

Recent Thoughts April 2009

The first quarter of 2009 marked the sixth consecutive quarter of declines for the U.S. stock market. It was a quarter that witnessed the S&P 500 reach a new multi-year low in early March before staging a powerful rally of almost 20% over the final three weeks of the quarter. The rally was ignited by positive comments from several bank CEO's regarding first quarter profitability combined with some long awaited clarity from the U.S. Treasury on its plan to remove toxic assets from bank balance sheets.

The Federal government has sustained its commitment to providing the funds necessary to help lay the foundation for a sustainable economic recovery. Initiatives have included traditional fiscal and monetary policy. However, due to the severity of the current downturn, the Federal Reserve and U.S. Treasury have embarked on non-traditional and, in some cases, unprecedented policy actions. The new programs range from purchasing Treasury bonds and mortgage-backed securities to a public-private partnership aimed at ridding the banks of the toxic assets sitting on their books.

One of the most tangible results of the newly implemented programs has been the decline in mortgage rates to historic lows. This has provided an opportunity for those who qualify to refinance their existing mortgage. However, many homeowners facing resets to higher rates have too little equity in their homes and are therefore ineligible to refinance at current rates. This problem will only be exacerbated as home prices are likely to continue declining. New Federal homeowner assistance programs have been rolled out to aid those on the verge of foreclosure. It is difficult to envision an end to the current economic decline absent stabilization in the housing market.

The duration of the current recession stood at 16 months through the end of the first quarter, matching the length of the mid-1970's and early 1980's recessions. Gross Domestic Product fell at an annualized 6.3% in the fourth quarter of 2008 and is expected to post a similar decline during the first quarter of this year. Unemployment continues to increase and most other economic indicators are weak or declining. Consumers have taken on a tremendous amount of debt over the last several decades (more than doubling relative to GDP). The process of de-leveraging that consumers are currently undergoing is slow and painful, but necessary to build a solid foundation for future growth. Many are expecting stabilization, if not renewed growth, in the economy as we move through the second half of 2009 and into 2010.

The efficacy of the myriad financial rescue plans has been debated endlessly. At a minimum, the plans have so far stemmed what could have been a much more serious collapse in the financial system. Corporations have started to return to the public debt markets to raise capital, fear over

the stability of money market funds has subsided and credit spreads have contracted as investors are once again willing to take risks. However, these programs carry a great cost.

Vast quantities of Treasury bonds have been issued and money printed in order to fund the various stimulus plans. The Fed is currently focused on the risk of deflation, which seems prudent considering the recent downward trend in the Consumer Price Index (CPI) and the first twelve month decline in CPI since the 1950's. However, it is imperative that the huge supply of dollars be removed from the system as the economy recovers in order to avoid onerous rates of inflation in the future.

Several financial companies have declared their intention to payback the TARP money they received last year. The public furor over Wall Street bonuses and the resulting regulation over executive compensation have provided the impetus for financial firms wanting to rid themselves of Congressional involvement in their day to day affairs. Some fear that financial institutions will repay TARP funds prematurely in order to avoid the compensation restrictions and risk their own recovery in the process.

Information technology was the only sector to post positive performance during the first quarter, while the financials were once again the worst performing sector in the S&P 500. Large-cap stocks outperformed small-cap stocks and growth stocks outperformed value stocks. Continued volatility in the overall market, and financial stocks in particular, should be expected over the coming quarters as the White House and Congress propose new plans or revise existing ones and the results of the financial stress tests are made public.

The landscape is littered with those who have attempted to call a market bottom during the recent downturn. We will not attempt a similar feat here. March 9th has been labeled a generational low for the stock market by some. The S&P 500 and Dow Jones Industrial Average closed at 676 and 6547, respectively, on that date. Even if it was not, we remain confident in the long-term future of U.S. stocks. Our approach to managing your portfolio will remain the same. We will continue to focus on holding a well-diversified portfolio of high-quality stocks that can weather the current market turmoil and emerge as even stronger businesses when an economic recovery takes hold.

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