

# INVESTMENT OUTLOOK

## First Quarter 2009 Review and Outlook by Whitney Brown

- ◆ Stocks rally in March, but finish down for the quarter.
- ◆ Feds pull out the stops to revive credit markets.
- ◆ Economic news continues to be grim.
- ◆ Households saving money, reducing debt.

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After a very rocky January and February, the stock market rallied impressively for most of March. From the lows, the major indexes advanced nearly 20% through the end of the quarter. Even with a very strong March, returns for the quarter were solidly negative. Most major market indexes saw double digit declines with the notable exception of the NASDAQ Composite that was down only 3%.

It is only natural to be skeptical of any positive action in the markets. The painful decline of the past year and a half has conditioned most of us to expect the worst. The March rally has carried through to early

April, and the nature of the current advance does seem to be more positive than the October and November bounces. The better performing areas in the first quarter included the technology-heavy NASDAQ, emerging foreign markets and growth stocks. Historically, stronger performance in these segments has been consistent with markets in recovery as opposed to continuing decline.



Another plus has been the stabilization of the financial sector stocks. Since they are a very significant weight in the market indexes, many market watchers have felt that the market really could not get turned around without the participation of the bank and insurance stocks. The pie charts on page 3 illustrate the sharp contraction in the value of the financial sector over the past year. It may be that the worst case scenario has finally been factored into current price levels and that future developments no worse than expected could be considered positive.

While some encouraging signs have surfaced for the markets, the economic news continues to be very grim. Most indicators of economic activity and employment remain at very low levels. The optimistic spin on recent data is that the rate of deterioration may be slowing. And, relative to the rest of the developed world, namely Europe and Japan, the U.S. is least impaired and likely to enter recovery sooner.

Recognizing the risks to the economy, the Federal Reserve and the Treasury have made it clear they will stop at nothing to revive the credit markets and reinvigorate the appetite for risk taking. The myriad

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<u>Market Measures</u>	<u>1<sup>st</sup> Qtr</u>		
S & P 500	-11.0%		
Dow Jones Industrial Average	-13.3%		
NASDAQ Composite	-3.1%		
Russell 2000	-14.9%		
MSCI EAFE	-14.6%		
Barclays Capital Aggregate Bond Index	0.12%		
	<u>3/31/09</u>	<u>12/31/08</u>	<u>3/31/08</u>
10-Year Treasury Bond Yield	2.68%	2.24%	3.43%
Three-month Treasury Bill Yield	0.21%	0.13%	1.38%

## First Quarter 2009 Review and Outlook (continued)

*(Continued from page 1)*

programs launched in recent months are all intended to shore up bank capital and restore confidence to and in financial institutions. Some may be working better than others, but the Fed and Treasury have definitely decided to “go big” in the belief that overwhelming force will be needed to keep this global credit bust from triggering a deflationary spiral that would be very difficult to reverse.

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Over the decades of boom and bust cycles since World War II, the Federal Reserve has managed to renew economic growth by manipulating short-term interest rates and the money supply. They will most likely succeed again this time, but there are reasons to think any recovery will be tepid. There is simply no getting around the tremendous decline in wealth from the double whammy of the housing bust and the worst bear market in a generation. Home equity credit lines and cash out refinancings are no longer reasonable options for spending beyond our means. Few investors could feel confident that regular capital gains will be available as disposable income. Households and small businesses have no choice but to reduce debt and save more money. The lack of demand for credit could persist for quite some time.

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The successive cycles of restarting the economy with easy money have thwarted much of the cleansing effects of recessions and allowed inefficiencies to build up in the system. Mitigating the damage from a burst asset bubble has usually led to another one somewhere

else. No one can know exactly where the next problem lies, but there will be unintended consequences of the massive increase in federal borrowing and spending. At minimum, we could expect higher long-term borrowing costs as the government will eventually have to offer higher rates to induce investors to purchase its debt.

A serious long-term issue that may develop after the near term crisis is under control is how governments, after flooding the system with liquidity and dropping interest rates to rock bottom, can prevent runaway inflation once economic growth resumes. The fear is that withdrawing the stimulus too soon could snuff out a nascent recovery, or that leaving policy too easy will create a bubble somewhere else.

Another concern involves the future of the U.S. dollar as the world’s reserve currency. Chinese officials have pointedly suggested that the world needs an alternative to the dollar, but at present there is no viable

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candidate to fill that role. No economy other than the U.S. is large enough to absorb the massive surpluses generated by the high-growth, export-driven Chinese economy and the tremendous oil revenues from the world’s oil-exporting nations. However, if the U.S. cannot get its financial house in order with regard to deficit spending and effective regulation of its financial system, the calls for an alternative may grow louder.

These are all problems for the years ahead. Closer at hand, the massive monetary and fiscal stimulus at work is bound to have a positive impact on economic activity. It is both encouraging and remarkable how much the global economic powers are emphasizing a cohesive and coordinated response to the ongoing credit crisis and recession. The timing and degree of any salutary effects are open to much discussion. As lagging indicators, unemployment and corporate earnings will continue to worsen even as the economy begins to grow again.

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## Change Coming for Financial Services Industry Regulation

The recent upheaval in the securities markets has all but guaranteed that change will be coming to the regulatory framework governing the financial services industry. Currently there are two different types of financial advisers governed by different regulators and different rules. Stockbrokers and salespeople who usually work for the large well-known financial firms constitute one group, and investment advisers and financial planners who typically work independently or for small firms represent the other. Congressional hearings and the drive to reregulate the financial industry have

advanced the concept of a single regulatory format to cover both groups. The ongoing discussion has highlighted important distinctions between the two broad categories of financial services providers.

Brokers are regulated by the Financial Industry Regulatory Authority, or FINRA. FINRA is sponsored by the brokerage industry itself. Under FINRA, brokers must recommend investments that are considered suitable for the client. As outlined in a recent column by Jason Zweig in the *Wall Street Journal*, suitability does not consider the cost-

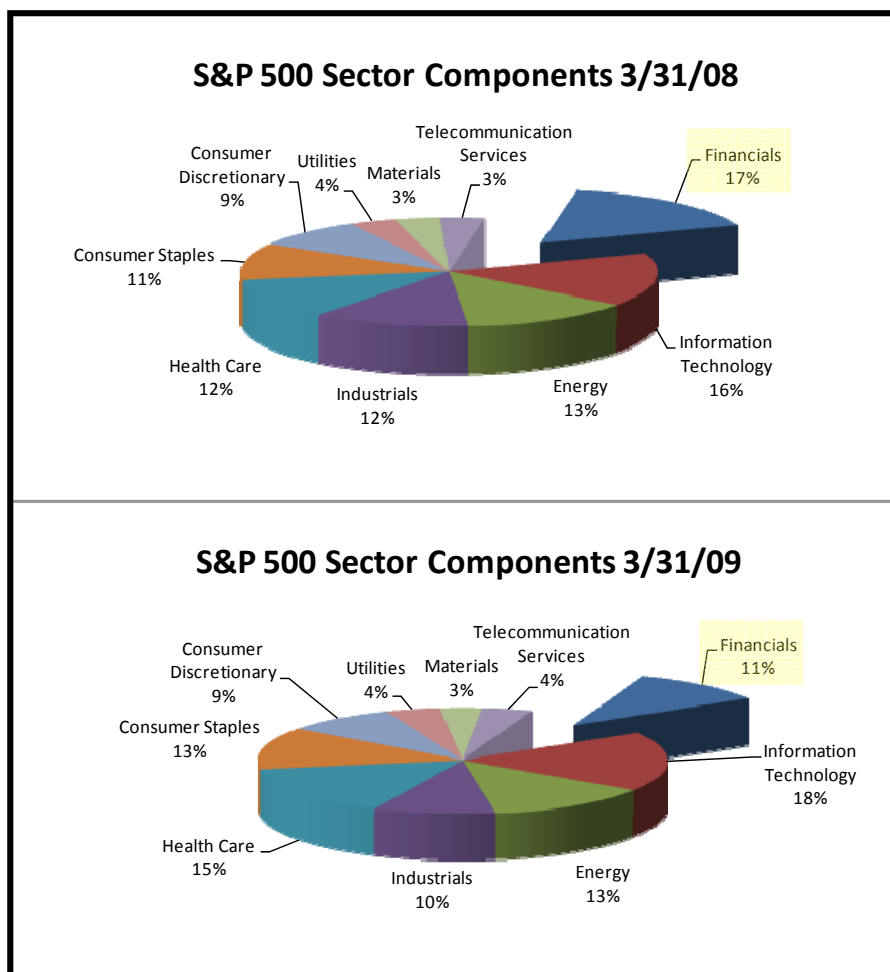
effectiveness of the investment or require the broker to disclose possible conflicts of interest, only that the broker have a reasonable basis to think that an investment is suitable for the client.

Investment advisers are regulated by the Securities and Exchange Commission. The SEC is an agency of the federal government and is charged with protecting investors. The SEC requires that advisers recognize a fiduciary obligation to clients. This fiduciary duty means that advisers must put clients' interests first at all times.

Clearly, the SEC has dropped the ball in some critical instances, most glaringly the Madoff fraud. However, in a recently published article, the executive director of the Investment Adviser Association makes it very clear that investors would be better served by the higher fiduciary standard of the SEC-regulated investment adviser industry. Also, Zweig quoted Mary Schapiro, the new head of the SEC, as agreeing that investors would prefer fiduciary duty as the standard for all.

It is too soon to know whether FINRA, the SEC or some new authority will become responsible for the entire industry or which standard will prevail. Congress will be sorting that out. It is not too soon to say that given the mistakes and abuses brought to light over the past year, investors deserve an effectively regulated financial industry that holds all advisers to a high standard of care that puts the interests of the investing public first.

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The market, on the other hand, has usually been a leading indicator and may be trying to tell us that the worst of the crisis is past. From present low levels it would be reasonable to expect much better long-term appreciation potential than was possible when the markets were at nearly double the current levels only 18 months ago. In fact, some prominent and reliable market forecasters have upgraded their expectations for returns on stocks over the next decade. Government bonds offer little positive investment appeal other than as way to protect capital. Current yields are low and prices are unlikely to rise as governments will have to offer higher rates in the coming years to continue funding enormous spending programs. Corporate bonds may provide some competition for stocks since yields are still

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elevated relative to Treasury securities.

A balanced portfolio is appropriate for these tumultuous times. Moderate exposure to stocks is in order given the extensive decline already behind us and the eventuality of a new cyclical uptrend. The extreme nature of this credit bust and the severity of the recession argue against an aggressive position in stocks until there is more evidence that the economy is on the mend. In addition, more than a few noteworthy market analysts remain very cautious on both the markets and the global economy. Many indications of market valuation and investor sentiment make a strong case that the market has bottomed, but the market will need to prove itself by moving higher and retaking lost ground in a convincing and sustainable way over the coming months.