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The Economy

With the economy contracting, both the domestic stock and bond markets have discounted a lot of good news.

This is a very scary time in our economic history. With the government orchestrated bailouts of the U.S. banking system, the two largest mortgage originators Fannie Mae and Freddie Mac, and the auto industry, we have reversed a 25 year trend toward smaller government, instantly reverting back to government playing a bigger role in our economy. What is unsettling to us is that no one knows the new rules since, in a large part, they haven't been created. This government intervention has taken many forms including a government orchestrated bankruptcy of Chrysler in which the senior secured lenders have virtually no say in the negotiation of the restructuring. Or, it takes the form of a government mandated capital infusion into a bank with subtle coercion on corporate governance and executive pay.

The U.S. economy is still contracting, but at a significantly slower rate than earlier this year. GDP growth declined in the first quarter by a (revised) -5.5% and we expect the second quarter GDP growth to come in at -1.0%. The seeds are planted for an economic recovery, but we are not out of the woods and expect that the recovery will be subdued.

Consumer confidence has increased and is back to levels not seen since last summer, while new claims for unemployment benefits have declined from April's high levels. We expect the consumer sector to start showing some signs of strength in two key areas: housing and autos. We believe we're starting to see stability in the long decline in the residential housing market. Existing home sales for the month of May, released by the National Association of Realtors, climbed to their highest level in seven months. The May release was the second straight month that sales improved. In addition, median home prices inched higher, up 3.8% for April.

During the quarter, Chrysler rushed in and out of a government assisted bankruptcy, ultimately merging with Fiat. General Motors entered bankruptcy and 40 days later has emerged a smaller (and hopefully) more efficient company. While the pending bankruptcies of two major auto companies is difficult to measure on consumption, we believe the combination of pent up consumer demand and government support will help to stimulate auto sales in the coming months. As evidence, June auto sales were tracking 9.69 million units annually which is an increase in levels reported earlier in the year.

Employment is a significant indicator of economic health in this recovery. Unfortunately, unemployment claims increased to 627,000 last month. The unemployment rate for June increased to 9.5% from a rate of 9.4% in May, its worst level in more than 25 years. With 6.7 million Americans looking for work, it will take some time for the economy to absorb those job seekers looking for employment. The savings rate increased significantly from 5.6% in April to 6.9% in May, the biggest leap in 15 years. This should help place the consumer on more solid footing and set the stage for a pickup in retail sales that could accelerate going into the holiday shopping season.

The downturn in the manufacturing sector has been more difficult to measure. Declines in U.S. manufacturing activity slowed last month setting the stage for a potential recovery in the second half of the year. New orders for durable goods declined in June after rising the prior three consecutive months. In addition, orders for capital goods surged by 4.8% in May. This might be one of the most encouraging signs that the severe downturn in corporate investment spending may be moderating. Yet, we remain cautious on any perceived acceleration in capital spending since it does not seem to be supported by announced corporate initiatives of increased capital investment.

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As a society, we are living beyond our means. But, instead of borrowing from our relatives, we're borrowing from foreign central banks to help make ends meet.

With respect to current monetary policy, the Federal Reserve is navigating a walk on a tight rope on a windy day. On the one hand, the Fed has dropped interest rates to near zero in part to help provide stability to capital markets and also as part of an effort to revive economic growth. Another part of the effort to stimulate growth was a massive ballooning of the Federal Reserve's balance sheet and need to fund all the bailout programs. As a result the need to fund these programs efficiently requires low interest rates. However, with foreign central banks already full on their investment in US dollar assets, it may require higher interest rates to entice foreign buyers to take on more exposure

After their June meeting, the Fed reiterated their initiative to maintain short interest rates at near zero percent. The Fed is also banking on low interest rates to help construct an opportunity for consumers to refinance their high rate home mortgages. Fixed mortgage rates correlate with the level of interest rates. In an effort to manipulate the rate on mortgages, the Fed announced plans to buy up to $300 million in long term US Treasury bonds by September and up to $1.25 trillion in mortgage-backed securities by year end. This is an unprecedented move by a central bank to stimulate economic growth through open market purchases which is part of a program called quantitative easing.

Quantitative easing describes an extreme form of monetary policy in which the central bank attempts to stimulate the economy by driving interest rates close to zero while purchasing government securities in the open market. It is consider a more dramatic move since normal monetary policy of manipulating short term interest rates is no longer considered effective toward stimulating economic growth. Quantitative easing described Japan's monetary policy as it attempted to emerge from a long recession in the 1990s. The Federal Reserve is implementing this form of monetary policy by purchasing government bonds (treasury and mortgage-backed securities in the United States) in the open market, by lending the new money to deposit-taking institutions, and by purchasing assets from banks directly. These actions have the effects of reducing interest yields on government bonds and reducing interbank overnight interest rates, and thereby encourage banks to loan money to higher interest-paying bodies.

In spite of the modest increase in oil prices and the government's heavy borrowing, the Fed indicated in its most recent release that it is not concerned about inflation. At this point, we tend to agree. With capacity utilization below 70% and unemployment at 9.5%, the evidence of slack resources in the system does not, in our opinion, foreshadow any pickup in inflation in the near term. We are more suspicious that the trading in oil futures is distorted by speculators exploiting lax regulation as opposed to real supply/demand balances.

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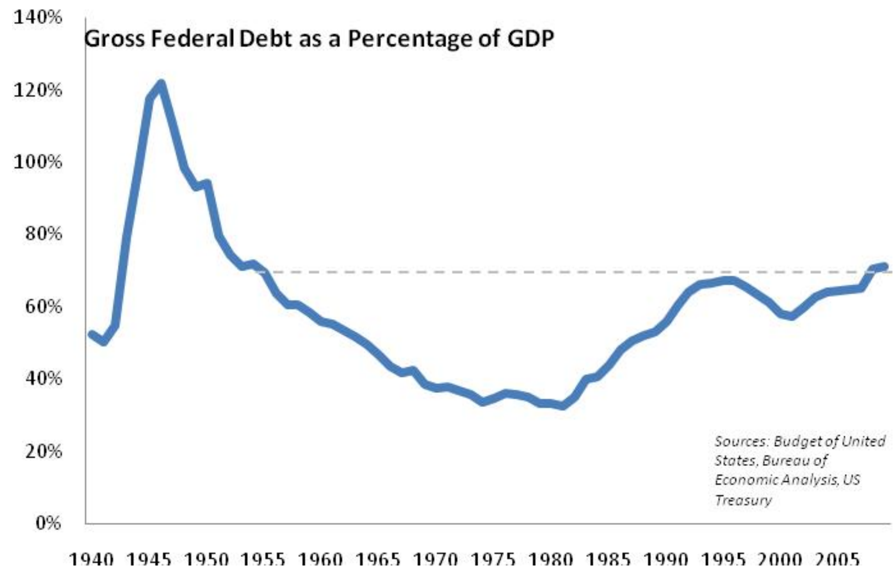
The government is navigating uncharted territory with our current fiscal policy. In an effort to avoid the total collapse of our capital markets last fall, the US Treasury and Federal Reserve implemented a number of programs with the explicit intent of providing much needed liquidity to our capital markets. In addition, President Obama pushed for a $700 billion stimulus package that would provide government supported spending initiatives also designed to add liquidity and support employment. In order to fund the bail out and spending initiatives, the US government simply has to print money. And, as spending has increased, US Treasury receipts have declined year-over-year compounding what is now a $1 trillion budget deficit.

The United States has been a debtor nation for many decades. For an economy as diverse and deep as the United States, debt can help stimulate economic growth, job growth, the free exchange of credit and trade. However, a ballooning growth in debt may result in an increase in interest rates either through an adjustment in the risk free rate or through an increase in the rate of inflation. In order to finance our economic growth, we have relied on an increase in foreign purchases of our debt.



The other danger is the potential for an increase in the rate of inflation. Both our current monetary policy and fiscal policy are inflationary. Ignore for the moment the fragile state of our financial system and need for liquidity to facilitate lending and credit. We expect the contraction in credit will help to offset some pressure that would normally build from increased spending. And, as we mentioned earlier, we are not concerned with any pickup in inflation in the near term.

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With the S&P 500 currently trading at 919 and expected earnings for 2010 at $74.10, the market is currently trading at a price/earnings ratio of 12.4 times. Assuming, a dividend yield of 2.8%, P/E multiple expansion of 1.1 point to 13.5 and earnings for the S&P 500 remain flat for 2011, we are forecasting horizon returns on domestic equities in the range of 6.0 to 8.5%. At current valuations, the equity market appears to have discounted a sustained economic recovery. However, we expect the capital markets will face challenges with tight credit and reduced leverage as the government reduces liquidity and pulls in some of the assistance programs.

With respect to the equity markets, we are in the process of reevaluating two important themes. First, our view of the auto industry is changing as Ford, GM, and Chrysler have addressed their individual problems in different ways. With new capital structures, dealer relationships, government support and pent up consumer demand, we are finding some interesting investment ideas both among auto manufacturers and suppliers.

The other equity theme we are revisiting concerns the bank sector. The U.S. financial system has achieved a renewed level of stability; however, that stability has come at a significant cost to many banks that diluted their stock to repay the TARP investment by the government this past quarter. We believe that certain well capitalized banks such as JPMorgan Chase and US Bancorp are well positioned to compete in the current environment. Yet, we are less sanguine about the prospects for earnings growth given the push for higher capital ratios and tighter lending standards. Also, there are bank and finance companies that are not as well capitalized including Marshall & Ilsley, CIT and American General Finance. We expect over the coming months that the capital structure of these institutions will be merged or restructured.

In the fixed income sector, we simply can't expect the Fed to maintain low interest rates for an extended period of time in the face of $2 trillion in debt issuance over the next two years. Our expectation is that interest rates will inch higher. With the 10 year US Treasury yield at 3.7% and recent historic inflation running close to 2.5%, the implied real risk free rate is near 1.2%. We expect to see the market adjust to a higher real risk free rate over the next year.

With credit spreads dramatically tighter in the investment grade corporate sector since the first quarter, we have to hunt harder to find good relative value. American Express, HSBC Finance and Oncor Electric are a few of the issuers that we find compelling in today's market. While we still the bank and finance sector is cheap on a relative value basis, spreads in many have credits have tightened back to their 2007 levels. Our investment strategy also favors investments in the debt of high quality utility companies, particularly first mortgage bonds. Also, we remain constructive on preferred stocks of high quality banks and utilities which benefited from a powerful "relief rally" this past quarter.

We believe that municipal bonds still offer investors outstanding value. While we expect to see credit deterioration across the municipal sector, solid credits such as Indiana will offer investors some good relative value in today's market. Indiana School Building Corporations which are backed by the state's Intercept Program are rated AA+ and can yield 5.0% in 20 year maturities. Our preference has been to stay with shorter maturities and earn a yield of 2.70% as a more conservative approach given the unusual market environment.

Gregory J. Hahn, CFA
Chief Investment Officer

Stephen P. Carr, CFA
Portfolio Manager

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