

# INVESTMENT OUTLOOK

## Second Quarter 2009 Review and Outlook by Whitney Brown

- ◆ Stocks post strong 2nd quarter gains.
- ◆ Economic slump easing.

- ◆ Monetary ease and stimulus now bring new challenges later.
- ◆ Financial reforms must maintain free and open system.

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The stock market rallied sharply in the second quarter continuing the strong rebound from the March low. Stocks easily notched double digit gains even after fading over the last several weeks of the quarter. The major U.S. averages such as the Dow Jones Industrial Average and the Standard & Poor's 500 Index have more or less recouped what they lost in the first quarter. Other important indexes such as the NASDAQ Composite and the Russell growth indexes are sporting sizeable gains for the full half-year. The emerging market index which fared among the worst for 2008 is now ahead almost 30% in 2009.

As is typically the case when the market rebounds from a major low, the lesser quality issues and those that fell

most during the decline usually lead the way up. That has been the case this time as banks stocks, small company stocks and emerging market issues have snapped back impressively. Leadership among small company stocks and growth issues such as technology stocks is also consistent with the market anticipating economic recovery in the months ahead.



Lately, economic news is not good but getting less bad. The rate of deterioration in most economic indicators seems to be slowing. June unemployment figures came in worse than expected, but unemployment is usually a lagging economic indicator. Historically, unemployment has continued to rise well after recession has ended. The Federal Reserve plans to keep monetary policy extremely easy for the foreseeable future. Any hint of tighter policy before the economy enters a self-sustaining expansion could spell disaster for the markets and kill any budding confidence in a recovery.

Aggressively easy monetary policy has sparked fears of rampant inflation in some circles. Granted, flooding the economy with money has inflationary implications, but the most urgent need is to ward off serious deflation that could take years to repair. Japan's moribund economy of the past decade is a prime example of what policy makers hope to avoid. Disinflation is the nearer term risk and the bold fiscal and monetary policies of the Fed and the current administration aim to nip it as soon as possible.

It remains to be seen whether or not the monetary policies undertaken will take hold. Credit spreads have narrowed substantially, indicating that the crisis in the credit markets has passed, but banks

*(Continued on page 2)*

<u>Market Measures</u>	<u>2<sup>nd</sup> Qtr</u>	<u>YTD</u>
S & P 500	15.9%	3.2%
Dow Jones Industrial Average	11.0%	-3.7%
NASDAQ Composite	20.1%	16.4%
Russell 2000	20.7%	2.6%
MSCI EAFE	23.8%	5.6%
Barclays Capital Aggregate Bond Index	1.8%	1.9%
	<u>6/30/09</u>	<u>12/31/08</u> <u>6/30/08</u>
10-Year Treasury Bond Yield	3.52%	2.24%    3.98%
Three-month Treasury Bill Yield	0.19%	0.13%    1.90%

## Second Quarter 2009 Review and Outlook (continued)

(Continued from page 1)

still appear to be hoarding capital rather than increasing lending. The financial origins of this recession may mean that the eventual recovery will be slower to take hold and more moderate when it does. The unavoidable need for consumers and businesses to repair their balance sheets by reducing debt has left the government as the only major player willing to increase borrowing to stimulate the economy.

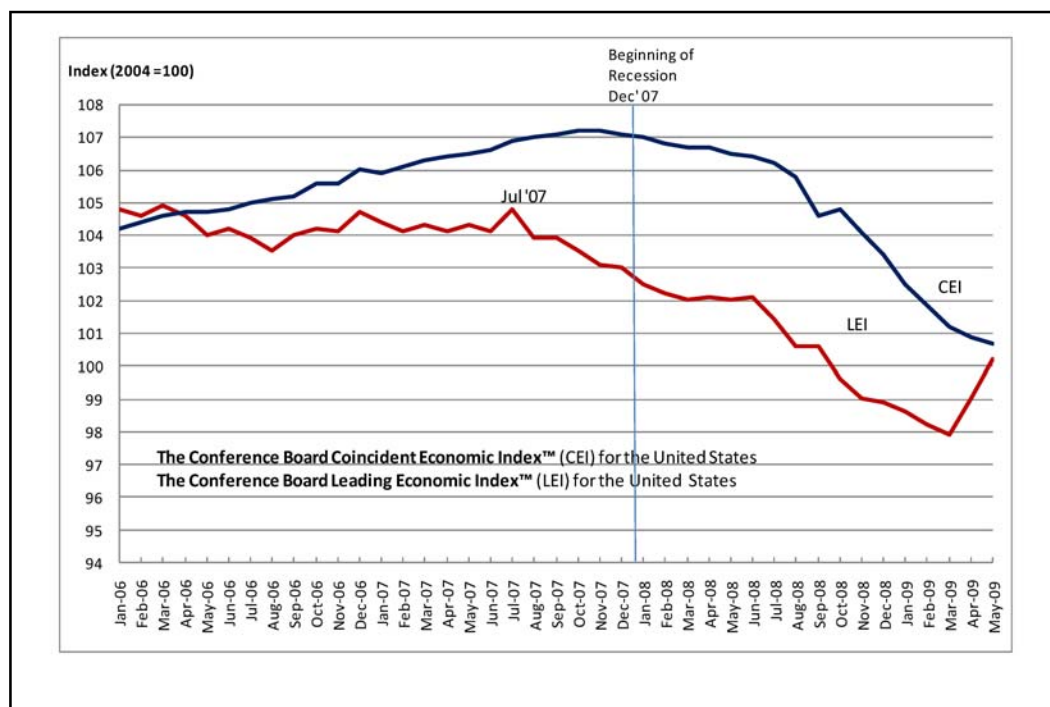
The effect of our government's recent actions has put downward pressure on the dollar, but concerns over a dollar crisis are not justified at this point. Treasury securities remain the preferred safe haven investment globally. Currency strength is a relative affair among nations, and as bad as things may be here, the U.S. is still the world's largest and most developed economy with unique geopolitical advantages. China and other foreign governments have expressed concern over our loose fiscal and monetary ways, but it is mostly talk at this point. For the near term, there simply is no suitable alternative to the dollar as the world's reserve currency. However, our failure to withdraw excess stimulus at the right time and to get our major fiscal problems under control in the coming years could well spell big trouble for the dollar.

Among our distinct advantages in the global economy is our free capitalist system. The innovation and broad access to capital that our system engenders has allowed the United States to prosper like no other nation. Despite the Civil War, the Great Depression and World War II, the U.S. has continually progressed with each generation experiencing greater growth and prosperity than the one before. Current efforts by the administration and Congress to reform and re-regulate our financial system are necessary to correct obvious flaws and afford reasonable protection to the investing public and the economy as a whole, but these efforts must preserve the dynamic and open system that has allowed us to thrive throughout our history. Booms and busts are an inevitable part of the economic cycle and over-regulation could lead to stagnation or other unintended consequences.

Looking ahead several quarters and beyond, the market is very likely to rally further after a modest correction. The recovery from the dramatic decline that ended in March is consistent with market performance after previous such episodes over the past century. Recent gains anticipate an end to the recession later this year, possibly as soon as August. The market rebound, followed by an end to the recession in the third quarter, a subsequent recovery in corporate earnings and a peak in unemployment would be right in line with the historical pattern of previous bear markets that occurred during recessions.

Improvement in economic indicators offers support for the market's optimism about the economy. The chart below illustrates the marked improvement over the past two months of the leading economic indicator (red) and the leveling out of the coincident economic indicator (blue).

This cyclical bull could carry into 2010 before a significant reversal, but we have little confidence that we have entered another major bull market such as the one from 1982 to 2000. The severity of this recession and the fiscal challenges ahead may cause the economic recovery to be weaker than most and stock returns to be more modest, but stocks are slated to provide better returns than bonds or cash for the coming period. As always, a diversified, balanced and flexible investment approach will be necessary to limit risk while participating in the available opportunities.

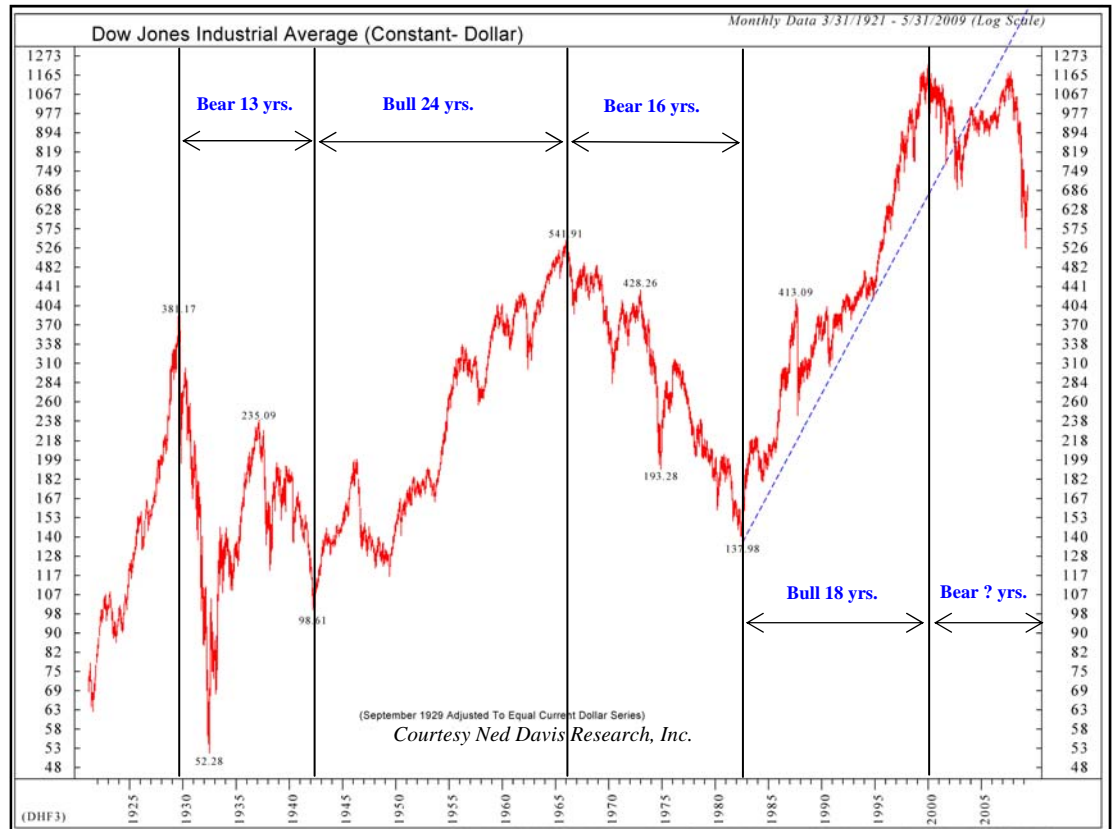


## Major Stock Market Trends by Watt Dixon



The chart to the right illustrates our thinking about the long-term stock market trend.

The red line represents the long-term progress of the Dow Jones Industrial Average adjusted for inflation. The vertical lines identify the points of long-term trend reversals, separating major bull markets from major bear markets. Clearly, we can see that major stock market trends over the past eighty years or more have lasted on the order of fifteen years or longer with the bear markets being shorter than the bull markets. The top in 1929 was followed by a series of successively lower peaks that finally reversed in 1942, and then, a major uptrend lasted until 1966. A major low occurred in 1982, and most recently the market topped in 2000. If the pattern holds, we should not expect a new major bull market for at least a few



more years. That does not mean there will not be great cyclical opportunities like the bull market from 2002 to 2007, but any investment approach should recognize that the major trend is not yet in our favor.

## Investment Philosophy by Walter Dixon

Given the recent turmoil in the financial markets, a brief review of our general investment philosophy and strategy may be helpful. While the philosophy is the same for all, strategy will vary somewhat, depending upon the client's specific investment objectives.

Our philosophy is considered conservative, because it is designed to limit loss of capital when market conditions are unsettled, such as now. When

conditions again appear favorable, our goal for the stock portion of the portfolio is to participate in the upswing at least to the extent of the general advance. Limiting losses in down times, while participating fully in advances, has generally produced above-average returns for our clients over a complete long-term cycle.

Most clients' portfolios are considered balanced, because they hold both equities and fixed income securities (bonds and cash reserves).

While we use a 33/67% fixed income-to-stock ratio as a starting point, from time to time the actual percentages will vary considerably from the norm, depending primarily upon client financial objectives, but also due to our assessment of current market conditions.

Risk of loss of capital is  
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POST OFFICE BOX 2768  
ROANOKE, VIRGINIA 24001-2768

TELEPHONE (540) 343-9903  
FAX (540) 343-7684  
WEBSITE: WWW.DHFB.COM

## Investment Philosophy (continued)

lessened in several ways. We concentrate client investments in securities of above-average financial quality, both equity and fixed income. Our experience has been that both fewer and smaller unexpected losses are incurred in these issues, compared to those of lesser quality. We also establish a range of potential equity exposure appropriate for each portfolio and vary the percentage in equities within the range, depending upon our view of cyclical (2-4 years) and longer-term (10-20 years) stock and bond market conditions.

In bond holdings we ladder maturities from one to ten years, when long-term interest rate conditions appear neutral. Again, based on our view of the likely direction of interest rates, from time to time we will shorten the maximum maturity significantly, to minimize the possibility of capital loss due to rising rates.

***While conditions remain quite unsettled near term, we appear to be in the early stages of a cyclical recovery.***

At present, we continue to maintain that we are in the middle stages of a longer-term bear market for equities that could last fifteen years or more measured from the peak at the beginning of this century. More recently, we have experienced a severe shorter term cyclical bear market that began in late 2007. While conditions remain quite unsettled near term, we appear to be in the early stages of a cyclical recovery. Our present view could be described as "nervously neutral."

Our bond ladder is shorter now with maximum maturities of 5-7 years in most cases. While we do not expect interest rates to go up significantly anytime soon, the shorter maximum reflects the current extremely low absolute level. We are in an unusually uncertain time, and no one's crystal ball is very clear.