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INVESTMENT MANAGEMENT

NEWSLETTER

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THE RECESSION IS MATURING
Now What?

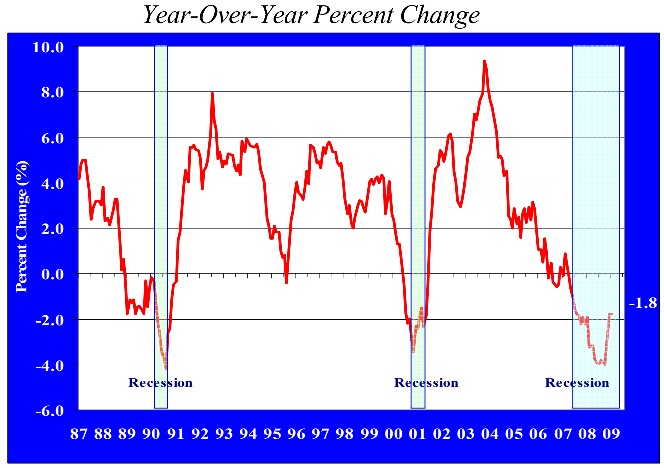
While it appears that a depression will be averted, we are in the midst of one of the worst economic downturns since the 1930's. During the last twelve months, the economy declined as much as 3.6% (Table I). In addition, 6.0 million jobs have been lost and the unemployment reached 9.5%. By way of contrast, the economy declined only 1.4% during the 2001 recession, only 2.9 million jobs were lost, and the unemployment rate peaked at 6.3%.

TABLE I
The Economic Decline
Year-Over-Year Percent Change

Quarter Ending	In Percent
Sep-08	-0.5%
Dec-09	-6.3%
Mar-09	-5.7%
Jun-09 Projected	-1.0% to -2.0%
Estimated Average	**-3.4% to -3.6%**

The Index of Leading Economic Indicators (Chart I) is a composite of twelve data series that leads the business cycle by about a year. This indicator began to stabilize earlier in the year and registered significant improvement over the last two months. This rise has been accompanied by an improvement in orders for manufactured goods, robust money supply growth, and massive Federal stimulus flowing into the economy. On this basis, the trough in this economic cycle is expected during the second half of 2009.

Chart I
Index of Leading Economic Indicators
Year-Over-Year Percent Change



The vitality of the recovery, on the other hand, will be constrained by the loss of trillions of dollars in household net worth associated with the plunge in real estate values and the worst bear market in stocks since the 1930's. Moreover, consumer spending will remain sluggish due to more stringent credit standards, an increase in savings rates, and a weak employment environment, all of which will temper the economic recovery. Growth for the second half of this year may only approach the 1.0% - 2.0% range, in contrast to the usual 4% - 6% acceleration that normally follows a recession.

Later in 2010, however, the growth rate should accelerate to 2.5% - 3.5% as the recovery gains momentum.

The outlook for corporate profits is more favorable. Profit margins are now at their lowest levels since 1994; however, corporations are entering the recovery with a leaner cost structure, and the growth in stockholder earnings will be substantially greater than the growth in the economy. For example, earnings growth could average in excess of 20% annually during 2010 and 2011.

INVESTMENT STRATEGY

The early March low in the Standard & Poor's Index appears to have been the trough for this bear market. Recoveries from such troughs normally occur in stages. During the initial recovery, there is a sharp acceleration from the lows such as the rally seen over the last four months, although such gains are usually accomplished over a longer period of time.

Looking forward, investors face a challenging set of asset allocation alternatives:

- Cash reserves offer low risk but extremely low returns due to monetary stimulus and continuing economic uncertainty.
- The yields on investment-grade bonds are substantially better, but future returns from this sector could be at risk due to the surge in the Federal debt, aggressive money supply growth, and resulting inflation fears.
- Stocks still have substantial recovery prospects, but there is the near-term risk that the rebound from the March lows may be somewhat aggressive and pre-mature compared to the expected acceleration in the economy.

Nevertheless, the longer-term outlook for further stock market gains is favorable. Strong earnings gains next year and a current benign interest rate environment suggest that stocks present a favorable risk/return profile. Table II compares the projected value range for the Standard & Poor's Index for the balance of this year and 2010 to the prior two recessions. The downside exposure for the balance of this year is modest compared to a potential double-digit upside gain. For 2010, the range of 973 – 1242 suggests a high likelihood of favorable stock market returns over the next 18 months. On this basis, short-term pull-backs in the stock market should be used as an opportunity to further increase equity exposure.

Table II
Projected Value Range for the Standard & Poor's Index
Recessionary Valuation Analysis

Standard & Poor's Price	06/30/09		913	
			ESTIMATE	
	1990-1991	2001-2002*	2009	2010
Current Price-Earnings Ratio			*15.6*	*13.6*
Peak Price-Earnings Ratio*	19.4	26.1	18.5	18.5
Trough Price-Earnings Ratio *	15.5	17.0	14.5	14.5
EMFA Estimated Earnings			$58.37	$67.12
Value Range High			1080 **	1242
Value Range Low			846 **	973
Potential Upside			18.3%	36.0%
Potential Downside			-7.3%	6.6%

*Recession occurred in 2001, stock market troughed in 2002

** Expected targets for 2nd half of 2009

The outlook for the fixed income sector is less compelling. With 30-day Treasury Bills yielding less than .2%, it is difficult to imagine a further easing in monetary policy. The current interest rate structure is a product of the recession, aggressive monetary stimulus, and abnormally low inflation rates. Once those conditions normalize, there should be upward pressure on interest rates. In just the last three months, the ten-year Treasury yield rose from 2.7% to 3.5%, causing its market value to decline in excess of 6%. Thus, purchases of fixed-income securities should be undertaken gradually, recognize the risk/return prospects within its various sectors, and consider that higher yields may be available later in the economic recovery.