



INVESTMENT
COUNSEL

MARKET OUTLOOK

Third Quarter 2009

With an encouraging three-month trend of positive market momentum established, it is time to re-visit our earlier words of caution to see if we should adjust our outlook. The equity market action in the past quarter was impressive. The market upturn was broad; there are few stocks that were down during the past quarter. The market upturn was sharp; there were over 400 stocks that were up more than 35% during the quarter just ended, and the average stock was up 24%.

The market action was due to a number of factors, mostly a general sense that the very worst of the global slowdown had been reached. After a steady pattern of decreasing payroll employment statistics, the numbers seemed to get “less bad.” The financial meltdown seemed to have stopped melting so much, and we even saw banks trying to repay the emergency funds loaned to them by the U.S. Government. Foreclosure notices seemed to have slowed down. Notice that this litany does not include positive news; we saw this past quarter what some observers called a “second derivative” market. The second derivative is the mathematical concept that one can measure the change in the rate of change, so a “less bad” change can be a positive second derivative. If one can forecast on the basis of a second derivative, then one found in the past few months many indicators that the market was heading up and it was time to be invested.

People with longer term memories will recall the trouble we all endured last year thanks to derivatives, and we are not sure a second derivative is less risky than any other derivative. We are encouraged by the recent flow of statistical releases, and the upward revisions to past statistical releases. We agree with the idea that the worst of the economic catastrophe of 2008 is behind us. We recognize that the rate of change has been improving. We are less convinced that we should extrapolate these encouraging data points into a

projection of a new bull market. We remain cautious about the strength of future economic growth.

Let us consider a few of the recently improving indicators and consider how we should extrapolate their trends into the future. Payroll employment is a key indicator. After a numbing sequence of layoff announcements, bankruptcies, and restructurings, American payrolls seem to be finding a bottom. The May data, released in early June, showed a better-than-expected decline of 345,000 jobs. Such a number only looks good if it is compared with the 500,000 and 600,000 declines we saw in the previous months for that statistical series. We look forward to seeing no net loss of payrolls later this year and some positive job gains next year. The key – second derivative – question is how quickly will we add jobs? We think job growth will be positive but modest; which means a gentle upward slope rather than a steep upward slope.

The second major statistic we find important is the ratio of houses to households. The Joint Center for Housing Studies of Harvard University recently released a report titled “The State of the Nation’s Housing 2009.” In that study, the researchers compared the average Owner Vacancy Rate at the end of the last decade with the same rate in 2008. The summary data suggests there are 928,000 more vacant homes than the researchers would expect if the historical ratios held. The U.S. Census Bureau tracks population, housing, and households. For the period between 1965 and 2008, the Census Bureau’s statistics suggest housing has grown at an average rate of 1.7%, and its data show households have grown at the same rate over the same long period. There are always vacant homes, and the 43-year vacancy average is 10.5%.

If we shorten our historical lens a little, the picture is not so balanced. Over the past three years, the average

household growth rate has been 1.0% while the average growth in homes has been 1.6%. Vacancy rates have moved up to over 14%. The Census Bureau's estimate for population growth is less than 1% annual growth, which means we are not forming households as fast as we did in previous periods. It will take longer to work down the inventory of unsold homes because we do not have a pool of new home buyers growing faster than the pool of home sellers. Based on these data, we believe the U.S. economy will be digesting its overstock of homes longer than the market thinks. In addition to the issue of servicing mortgages on houses that remain stubbornly unsold, there is the added cost of maintenance of vacant housing.

Since we believe the indigestion caused by the housing binge of the past few years will remain with us longer than we would like, we are taking a generally cautious view of future growth and positioning our portfolios accordingly. On the bond side, we expect rates to rise over the next five years, but they are not high now. We have to accept the lower yields currently available. Our cautious stance manifests itself in the shorter average maturity of our bond portfolios. There is no need to extend maturities if we expect higher yields in the interim.

On the equity side, we have been preferring strong stable franchises with stocks that pay dividends. The stocks of these companies have not participated as much in the recent run-up; "dividend aristocrats" have trailed the average stock. We think they will "trail" on the way down, too, as the stability of their product lines and the safety of their dividend flows will be viewed positively in a slow-growth economy and a range-bound market. We are also maintaining a little cash buffer, which we can put to use in the event of a pull-back later this year.

Our longer term forecast remains positive. The government actions have stabilized the financial system. In addition to a large spending stimulus, government has expanded its role in the economy with initiatives in health care and environmental regulation. We expect

to see some acceptable compromise. Watching what happened to the auto industry has reminded other industries that government assistance can be a mixed bag. Spending a trillion dollars in stimulus with as yet little infrastructure impact has raised deficits to historic levels and made additional spending politically more difficult. The private sector will adapt to the larger government role in business, and it will adapt more quickly as that role becomes more clearly defined. Americans are increasing their saving, which has a negative impact on consumer spending but augurs well for our future financial stability. Along with the rest of the world, we have taken a mighty blow, but we are picking ourselves up and beginning to move forward in a growth mode.

In other news, Bernie Madoff was sentenced to 150 years in jail for his massive theft of client assets over a 20-year period. There have been many opinions offered on the main lesson to be learned here. Madoff's victims were tricked in part because his investment approach was abstruse, in part because his approach does not work with large asset pools, but mostly because his clients had to rely on him for reports of their assets. Unlike Madoff's clients, our clients can see what they own for themselves. We do not have custody of our clients' assets, only a limited power to make trades in their accounts on their behalf. Our client custodians offer paper reports and web-based access to the accounts independent of the reports and access provided by ZWJ. This double access is the best protection against fraud by an adviser.

Some of the Madoff victims took from their experience that nobody should have all his money with one adviser. We respectfully disagree with that conclusion. A single adviser can often be the best solution for a client, as long as there is trust in that adviser. Having an independent custodian hold client assets is an excellent way to protect clients against fraud. We have always used outside firms to hold client assets because it is the best way to serve the client.

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