



A N D E R S O N
H A G L A N D
& C O M P A N Y

NEWS & MARKET ANALYSIS: 3Q 2009 | OCTOBER 15, 2009

“The Great Recession” (but not “The Next Depression”)

Capital markets continued to improve in the third quarter. The S&P 500 stock index had its second consecutive +15% quarter, and bond markets provided positive returns due as interest rates fell. Steady improvement in the mix of economic news and the vast liquidity created by the Federal Reserve are the key elements in the developing storyline.

STOCK AND BOND MARKET RESULTS

	3rd Quarter	2009 First Half	Year to Date
S&P 500 Stock Index	15.6%	3.2%	19.3%
Salomon Medium-Term Treasury Bond Index	1.6%	-2.5%	-0.9%
Merrill Lynch 3 to 7 Year State Muni G. O. Index	3.9%	2.5%	6.6%

The dominant economic theme of the spring and summer has been relief that the “Great Recession” appears increasingly unlikely to turn into the Next Depression. Stocks have benefited from a rebound in manufacturing activity. Home prices have stabilized or ticked up in most parts of the country, and consumer confidence has bounced off the lows of last spring. Earnings estimates for public companies have risen as corporate managements have done a better than expected job of cutting costs and maintaining margins.

Bond prices have benefited both from the improved economic news, which has encouraged investors to buy riskier debt instruments, and from a lack of inflation that has led to lower bond yields and, therefore, higher bond prices.

THE WALL OF MONEY IS TALLER THAN THE WALL OF WORRY

On Wall Street they say that bull markets climb a wall of worry. In the current market, however, it seems more apt to say that a wall of money has overcome the wall of worry. The Fed has pushed interest rates so low and has pumped so much cash into the banking system, that, in a sense, investors have been forced to put aside their worries and to invest in risky

assets. When the economy froze up last fall, the Fed lowered its short term interest rate target to a range of 0.00% to 0.25%. This near zero rate gave trillions of dollars parked in money market funds a good reason to start looking for better returns.

To lower longer term interest rates, the Fed committed to purchase \$1.5 trillion of Treasury and mortgage related bonds. These ongoing purchases are providing a home for new mortgage loans, which are repackaged into bonds and sold to the Fed. They also provide demand for bonds, which keeps bond prices up and interest rates low. Importantly for asset prices in general, the purchases have allowed the Fed to flood the banking system with new money. The Fed is a unique buyer because it has the ability to pay with cash created out of thin air or, more precisely, through a few keystrokes. This newly created cash arrives in the seller's account earning today's short term interest rate of close to zero.

To do better, the seller must buy an asset that is riskier than cash. Normally, real estate would be an asset class that would benefit from all this money looking for returns. This cycle, however, real estate has been sidelined because lenders are unwilling to provide the financing that is necessary to do deals. As a result, stocks, bonds and commodities have been big beneficiaries of the quest for higher returns.

STOCK MARKET STRATEGY

We feel the stock market is at a transition point. After the dramatic decline that ended in early March, stock prices have bounced more than 50%. This rebound has been supported by a stabilized economy and a better backdrop for corporate earnings. The rebound appears also to have been enhanced by the wave of money finding its way into asset prices. Stock prices reflect an optimistic outlook about the way things will go from here, but that is not a surprising outcome given the amount of money looking for above zero returns.

In this context, we are beginning to reposition stock portfolios. For the last two quarters, our portfolios have been overweight economically sensitive industrial, energy and technology stocks. This has worked well, and these stocks have appreciated dramatically as the economy has stabilized.

As we look forward, we believe that the economic recovery may not live up to the optimism reflected in the prices of the more cyclical stocks. The economy has stabilized, but we are skeptical about its ability to resume the 3% inflation adjusted growth the U.S. enjoyed the last 30 years. Growth over that period was enhanced by an accumulation of household debt that now will need to be paid down or grown into. Either way, the economy looks set to grow at a slower rate, and we are looking for companies that will outperform in that environment.

Three themes are interesting in this context. First, companies with strong franchises that are economically resilient. Second, companies in sectors that we believe will receive sustained support from the government. For example, home improvement retailers appear attractively priced and are beneficiaries of increasing transaction volumes of existing homes, which the government is supporting through tax credits as well as through its mortgage bond purchases. Third, companies with exposure to more rapidly growing foreign economies. Many of these are the same multinational industrial companies that have done well in your portfolios,

and their international prospects combined with their valuations may lead us to hold some of them further into the cycle.

BOND MARKET COMMENTS

Our bond logic and positioning remains largely unchanged from last quarter. We continue to take advantage of the higher yields available on longer maturities and have generally reinvested bond cash ten to fifteen years out on the yield curve.

Inflation continues to be the primary concern among bond investors. The lowering of interest rates and the printing of money by the Federal Reserve has created the conditions for accelerating inflation. It does not necessarily follow, however, that there is a high likelihood of inflation occurring (witness Japan's experience 1989-2009), and despite continued stimulative actions by the Fed and massive borrowing by the Treasury, inflation expectations as reflected in the bond market fell in the third quarter.

As we wrote last quarter, there is an unusual amount of slack in the labor market and in the manufacturing sector, and we believe some of this excess capacity needs to be put back to work before we will see prices of goods and services accelerate. Additionally, the ongoing reduction of debt by households is a very deflationary activity. At a broad level, the borrowing by the Treasury and the liquidity created by the Fed are designed to counter this retrenchment by consumers. Until there is more evidence that the government has overshot its goal of offsetting weak demand in the consumer sector, we do not believe inflation expectations will take off.

Finally, bonds play a valuable diversifying role in portfolios. If the U.S. economy drifts into deflation, bonds will be the asset with the most potential to create wealth for investors. For example, in a period of -1% deflation, a Treasury bond that yields 3% creates real spending power at the rate of 4% per year. That would be an outstanding result in a deflationary context that would likely cause negative returns for most other asset classes.

ADDITIONAL COMMENTS

We encourage our clients to reflect upon their reaction to events of the past year and whether current circumstances support the asset allocations in place. If you would like to initiate discussion about your situation, please give us a call.

Last month we launched our firm's new website, which we invite you to visit. Please share any thoughts or comments you have about the site, and please share the address, www.ahco.com, with anyone you believe would be interested in learning about Anderson, Hoagland & Company. Lastly, find enclosed copies of our Privacy Policy and our Proxy Voting Policy which we are required to send to you annually.



A N D E R S O N
H O A G L A N D
& C O M P A N Y