

Economic & Market Update
Crawford Investment Counsel, Inc.
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2009 was a momentous year. The U.S. and world economies emerged from the longest and deepest recession since the great depression. Stock markets around the world, in both developed and emerging economies, responded to massive monetary and fiscal stimulus as liquidity was restored, and the promise of recovery was fulfilled. Bond investors were also rewarded, although at more modest levels. Yield spreads in both higher and lower quality bonds contracted as the frozen credit markets of 2008 loosened and recovery became apparent. While there was much talk about the risk of inflation due to the aggressive liquidity measures provided by central banks, and budget deficits in the U.S. and other countries, to date inflation has remained under control. This allowed government debt to continue to trade well. It was a year of speculation in gold shares, and commodities were strong as they discounted the implied demand from developing economies. Finally, the dollar resumed its orderly decline after rallying sharply during the depths of the credit crisis and recession. All in all it was a year of opposites, weak across the board in almost all asset classes during the early part of the year, and strength later as economic recovery became more apparent.

It is now time to look forward into 2010. We enter the year with several basic assumptions as to how the economy will unfold. There are implied investment assumptions that follow from the economic views. Our assumptions are:

- The U.S. and world economies have entered a period of sustained economic recovery that will last for several years, at least.
- The rate of growth in the recovery will be sub par compared to previous recoveries from deep recessions.
- The unemployment rate in the U.S. will decline slowly.
- Inflation will remain dormant for the intermediate term, at least.
- Interest rates may drift higher as the recovery gains strength, but will not rise dramatically.

We recognize that to speak of the end of the recession and the beginning of recovery may sound outrageous to the roughly 10% of our workforce that are unemployed. But “technically” the recession is over because real GDP (Gross Domestic Product) was positive in the third quarter of 2009 at 2.2%, and most likely was in the 3-4% in the fourth quarter. Almost all economic series are now indicating gains on either a month to month basis or year to year. Monetary and fiscal stimulus is a powerful combination, especially when applied with such force as currently. Much of the real GDP being produced now is the result of increased government spending. Only when the economy is growing organically can we be assured that the recovery is sustainable, but

this should become apparent later this year. For sustainable recovery to be firmly in place, consumption and private investment need to improve.

Our second assumption, that the rate of growth in the recovery will be sub par compared to the aftermath of other deep recessions, relates primarily to what we consider the impaired ability of the consumer to be a strong force for growth. Usually, it is safe to assume that the deeper the recession, the faster or more robust the recovery. This time, however, the consumer, who provides some 70% of GDP, comes out of this recession with some serious baggage. Not only is his wealth still sharply lower as a result of the loss of value in home and stock prices, but his debt remains high, and unemployment is a threat. This makes most consumers nervous, and that is not the prescription for spending. As a result, the savings rate is up, and households are undertaking means to reduce debt. This deleveraging process is a major factor that is inhibiting the recovery. For those who need credit, banks are largely unwilling. They were severely damaged by the recession, and are doing everything they can to clean up their loan portfolios and maintain their capital at adequate levels. Federal Reserve Chairman Ben Bernanke sums it up when he says, "Household spending is unlikely to grow rapidly when people remain worried about job security and have limited access to credit."

A big part of consumer reluctance has to do with unemployment, either real or implied. If 10% of the workforce is unemployed, many more worry about it happening to them. We expect the employment condition to improve, but only slowly. Our view reflects caution on the part of hiring organizations as evidenced by the fact that part time workers are now at a very high level relative to normal practice, and the average workweek is historically low. Until the workweek reaches more normal levels, it is unlikely that employers will convert part time workers to full time, or commence hiring of new employees. Furthermore, structural changes in the auto and housing industries, two of the largest and more important sectors of the economy suggest slow recovery in hiring. Since the peak of hiring in these industries, over two million jobs have been lost in auto or housing related activities. With auto production depressed and housing showing only meager signs of improvement it is hard to see these industries being major drivers of hiring over the near to intermediate term. In its latest forecast of economic conditions, the Federal Reserve forecasts unemployment to decline slowly, reaching a level of only 7% in 2012. This slow decline will represent a headwind to overall growth for an extended period.

There is good news. With resource utilization so low, such as manufacturing capacity at around 71%, and plenty of slack in the labor force, it is hard to see how a general inflation can develop. Once the economy gets into full fledged recovery mode with higher rates of growth, it will be necessary for the Federal Reserve to remove some of its liquidity measures to help ward off any inflationary threats. Time will tell if they will be successful in this endeavor. For now, however, with supply capability far outweighing demand, inflation is less of a worry than deflation. Neither high inflation nor deflation seems probable over the near term, but investors should be aware of the risks on both sides.

Our view of inflation carries over to the outlook for interest rates. Over time inflation is the main determinant of interest rates. It takes only a glance at a chart of interest rates and inflation over time to see a strong correlation in the trends of the two. We expect the U.S. Treasury ten year note, the accepted interest rate benchmark, to trade within a fairly narrow range this year. As the economic recovery proceeds it is reasonable to expect interest rates to drift upward somewhat, but our expectation is that they will remain low by historical standards.

The environment we foresee is on balance positive. While almost all economic series remain depressed, they are all moving in the right direction, and point toward sustainable recovery. We believe stocks will do well this year, although it should be noted that the recovery in the stock market has outrun the recovery in corporate earnings. This has led to an expansion of price to earnings ratios such that further progress is needed on the earnings front to propel stocks higher. We believe this will occur, but market gains in 2010 are not likely to be as robust as those of 2009 when the market was moving higher in anticipation of the recovery.

While our view of things to come in 2010 is positive, we expect the business environment to remain intensely competitive. We are mindful that our outlook is subject to risk. Many fear a “double dip” in the economy as a result of lingering unemployment, restrained credit, and deleveraging influences. An economy does not go through the wrenching correction we have endured without major structural challenges, and the aftereffects will be influencing economic behavior for an extended period. With these caveats, we are of the opinion that regardless of risk tolerances, the best hedge against negative developments is to remain invested in very high quality stocks and bonds.