



INVESTMENT
COUNSEL

MARKET OUTLOOK

Fourth Quarter 2009

The third quarter was very strong, driving the broad S&P 500 index up 16% and putting its year-to-date return at 19%. Since the end of March, the S&P 500 index is up 34%, which is a welcome turnaround from the market's direction during the first part of the year. Having concluded the world is not headed for disaster, investors have been moving back into riskier asset categories over the past six months.

In the fixed income category, 10-year U.S. Treasury Bonds had the poorest performance this year, down 9.75%. The risk premium, which is the difference between bonds issued by the U.S. government and corporate bonds of the same maturity, was approximately 4.5% at the beginning of the year, and it has narrowed to less than 2% recently. The U.S. government is doing everything it can to keep rates low, and investors have reduced the risk premium they require for bonds issued by corporations and municipalities.

We saw the same reduction in risk premium on the equity side. A reasonable proxy for risk is market capitalization, which is a representation of the size of the company. The Russell 2000 equity index, which is an index of smaller U.S. companies, was up 46% versus the large company S&P 500's 34% gain. Emerging markets outperformed in a similar fashion, another indicator of appetite for risk. Equity investors enjoyed a solid bounce after the dramatic declines of 2008 and early 2009.

The sharp swings in sentiment and market direction over the past nine months remind us of the importance of having a long-term asset mix and remaining faithful to it. The market is a two-headed hydra. It has one head driven by rational expectations of future after-tax earnings streams, and it has one head driven by fear. The market prices in the greatest fears: the fear of having nothing left, which causes some to sell at the market bottom, and the fear of missing the next

long-term move upward, which causes some to buy at the market top. The market also prices assets rationally. When there is a reasonable basis for expectations of sustained earnings growth, market prices will move up. Perceiving sustainability of earnings, investors agree to pay a little bit more.

Our charge as investors is to balance the two heads of the market hydra. In 2008, we removed riskier stocks from equity portfolios and mitigated the impact of the market decline. We let our cash levels creep up while the market thrashed in uncertainty during the finance industry embroglio of late 2008. On the fixed income side, we looked at interest rates and the spreads between different categories of bonds. We made some moves toward "riskier" bonds from U.S. government bonds because the spreads were quite wide. We have been net buyers of equities in 2009, and our accounts reflect our participation in the broad market move up.

Where we traded riskless for riskier on the bond side, we were less comfortable making the same trade on the equity side. Perhaps that has not been the best choice over the past six months, but we think the emotional head of the market hydra might be dominant right now. One of our research service providers makes the case for investing on the notion that fund managers need to beat the benchmark, and they are rushing to put cash to work. We agree there is a rush to catch up, and that rush can move the market higher. We ask what happens when the fund managers have spent their cash? The shares of stable franchises that pay solid dividends – that is to say the shares of companies we like for the long term – have gone up but not as much as the shares of franchises that experienced near deaths in February and March. Amid this emotional fear of being left behind, we look for the reasonable basis for sustained earnings growth.

We see nothing definitive to indicate we are entering a new period of sustained economic growth. We seem to have found an economic bottom, but we are not sure we have moved onward and upward. Real estate, durable goods orders, and employment are three key indicators of our collective financial strength. We can look at each series for an answer to our question.

Recent real estate figures suggest that home prices have stabilized, and they may have even risen in some markets. The Existing Homes Months Supply index shows an improvement from a 10-month supply of homes for sale to 8.5 months' supply, but that better number remains about twice the normal level.

After falling 6.4% in the first quarter, U.S. Gross Domestic Product (GDP) fell only 0.7% in the second quarter. Falling less than the rate of decline in the prior period is an improvement, but the number means the economy is still contracting. Because some series like GDP are quarterly, we look to monthly series for indications of the current quarter. Durable goods orders are a measure of domestic industrial activity and direction. The year-over-year comparisons bottomed in March at -30%, and we have seen signs of sequentially improving comparisons to the August report of -19.1%. Analysts and forecasters are left wondering if the latest report heralds a return to growth in durable goods or is merely a one-time blip due to inventory re-stocking.

At the root of a home purchase or a durable good order is a job, which is why we study the employment report each month. The good news is that we lost only 216,000 non-farm jobs in August, which is a significant improvement over the -741,000 of January and -681,000 of February. On the other hand, the economy has to stop shedding jobs before there can be a period of sustained growth. With 6.9 million jobs lost since January 2008, we will need some time just to repair the damage. We are confident the U.S. economy and the global economy will recover. We have great faith in the energy and goodwill of people in general. The old Monty Python skit with the Black Knight hopping

on one leg while claiming he has suffered but a flesh wound captures something of the indomitable human spirit. Flesh wound or flood, we will recover. We will rebuild. We will get a new job. We will buy a new car some day. We can invest in the future now.

We have confidence in the human spirit, but we invest in stocks and bonds. We continue to favor stable franchises with solid dividend policies because we expect growth rates to be attenuated. Our research uncovers individual companies that are growing well despite the sluggishness of the overall economy. Recently, the majority of companies have been hitting their earnings guidance but missing on their sales guidance. This comes from great cost controls instead of great sales results. We are finding bond yields compressed to the point where equity dividend yields sometimes produce greater cash flow. The higher yields available further down the quality scale do not tempt us; rather, we accept the reality that quality fixed income securities will over the next few years not generate the high returns of past years.

K Street is as important as Wall Street these days, and we watch the ups and downs of Washington, D.C. for signs of danger to our investments. Recent speeches at the United Nations remind us of the need to take foreign affairs seriously. We have to consider how public policy might affect our portfolios, taking opportunities when they present themselves.

Our client portfolios are solid. We own quality companies on the equity side, and we have strong holdings on the fixed income side. We look on the margins for interesting and attractive stocks and bonds, but we will not compromise our commitment to quality. We have some cash in most accounts, but we remain believers in the asset classes. Investing is not a repetitive binary "in-or-out" game; rather, one must adjust the mix of securities and asset classes along the way. We remember who won the race between the tortoise and the hare. We are long the turtle.

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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