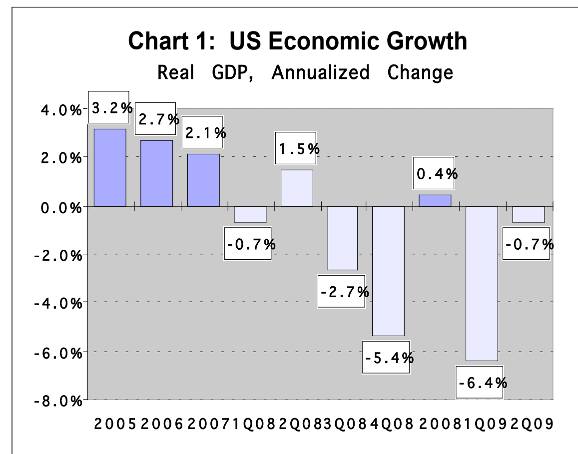
Investment Update
Third Quarter 2009

Economic Developments

Since March, when the news finally stopped getting worse and the first signs of a tentative economic recovery began to appear, conditions have improved dramatically. After fears of a complete collapse of the financial system began to fade during the spring and credit markets began to function again, what started as economic "green shoots" have grown into more sturdy plants. During this September, the economic data releases have brought news that has usually been better than expected, and charts of these data series have strikingly similar V shapes.

US real economic growth during the second quarter of -0.7% was just reported. While the economy was still shrinking at that time, the rate of decline was not nearly as bad as during the previous two quarters. Given the increasingly positive data since then, it seems very likely that positive growth has resumed during the third quarter.



To review a sample of the improving data, we follow the lead of Paul Kasriel, Chief Economist at Northern Trust, who is regularly recognized for the accuracy of his forecasts. He finds that the following indicators reliably mark the ends of recessions when they show sharp changes in direction:

- The Production Index component of the ISM Manufacturing Index, which bounces sharply near the end of recessions. Like many other measures of economic activity, the PI component collapsed late in 2008 to the low 30s but has recently bounced to 52.9 in June, 57.9 in July, and 61.9 in August. Likewise the New Orders component of the ISM Manufacturing Index, which has improved from below 30 late last year to 64.9 in August. (Broad measures of activity in the larger non-manufacturing economy are also improving, though they do lag the rebound in manufacturing somewhat.)
- Outplacement firm Challenger, Gray & Christmas adds up announced corporate layoffs each month. Mr. Kasriel looks at the change in announced layoffs year-over-year. This indicator usually peaks during recessions, then declines sharply as recessions end. Compared to the same month last year, September 2009 layoffs were 50% lower.
- Initial Claims for Unemployment Insurance is complied by the Department of Labor from data supplied by the 50 states. Again looking at the year-over-year changes, first-time unemployment claims peaked earlier this year at levels more than 90% higher than one year earlier, but have been steadily declining and now are only about 20% higher than a year ago.

Now that it seems likely that the deepest and longest recession since WWII is over, what sort of a recovery can we expect? We discount the likelihood of a double-dip recession for a number of reasons.

The improvement in economic activity that we have seen so far this year is sufficiently broad-based that continuing recovery is probably not dependent on temporary measures like Cash-for-Clunkers or tax credits for home buyers. Commercial real estate loans, which will be an ongoing problem even in an improving economy, will probably not impact the banking system as a whole to the extent that residential mortgage problems have, as commercial mortgages outstanding equal only about 20% of residential mortgages outstanding. Employers likely cut too many jobs as the economy slumped and will begin

rehiring once a clear recovery is underway – remember that employment lags the overall economy. Finally, the Fed is unlikely to tighten monetary policy for quite a while.

The economy still faces familiar headwinds that probably mean a relatively slow recovery. A greatly expanded economic role for the government almost certainly hampers growth. A recovering, but still weak banking system continues to be stingy with its credit - if banks can't or won't supply the necessary loans when demand for credit revives, that will constrain growth. Consumers are predictably saving more after living beyond their means, and while that may be a healthy development in the long run, in the short run growth will have to come from other activity.

Fortunately, the prospects for U.S. economic growth are improved by what has happened in the rest of the world, and the outlook for growing U.S. net exports is good. Growth in much of the rest of the world, especially in the emerging markets, has held up much better than in the Old World of Western Europe and the U.S. Rising standards of living in the developing world mean growing demand for everything from agricultural products to pharmaceuticals to capital equipment to technology and services. The U.S. is well-positioned to capture export market share over time. Other more export-intensive countries such as Germany and Japan have rapidly aging populations that will consume an increasing share of their resources, meaning less investment in export-related industries.

Equity Markets

Stock markets have continued to rally strongly, recovering from the depression-scenario discounts that collapsed every market following the bankruptcy of Lehman Brothers in September 2008. Companies have generally done a very good job of cutting costs as revenues weakened in the recession, and profits in both the first and second quarters have consistently beaten expectations. But investors are questioning how much more growth can come from cost-cutting. Profits in the upcoming reporting season may well beat expectations again, but unless companies begin to indicate that their end markets are improving or report profit growth that comes at least in part from improving revenues and not just cost-cutting, it is hard to see how stock prices move much higher in the short run.

Table 1: Equity Index (Percentage Price Change)

	2008	3Q 2009	2009 YTD
S&P 500	-39%	15%	17%
NASDAQ	-41%	16%	35%
MSCI EAFE	-45%	19%	26%
MSCIEmergingMkts	-50%	21%	56%

Because there are strong signals that the recession has ended, there is a good chance that end-market conditions are improving and that the improvements will be much more visible by year's end. By then, revenue growth may begin to support higher earnings growth.

With numerous headwinds still facing the U.S. economy, we are looking for opportunities to add investments outside the U.S. where growth prospects are better. Within the U.S., companies with significant overseas business, particularly those whose commodity-related businesses would provide some protection against inflation, are also attractive.

Fixed Income

The most obvious feature of today's bond and money markets is low yields. Short-term investments yield little more than zero, rates all along the yield curve are close to historical lows, and U.S. Treasury obligation yields relative to comparable corporate yields are extremely low. The past few months have seen huge money flows out of money market funds into longer-term bond funds as investors search for more yield. While it is tempting to chase extra current income in this environment, longer-term bond investments carry more interest rate risk. With rates as low as they are now, higher rates at some point are a reasonable expectation. At the moment, the Fed is on hold and inflation is not a headline risk, but at some point that will change. If higher interest rates result from Fed actions or changed inflation

expectations, principal losses on longer-term bonds could more than offset the additional income they produce now.

Rather than taking on more interest rate risk by moving into longer-maturity bonds, we prefer to maintain relatively short average maturities in our bond portfolios and not be in a hurry to reinvest proceeds from maturities. It is often possible to improve yields somewhat by adding high-quality corporate bonds and the new taxable Build America municipal bonds. Also, tax-exempt municipal bonds can still improve after-tax yields for high-tax-bracket investors, but municipals in general are no longer the bargains they were earlier in the year.

The information contained in this report has been taken from trade publications, statistical services and other sources, which we deem reliable. We do not represent that it is accurate or complete, and it should not be relied upon as such. Any opinions expressed herein reflect our judgment at this date and are subject to change.

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