



## O'BRIEN MANAGEMENT QUARTERLY REVIEW

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### Economic Overview

**By Mary Jo English**

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It appears that the U.S. economy is at an inflection point, making the transition from recession to slow growth. The two major government programs of the past year, the fiscal stimulus package and the Federal Reserve's herculean monetary policy interventions, have brought an end to the year-and-a-half long Great Recession and placed the U.S. on a path to economic recovery. Economic growth is likely to be positive for the second half of this year, business profits are improving, declines in the housing market have stabilized, individual and company balance sheets are being restructured and the stock market has surged as some "animal spirits," or increased risk-taking, have returned to the financial markets. However, growth will be slow because of continued retrenching by consumers and continued job losses.

#### BALANCE SHEETS

The Federal Reserve's various programs have reduced interest rates and lessened the credit crunch. Companies have been able to raise capital again. Record amounts of money have been raised in the corporate bond market this year. The loosening of the credit crunch has provided non-financial companies the opportunity to restructure their balance sheets. A growing number of firms are finding they can raise capital at economically appealing levels and exchange short-term debt for longer-term debt. Steadily improving profits will improve corporate interest coverage ratios, that is, the amount of money firms dedicate to servicing their debt. This means non-financial companies' fundamentals will get stronger.

Despite government assistance and increasing corporate and individual creditworthiness, many banks still have weakened balance sheets themselves and seem reluctant to lend. Consequently, while the cost of credit has declined, the availability of bank credit remains tight. While some banks have significantly improved their own

capital positions, others still have too many bad loans on their books and are conserving capital. In particular, there are increasing failures among small banks caused by large exposures to bad commercial real estate loans. Consequently, banks are maintaining conservative lending policies, limiting the supply of affordable credit to the economy.

Individuals, whose consumption accounted for more than 70% of U.S. Gross Domestic Product (GDP) growth during the past decade, also need to improve their balance sheets. During the boom years, consumers took advantage of cheap and plentiful credit as well as the equity in their homes to finance consumption. Bank of America estimates that the "upper class," or households in the 90<sup>th</sup> to 100<sup>th</sup> income percentiles, increased its debt-to-income ratio from 80% to 110% over the past two decades. They also estimate that the "middle class," or households in the 40<sup>th</sup> to 90<sup>th</sup> income percentiles, increased its debt-to-income ratio from 100% to 200% over the past two decades. Clearly, households took on too much debt. During the Great Recession mortgage defaults and credit card delinquencies soared as consumers found credit unaffordable or unavailable altogether.

Consumer deleveraging has begun, but it may mean different things for the "upper" and "middle classes". Over the past year the number of outstanding credit cards has declined and household borrowing to disposable income ratios have improved. For the "upper class" deleveraging is likely to be modest and have little impact on their spending. However, the "middle class" has a much greater debt burden to unwind. It seems likely that as "middle class" American consumers are forced to save, reduce debt, and live within their means, they will also significantly reduce consumption. This will affect U.S. economic growth. In 2007, the "upper class" contributed 42% of consumer spending while the "middle class" accounted for 46%. It remains to be seen if the "upper class" half of consumer demand, on its own, will be able to support even a moderate consumer-led recovery.

## HOUSING MARKET

Housing prices and activity have recently improved but remain vulnerable to the risk of individual real estate foreclosures. Government programs like the housing tax credit have improved housing affordability and spurred demand. The Fed's purchases of mortgage-backed securities has reduced mortgage rates, which now hover at 5% for a 30-year conforming loan. Thus, the Fed's programs and efforts have allowed interested individuals to borrow at cheap rates. The S&P/Case-Shiller 20-city home-price index, a gauge of U.S. home prices, rose in July from June, the third straight monthly increase. Prices remain below year-ago levels. Robert Shiller, a Yale economist, expects that prices will move sideways for several years as the recently-installed government programs to support the housing market are eliminated and replaced by private demand. Housing inventory volume is declining, indicating that private demand is slowly increasing. However, there is considerable worry that the "shadow" inventory -- anticipated or potential future foreclosures -- could, if realized, cause a surge in supply and renew strong downward pressure on housing prices.

### BUSINESS PROFITS, THE STOCK MARKET and ANIMAL SPIRITS

The stock market fell 57% from its 2007 peak to its March 9, 2009 trough. Since the low, the market has rallied more than 50%. Never before has the market rallied this far, this fast. It is clear that "animal spirits" or risk-taking and confidence have returned to the stock market. One example of how the markets have thawed is seen in the recent number of initial public stock offerings (IPOs). In the six months after Lehman went bankrupt, there were only two IPOs in the U.S. In only the last week of September 2009, there were seven IPOs.

However, the market's value is still 30% below its highs, and will require a continued strong rally to reach its old highs. Does the market deserve to rally further? Some investors are doubtful as many valuation metrics indicate a fair-to-overvalued market. The near-term direction of the market will depend on future earnings. One of the key catalysts to the stock market's recent six-month surge has been an improvement in corporate profits. S&P 500 company profits are still expected to decline over 20% in the third quarter (Q3) of 2009 relative to Q3 2008, but this is considerably better than Q1 2009, when profits fell by 36% relative to Q1 2008. A majority of companies have beaten analyst earnings estimates in the past two quarters and this has lifted stock prices higher. Many people expect the trend of earnings announcements beating expectations to continue. However, it is

important to note that the majority of recent profit improvements have come as a result of cost cutting and not as a result of an improvement in sales. It will be difficult for firms to sustain profit improvements for long through cost cutting alone. Government stimulus spending is helping to support sales by compensating for depressed consumer demand; for example, the Cash For Clunkers program generated 700,000 vehicle sales. Stronger than expected sales driven by private demand would be a welcome development in Q3 and Q4 2009 earnings announcements and could signal a sustained market rally.

## UNEMPLOYMENT

A concern of the Federal Reserve, businesses, and individuals, is the rising level of unemployment. There have been nearly eight million jobs lost since employment peaked in 2007. For context, there were two million total job losses during and after the 2001 recession. The prime age male unemployment rate is at a record high of 10.4%, up 6.5 percentage points from the beginning of the recession. In comparison, during the 1981-1982 recession, the prime age male unemployment rate peaked at 9.3%, rising 4.2 percentage points during the recession. According to the NY Times, job seekers now outnumber job openings six-to-one. Unemployment is a lagging indicator, and unemployment rates will continue to rise even as the economy recovers. Businesses will be reluctant to hire until they forecast sustained improved demand for their products. Wage growth has declined in this environment.

## PROGNOSIS

The U.S. is on a path to recovery. GDP growth will be marginally positive this year and next. Government support has been a large contributor to the growth turnaround story. Government programs are providing some support while the underlying economy restructures and regains its footing. Without the extension of unemployment benefits, consumer spending and economic growth would likely have declined further. The economy would probably still be in recessionary mode if not for programs such as these. Once this support is removed, other segments of the economy will need to step in and fill the void. There are some signs in the housing market, the stock market and in corporate America that confidence is building. Large numbers of U.S. consumers, however, will remain hamstrung by their debts and decreased net worth. The key variables contributing to U.S. growth will likely look different over the next few years than they have over the past decade as we are likely to rely less on U.S. domestic consumption.

## Market Update

By Allison S. Gates

Investment Research Associate

During the third quarter of 2009 the equity market continued to surge from its 13-year low on March 9<sup>th</sup>. Our portfolios took part in this exuberant rally, making significant gains in both stock and bond funds. Throughout the quarter a few themes emerged. First, value stocks of every size outperformed growth stocks. There are many factors that contributed to this outperformance, but one important factor is the impact created by the fall and subsequent rebound of financial companies, which are traditionally considered value stocks. A second theme was the dramatic recovery of low-quality stocks as opposed to high-quality stocks, partly reflective of investor willingness to take more risk. Lastly, on the fixed income side, our main holdings produced stellar returns, validating our decision to buy them last year.

During the severity of the crisis, financial stocks fell further than stocks in all other sectors, and when investor sentiment changed post-March 9<sup>th</sup>, financials rallied more than all other sectors. This is illustrated by the Vanguard Financials ETF. From the collapse of Lehman Bros. on September 15, 2008 through the low on March 9, 2009, the Vanguard Financials ETF plunged 66% whereas the S&P lost 46%. In contrast, from March 9, 2009 through the most recent peak on September 22<sup>nd</sup>, the Vanguard Financials ETF gained 126% whereas the S&P gained 58%.

Stocks of all styles and sizes have participated in the rally, and our stock mutual funds have been no exception. On average, each of our funds gained about 20%. Given our current economic outlook, that includes the likelihood of both ups and downs, we prefer to invest in funds with a high-quality bias, which means that the fund managers invest mainly in companies that have financial strength and that avoid significant leverage, or borrowing. Because of our preference for high-quality investments, a few of our funds underperformed their respective category indices this quarter as the most striking gains came from low-quality stocks. Typically in low-quality rallies, the indices, which are comprised of an entire universe of stocks in a particular category, outperform actively-managed funds, whose managers often become defensive and emphasize stocks of the highest quality. In talking with our mid-cap and small-cap value fund managers about their most recent underperformance, most of them remind us that their funds generally lag in rallies led by lower-quality stocks. They position their funds to

outperform the index over a full market cycle and history has shown their success.

On the other hand, a number of our stock funds outperformed their respective indices through a combination of strong stock selection and an allocation to international holdings. One example is the Dodge & Cox Stock Fund, which returned just under 20%, besting its index, the Russell 1000 Value. The managers of this fund invest with a three-to-five-year time horizon. Thus, though some of their stocks participated in the low-quality rally, they expect these same stocks to be good investments over the long-term despite any recent distress.

In the fixed-income space, it is worthy to note the performance of our principal fixed-income holdings: the Vanguard Short-Term Investment Grade Bond Fund and the PIMCO Total Return Fund. Both funds handily outperformed the Barclay's Aggregate Bond Index this quarter. The performance of both funds on a year-to-date basis is truly impressive; each fund has gained slightly over 12% so far in 2009. This reflects the partial restoration of the fixed income markets that has occurred after the worst of the credit crisis passed.

Index Performance		
Stock Indexes	Q3 2009	One Year
<i>S&amp;P 500 (Large U.S. companies)</i>	15.62%	-6.91%
<i>Russell 2000 (Small U.S. companies)</i>	18.64%	-9.89%
<i>MSCI EAFE (Large Foreign companies)</i>	19.52%	3.80%
<i>MSCI Emerging Markets</i>	21.04%	19.44%
Bond Indexes		
<i>Barclays Aggregate (U.S. bond market)</i>	3.74%	10.56%
<i>Barclays Corporate Index</i>	8.12%	21.77%
<i>Barclays High Yield</i>	14.22%	22.34%
<i>Barclays Municipal</i>	7.12%	14.85%
<i>Barclays 3-month T-Bill</i>	0.05%	0.32%
Alternative Asset Indexes		
<i>Barclays TIPS Index</i>	3.08%	5.67%
<i>Dow Jones-AIG Commodity Index</i>	4.24%	-23.71%

Given our current economic outlook, which includes slow growth for the near term, we believe that it is important for our investments, both stock and bond funds, to be focused in high-quality companies. The management of these companies emphasizes the importance of financial stability and modest levels of debt. Such investments are pre-positioned to experience stable growth in the upcoming period in which borrowing on a large scale will be reduced. We will continue to monitor the progress of the economy and the markets, making changes to portfolio positions where appropriate and prudent. Thank you for your ongoing trust and confidence.

### The O'Brien Management Investment Committee

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