

Recent Thoughts October 2009

The upside momentum that started this spring continued through the third quarter for stock markets around the world. The S&P 500 registered its best back-to-back quarters since the mid-1970s and reached levels last seen in the fall of 2008. Economically sensitive sectors (Financials and Industrials) were once again the best performing market sectors during the quarter, while defensive sectors (Health Care, Utilities and Telecom) lagged. It is quite remarkable how dramatically market sentiment has changed over the last 12 months.

In September 2008, Fannie Mae and Freddie Mac were seized by the government, Lehman Brothers filed for Chapter 11 bankruptcy and the Federal Reserve authorized a rescue package for AIG. Over the ensuing six months, banks failed and merged, an alphabet soup of Federal programs and guarantees were instituted, a “stress test” was conducted, and the Federal government took sizable ownership stakes in several large financial institutions. These events culminated in a multi-year low for the stock market in early March of this year. Global markets appeared to be enduring a full-blown credit crisis and the mood was dire.

The major stock market indices are up 50% or more since hitting the March low. The recent rally has been propelled by improving economic indicators and corporate earnings that have exceeded expectations. The housing market has shown some signs of stabilization, several barometers that measure activity in the manufacturing sector have turned positive and, following four straight quarters of decline, third quarter Gross Domestic Product (GDP) is expected to rise. Following many months of shaken confidence and a lack of financing, the market for mergers and acquisitions has also shown signs of life. High profile, multi-billion dollar deals announced by Kraft, Abbott Labs, Walt Disney and others are a positive sign that the market for such deals may be thawing.

The positive earnings reported by corporate America recently have been driven, in large part, by cost cutting rather than revenue growth. Cost cutting measures are important to ensure efficient operations conducive to earnings growth. However, revenue growth is essential to the sustainability of renewed earnings growth. As we have noted many times in the past, stock prices ultimately go where earnings go. Therefore, a sustainable rise in earnings is critical to support a continued rise in the stock market.

There are several risks and headwinds that the economy faces on its road to recovery. Consumer spending will remain under pressure as unemployment remains high and consumers continue to pare back debt loads. Foreclosures will continue to plague both the consumer and many financial institutions. Banks will also face additional losses as commercial real estate loans begin to sour. Lastly, and perhaps most important, it remains to be seen how sturdy the economic foundation will be once government aid is removed from the system.

Longer term, the budgetary situation in Washington D.C. is troubling. The budget deficit for the recently completed fiscal year was approximately \$1.4 trillion while the total federal debt outstanding is approaching \$12 trillion. The \$1.4 trillion deficit – the largest as a percent of GDP since World War II (10%) – was inflated by the various programs put in place to combat the severe downturn in the economy and most likely will not become the new normal for budget deficits. However, even if President Obama’s pledge to reduce the budget deficit by half before the end of his first term is realized, outstanding debt will still rise by \$600-700 billion per year. The Congressional Budget Office projects that an additional \$7 trillion will be added to the federal debt tab by 2019. People are starting to take notice of this alarming trend.

It is interesting to dissect how different types of stocks perform under various market conditions. While virtually no stock escaped the downturn of 2008, stocks with the weakest financial strength ratings fared much worse than those with strong ratings. That trend has reversed this year as lower quality stocks have outperformed high quality stocks by a wide margin, especially since the market reached its low in early March. Leadership by lower quality companies is normal as the economy emerges from an economic downturn. Many of these weaker companies were perceived to be on the brink of failure during the depths of the downturn.

One of the hallmarks of our investment philosophy has always been the use of high-quality stocks in the portfolios we manage. The focus on quality was responsible for our out-performance relative to the market last year. Conversely, our focus on quality has become a slight headwind so far this year, for the reasons noted above. However, based on our ten and twenty year track records, through which the average Eads & Heald equity portfolio has outperformed the S&P 500, we remain steadfast in our conviction that our clients are best served with a diversified portfolio of high-quality stocks.

**SUITE 760
2100 RIVEREDGE PARKWAY, N.W.
ATLANTA, GEORGIA 30328
TELEPHONE: (770) 988-9556
FAX: (770) 988-9378
INTERNET: www.EadsHeald.com**