



# **Economic & Investment Outlook**

**Third Quarter 2009**

By Daniel P. Crawford, CFA  
Senior Vice President and Managing Director, Chief Investment Officer  
NexTier Wealth Management

July 1, 2009



## Investment Outlook

### 2009 – Third Quarter

## Economy

- After nearly two years, the Great Recession will end during the fourth quarter of 2009.
- Negative GDP growth for the 1st two quarters of 2009 followed by below trend growth in the 2nd half. Full year negative GDP growth of 2-3%.
- Unemployment rate continues to increase and nears 10% by year end.
- Federal Reserve's Zero Interest Rate Policy (ZIRP) expected to be in place throughout 2009 and into 2010. Quantitative easing will be the Fed's action of choice in 2009. Create money to purchase Treasuries, agencies, and mortgage backed securities and finance lending facilities – an attempt to keep interest rates low. Fed's balance sheet approaches \$3 trillion.

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- Inflation remains dormant and of no concern in the immediate future. High unemployment and underutilization of resources have created a deflationary environment. Longer term – inflationary pressures will emerge due to massive amounts of U.S. spending and debt issuance.
- The U.S. dollar has benefitted from the flight to quality caused by the global financial crises. The U.S. dollar may weaken later in the year if inflation accelerates faster than expected, particularly against emerging market currencies.
- Potential conundrum for the Federal Reserve: How will the Fed remove the excess liquidity from the financial system without squashing the anemic economic recovery?
- We anticipate home prices nationally to drop an additional 5-10% on top of the 30% already experienced from the mid 2006 peak. A housing recovery is not expected until the 1st half of 2010, at the earliest.

## **Fixed Income & Interest Rates**

- Long term interest rates will drift higher as:
  - 1) investors focus on inflationary pressures
  - 2) the supply of treasuries increase dramatically as the U.S. deficit widens (est. \$2.2 trillion in 2009) due to stimulus packages and the multitude of financial rescue programs.
- Bond returns over the next twelve months will be constrained by rising intermediate to long-term interest rates. Yields on Treasuries remain at historical lows.
- Steepening Treasury yield curve reflects strong crosscurrents in the economy and market.
- High yield corporate bonds maintain their attractiveness at these levels as credit spreads have narrowed from historical highs. Investors are adequately compensated for the higher anticipated default rates and bankruptcies of these debt issuers.

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### Equities

- Financial markets will continue to experience volatility as the credit markets continue to stabilize and economic activity improves. The Great Recession is expected to end in Q4 '09. Therefore, as a Leading Economic Indicator (LEI), the stock markets should strengthen from these levels. Sustainable economic growth is necessary for the markets to move higher from these levels.
- Equity markets should benefit from the pent-up demand that builds during a recession and the extraordinary fiscal and monetary policy responses designed to stimulate the economy.
- Equity valuations are at reasonable levels but not cheap with the S & P 500 trading at 15 times 2009 estimated operating earnings. 2009 S&P 500 estimated operating earnings of \$58(e) will be slightly higher than the 2008 S&P 500 estimated operating earnings of \$50.
- Emerging Market equities, particularly Asia, remain relatively attractive due to favorable valuations. This group will be early beneficiaries to the global stimulus underway.