



INVESTMENT  
COUNSEL

## MARKET OUTLOOK

Second Quarter 2009

The stock market had a difficult first quarter, but it began to show some signs of recovery toward the end of March. Along with the market recovery, we saw some signs of economic progress. We think those trends will continue, though we do not look for a sharp recovery. Housing prices and employment are likely to post numbers in the coming months that are “less bad,” which is perhaps the beginning of a change into “good.” The U.S. government continues to strengthen the financial sector so that credit will be available, and there are indications that credit is loosening for qualified applicants.

We have previously expressed our view that investors should prepare for inflation on the horizon. In light of all the current signs of retrenchment and falling prices, one might ask for some clarification on our concerns about inflation. The Consumer Price Index (CPI), which captures the change in prices for a broad basket of goods and services, is reporting almost no inflation (0.24% year-over-year as of February). The low CPI numbers in the press seem to confirm what we see. We watch the price of individual goods, such as steel, come down because supply exceeds demand. We all understand that steel prices will go up when steel suppliers feel confident they can push through a price increase on account of all the customers knocking on their doors.

Changes in the broad measure, however, are due to changes in the amount of money or credit circulating in the economy. When the price of not only steel, but labor and milk, goes up, it is a monetary phenomenon rather than a market phenomenon. When something is suddenly more plentiful, we are less careful about using it. Scarcity enforces discipline. This is as true of money and credit as it is of steel and milk. Our monetary system built around the Federal Reserve allows political leaders to take extraordinary steps to direct the economy according

to their goals. In response to the credit crisis of last summer, U.S. policymakers took those extraordinary steps and plan to continue. The U.S. government budget is \$3.6 trillion, and it adds \$2.5 trillion to the government’s current debt of \$10.7 trillion.

To finance this year’s spending, the U.S. government will issue more debt. The question arises, who will purchase the debt? There have been two significant buyers of U.S. government debt historically. One is the government trust that pays out Social Security from its accumulated FICA tax receipts. The other is foreign governments, which have recycled dollars they accumulated through exports to the U.S. If those two purchasers continue to buy U.S. government debt, we should not expect a significant change in yields on Treasury bonds, as the market would remain in balance. If for some reason those two significant purchasers were less willing or able to buy the newly issued Treasury bonds, we should expect Treasury yields to move up until they could attract other buyers.

We see risk to Treasury yields because we do not see the traditional buyers of Treasury bonds able to absorb the increase in supply as they have in the past. Their appetites for Treasury bonds have grown over the decades, but we do not see it continuing to grow. In the 1970s and 1980s, government trusts held 20-25% of the gross U.S. debt, which tripled from \$560 billion to \$1.76 trillion. Over the past decade, the trusts have bought Treasury bonds aggressively. They held about 40% of the gross debt at year’s end. As the Baby Boomers move further into retirement, the Social Security trust fund will be a net spender rather than a net saver. Its appetite for Treasury bonds will diminish.

Like the Social Security trust fund, foreign governments may not have spare dollars to invest in Treasury bonds in the future. Over the past 25 years, foreign debt has

grown from 12% of gross debt to 30% at the end of 2008. In this decade, foreigners have bought nearly 80% of the U.S. government's public debt offerings. Those foreign governments may cut back their purchases for two reasons. First, almost every government around the globe is responding to the current recession with increased spending and other "counter-cyclical" initiatives. Like the U.S., they are spending government funds to get their economies moving again. The second reason is that U.S. imports are down, which means fewer U.S. dollars are going abroad and need to be recycled into U.S. investments. Furthermore, many of the high-growth countries had commodity-based economies. As the price of oil and other commodities declined sharply over the past year, emerging economies were the most affected. Countries like China are working hard to develop domestic demand so as to reduce their reliance on exports to the U.S. and other developed economies. China recently announced a \$585 billion stimulus package of which only \$170 billion will be funded by the Chinese government. Some of China's \$1.9 trillion foreign exchange reserves will have to be tapped to pay the balance of the stimulus in China.

If the government trusts and foreigners are less likely to buy the new issues of Treasury bonds, who will step forward to fund our government spending? It will most likely be our government, in the form of the Federal Reserve. We believe at some point the financial world will see that the Federal Reserve is printing money to buy bonds issued by the Treasury to fund government spending. The general level of interest rates will rise as investors demand higher yields to offset the dilution created by the Federal Reserve's bond buying activities. We expect the long end of the yield curve will react first, as long-term bond investors are most hurt by inflation. Since a significant percentage of the consumer price index is based on housing costs, the sharp decline in housing prices will keep the reported numbers down long after the Federal Reserve's bond buying program kicks off. Eventually, CPI will reflect the reduction in purchasing power of the U.S. dollar.

Because we see inflation increasing, we have gradually been shortening the maturities of our bond portfolios. An example of our increased attention to inflation has been to sell regular Treasury bonds and buy Treasury Inflation Protected Securities (TIPS), which pay a lower interest rate but adjust the bond position size according to moves in CPI. In this way, we can protect our clients from erosion of purchasing power when inflation begins to move through the economy.

Our expectation of increased inflation has led us to construct our equity portfolios with attention to dividend policies and the value proposition of the products sold by our companies. Companies with compelling products are more likely to be able to push through price increases. We have been relatively under-exposed to companies that sell consumer discretionary goods, as we expect consumers globally to prioritize their spending on goods and services that are necessary.

Our anticipation of increased inflation has reduced our market expectations, as inflation has a dampening effect on equity valuations. The long bull market of the 1980s and 1990s was extended in part by the gradual expansion of price-earnings ratios. Good companies growing their earnings sold at higher multiples even if their growth rates did not increase. We expect in the years ahead companies will be able to grow, but we should not count on multiple expansion as well.

We will remain flexible in 2009 as we have in the past, determining what makes the most sense for our clients in the current environment rather than rigidly applying a mechanical process. We were reminded last year that sometimes one must survive in the short term in order to thrive in the long term. Our higher-than-normal cash reserves will find their way into attractive long-term equity and bond investments because those are the asset classes one must be in for the long term. And we will always be glad to talk with our clients about what we see in the investment world and how it might affect their portfolios.

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