the change in the price of homes begins to stabilize, consumers will have a stronger sense of where they stand economically and be encouraged about the future. As economic activity begins to improve, we expect to see a recovery in the price of oil from current levels below \$40 per barrel. Payroll employment, home prices, and oil will be our primary indicators for improving consumer sentiment and activity in 2009.

The fixed income markets are intimately connected with economic factors, and they will respond in 2009 to the government's stimulative efforts. One of our regular correspondents introduced us to the phrase "fear bubble," which we think captures the current state of fixed income markets. The Fed has reduced its target rate to nearly zero, and T-bills have been trading awhile now at yields of nearly zero. To accept a zero return, an investor

must view all the other available choices as toxic. The flight to safety in the fear bubble has widened sector spreads to historic levels. The 10-year Treasury note yields less than 2.1%. We do not think that will persist through all of 2009. We expect the spreads to narrow as the Treasury yields climb closer to corporate bond yields. This suggests to us that a trade out of Treasury bonds and into corporate bonds will reward investors.

We must also choose an appropriate maturity for our corporate bonds. The long term impact of the government's reflationary activity will be inflation. The government will get what it wanted: no deflation. We expect it will over-shoot its target and return us to sustained and higher inflation than we have seen in awhile. If we are right, then we would be better served to choose shorter maturities for the corporate bonds we buy with the proceeds from our sale of Treasury bonds. About the time our corporate bonds are maturing, we think the yield curve will reflect the fact that inflation is here to stay. At that point, we would like to buy bonds at yields that incorporate higher inflation expectations.

Economic recovery in the U.S. has historically been led by consumers. The consumer segment represents more than 60% of our gross national product, and once it gets moving it is a powerful force. Most Wall Street strategists are forecasting a fairly quick recovery, but we think the bounce back will be a little delayed and the bounce will be a little lower than in the past. One cannot omit the Baby Boom from any analysis of consumer activity in the U.S. The Boomers got the shock of their lives when they looked at their 401(k) statements in September and October. We do not know how they will react, but they are solidly middle-aged and some are already in retirement. This demographic bulge may show a reduced propensity to consume, to use some Keynesian economic lingo.

While the consumer's recovery may be somewhat attenuated, we think business investment will continue. We never cease to be amazed at the costs businesses are able to cut through re-tooling and technology, and we expect businesses to continue these efforts. While business investment will continue, we do not think it will be financed

with debt. Outside the financial sector, corporate balance sheets are generally strong, with debt-to-capital ratios near 10-year lows. Funding capital improvements out of current cash or free cash flow implies a slower rate of growth, which is what we expect to see.

Applying these expectations to ZWJ equity portfolios, we will put some of our cash reserves to work in companies that have cogent business models, good cash flow, and are financially strong. This is really no change from the characteristics we always look for, but it bears repeating. The dramatic negative returns in the equity market offer opportunities to buy great companies at attractive valuations. A long-term equity investor must look across the valley of recessionary earnings to the more distant, but brighter, future. The U.S. economy will be one of the stronger economies around the globe, so we may look for more domestic opportunities. We think some of the cash hoards on corporate balance sheets will be used to acquire strong companies, so we may look for some smaller companies that would be attractive to an acquirer. As we expect 2009 to be a news-filled year, we think the market volatility of 2008 will continue next year. Buy-and-hold, which had been the winning strategy for nearly 20 years from the early 1980s, may be supplanted by trim-and-round. When the stock price of a good company gets ahead of the fundamentals, we may need to take some winnings even though that means taxes. Likewise, we may see some dips, and we need to move in during times of market weakness.

Our clients with balanced accounts have seen in 2008 how different asset classes can produce returns that are not synchronized. Bonds are good for disinflationary times, for the coupon interest is reliable and the principal repaid has increased purchasing power. Bonds are also good

for uncertain times, for the coupon payments are a steady source of funds. It is possible the U.S. economy returns to positive-but-muted growth rates. In such an environment, bonds will be a positive contributor to portfolios. Stocks, on the other hand, have been a reasonable protection against inflation. Just as bonds provide safety, investors cannot ignore the importance of growth. Equity participation in a dynamic business enterprise provides the flexibility to adjust to changing economic environments. While the bonds in balanced portfolios will protect against deflation, we think the government will eventually get the inflation it wants. In that environment, the bonds provide safety but the equities provide growth and protection against the declining purchasing power of the currency. Our job in the fixed income and equity components of a balanced portfolio is to prepare for inflation ahead of the time when everyone sees it in government statistics.

We apologize for the longer length of this market outlook. If you skipped to the end for a summary, here it is. The new Administration will press ahead with a spending stimulus. Short-term deflationary fear will be replaced by long-term inflationary expectations. Treasury yields will rise as confidence returns to our capital markets. Market volatility will remain elevated as the change in expectations spreads through market participants. We will keep active in client portfolios to be positioned to profit as expectations evolve. We all look forward to a hopeful 2009.

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