Economic & Market Update
Crawford Investment Counsel, Inc.
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After a slow start in January and February, the U.S. stock market performed well in March, picking up where it left off in the last three quarters of 2009 and providing a good start to the year. Domestic and foreign fixed income also produced positive returns, although at more modest levels than stocks. Concerns over sovereign debt were a factor in the international debt markets. International equity returns were mixed, and for a change, generally not as strong as U.S. equities. Notably, emerging markets were soft, led by a decline in the Chinese stock market. Within this environment the value of the portfolio improved.

While most investors are pleased with the continued upward movement of the stock market, many are confused as to why it is rising, or concerned that it is a false move that may collapse under the weight of reality at any moment. While it is impossible to know at any point in time whether the stock market is reflecting economic reality, or is priced properly, certain judgments can be made as to why it is performing as it is. Currently, there seems to be a conflict between the state of the economy, with special reference to an unemployment rate that is still near 10%, and the rising stock market.

A review of recent history may be helpful. As we do so it is important to keep in mind that the stock market is a forward looking mechanism. It tends not to reflect current conditions; rather it is a good measure of what investors are expecting to occur at some point in the future. In other words, people do not invest in stocks for what has happened, or is happening now, but they do invest for a future return based on what they believe will happen in the future. Any view of the future will be impacted more or less by current events, but conditions are always changing, and fear and greed become entwined with the outlook, leading to a complicated picture. These caveats aside, it is safe to say that the stock market always sends a message about expected future developments.

Getting back to our review of recent history, recall that the S&P 500 ended it's severe decline in the first week of March a year ago. Peak to trough the decline was almost 55%. The decline was brought on by the fact that the U.S. economy was in a recession, and was complicated greatly by the emergence of the greatest financial crisis since the Great Depression. Stock values declined precipitously, especially in the latter stages, on fears that the financial crisis would indeed lead to another Great Depression. Extreme measures by the authorities, namely aggressive monetary and fiscal policy, led to stabilization and as investors began to believe that there would not be another depression there was a collective sigh of relief. As soon as the potential for a depression was off the table, the view of the future was changed dramatically, and the market began to reflect this changed view with a strong move upward. Within three months there was a gain of some 200 points on the S&P 500.

Once this initial move up was completed the stock market began to look forward for something more than just the avoidance of a depression. The next step was to look for resumption of growth in the economy, and the end to the recession. As this view of the future was taking form, the market basically treaded water for a few months. But as positive Gross Domestic Product (GDP) became more of a probability, the market began to move up again, coincidentally, for another 200 points in the next four months.

From last October through the end of February, the gains in stocks were minor. But this March stocks began to give signs of wanting to move higher as the collective view of the future was once again changing. There has been a segment of the investment community that has been of the belief that the economy would experience a "double dip" by falling back into a recession. The fear is that the economy, revived temporarily by monetary and fiscal measures, just does not have the staying power to keep moving forward, so it peters out into another recession. If so, corporate earnings and dividends would be impacted and this would be a major disappointment for the stock market. Now, however, with the continued improvement in almost every single economic measure, confidence in economic sustainability is growing, and the "double dip" scenario is losing credence. The market's view of the future is forming around the idea of a sustainable economic expansion, hence, the improvement in stocks.

Our chronology of events explains in large part why stocks have made their recovery move over the last year. From this point forward, what other worries might fade and give even further impetus to stocks for another move upward? If investors were to begin perceiving a higher rate of growth in the recovery phase than currently expected, this would be a positive change. Such a development would in fact contradict one of our expectations, one that we would be happy to see proven wrong. We believe this economic recovery is likely to be at a slower than normal growth rate, compared to other expansions. Lingering unemployment problems, restrained credit growth, and general deleveraging of balance sheets are structural issues that are not likely to go away soon. In our opinion, because of these structural impediments, it will be difficult for the economy to sustain normal rates of growth during this expansion phase. We have quantified this as perhaps a 2% to 2.5% growth rate over the span of the recovery, as opposed to a 3% to 3.5% normal growth rate. Even within our scenario, which is at its essence positive, we believe there is room for stocks to continue working higher over the course of the expansion. The expectation of a more rapid growth rate would obviously imply a more vigorous move upward by stocks.

There is one longer term issue that is particularly worrisome to investors. As a result of the recession, there has been a considerable contraction in tax revenues, leading to large federal deficits. If sustained these deficits will cause very large increases in federal debt in the future, with potentially serious consequences. At some point the value of the dollar could be impacted negatively and interest rates could be forced higher. High rates of inflation would also be a possibility. These potential developments are seen clearly in Greece right now. We do not predict the eventual occurrence of such a scenario for the U.S., but will acknowledge the risk of it happening. It is not a serious problem over the short to intermediate term, but we will be carefully following developments in this area. Having noted this potential problem, the fact that investors worry about this makes it another element of fear that shapes expectations of the future. Should these fears turn out to be unfounded, or even less worrisome, it would be one more stepping stone for stocks to continue their move upward.

One of the oldest stock market adages is that "the market climbs a wall of worry." There is always plenty to worry about. Because the stock market is forward looking, as the market changes its views on whatever the worries of the day are, it has the potential to move higher. The stock market seems to divine signs of the future that are not so apparent on the surface. This does not mean that the market is always right, but history suggests that it is more often right than wrong.

The recovery in the stock market from its depressed lows has obviously been a fortuitous development. It is hard to remember just how bad things seemed just a year ago. Fortunately our economic and governmental system is organized in such a way that it has within it the ability to implement rescue measures, and possesses inherent strengths and stabilizers that enable it to withstand severe stress. As is usually the case with us, we are currently looking forward with a measure of optimism. It is too early to claim victory; an economy simply does not go through a period of stress such as we endured in this recession/financial crisis without a lengthy period of healing. However, the continued improvement in almost all economic series suggests further progress ahead and an environment where investment in high quality companies will be rewarded. We were heartened by the recent employment report of 162,000 new jobs in March. This is a major development, as it is the best month of job creation since 2007.

Our letters typically deal more with the economy, and less with the stock market. Within our commentary we have incorporated the essentials of our economic outlook, but to be specific, we believe we are in the early stages of a sustainable economic recovery that will last several years, at least. That said, the rate of growth is likely to be subpar when measured over the entire recovery period. Inflation is now practically nonexistent, and we expect it to remain controlled. Interest rates are expected to drift upward as the economy continues to expand, but are likely to remain low by historical standards.

Turning briefly to the outlook for fixed income, we continue to favor corporate and municipal debt. Demand dynamics remain favorable in both sectors. Corporate balance sheets are improving with the economy, and municipal buyers seem content with the safety and tax advantages of municipal bonds, even though yields remain very low. From a credit standpoint, we continue our practice of focusing on "essential services" municipal debt.

Our above stated view that inflation should remain well contained implies a range bound yield environment for bonds. Looking forward, when the Federal Reserve begins raising the Federal Funds rate, some increases in yields should be expected.

Sincerely,

John H. Crawford