



Two emotions are now prevalent following one of the most remarkable market rallies in financial history.

The first, for obvious reasons, is relief.

At the market's bottom in early March, the broad market was trading at levels not seen since 1997. The rebound has returned hope to the investor class, which includes just about everybody these days given the average worker's dependence on 401(k) and similar retirement plans.

Accompanying this relief is disbelief.

Given all the negatives – high unemployment, lower housing prices, yawning budget deficits, and a falling dollar, to name only a few of the worries – many question the sustainability of the 60%+ move off the March lows. It is only normal to believe the market's come too far, too fast.

That, however, might not be true. While a mild pullback would not be a surprise, it's also important to remember that the rally occurred off a very low base...again, 1997 levels! The market lows were marked by extreme fear – fear of another Great Depression, in fact – and enormous illiquidity. There were many market players that, for one reason or another, were forced to sell at exactly the wrong time. Simply put, the market overshot to the downside. Within that context, and also with the knowledge that the market is still approximately 30% lower than it was two years ago, the recent rally is a bit more understandable. And for reasons we will flesh out further, it is probably sustainable as well.

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FALL
2009

ECONOMIC OUTLOOK

In our Spring newsletter we opined that the Fed's primary objective was to stop deflation in nearly every asset class, whether it was stocks, bonds, real estate, or commodities such as oil, wheat, and copper. The 1930's were marked by severe deflation, and the prospect of history repeating itself was not palatable in the least.

For the most part, it looks as if the Fed has been successful. Stocks are up substantially, of course, but so are most commodities. Credit spreads, which measure the amount of incremental return an investor demands for taking on additional risk, have narrowed dramatically since the start of the year, resulting in a significant rally in almost every segment of the bond market. Even real estate prices have firmed a bit, albeit at lower levels. It looks as if deflation is off the table, and that's a really good thing.

So instead of a repeat of the Great Depression, it looks as if we have encountered what many are calling the **The Great Recession.**

Given the length and depth of the downturn – the worst by both measures in decades – the name is certainly appropriate. The good news is that it looks as if the recession ended this summer. Following declines in Gross Domestic Product (GDP) of 6.4% and 0.7% in the first and second quarters of 2009, respectively, GDP advanced 3.5% in the third quarter, and we look for growth of approximately 2.5% in the final quarter of the year.

The pronounced rebound that we forecast is primarily due to the beginning of an inventory rebuilding cycle as well as the positive impact of the “cash for clunkers” program and other temporary government stimulus programs. Recall that at the height of the financial crisis, credit availability was greatly diminished and that in turn led to commercial activity grinding to a halt. In an effort to conserve cash, many companies (and consumers as well!) stopped spending on anything but necessities and concentrated on liquidating inventory. The inventory drawdown was historic in size and scope, and the economy is now benefitting from companies returning to more normal levels of inventory.

Although the recession might be technically over, there is little doubt in our mind that consumer sentiment will remain subdued for some time. Unemployment continues to be a problem and consumers continue to retrench. Consumer spending has actually remained relatively strong throughout much of the crisis, but the composition of the spending has changed dramatically.

Spending on durable goods – big ticket items – has taken a big hit as consumers have sought to reduce their debt levels. Although we are beginning to see evidence of an improvement in discretionary spending (for example, it looks as if auto sales are ticking up in October, even without the government incentives), it will take some time before we reach levels that can be considered “normal.”

This shouldn't surprise many, however, since unemployment and consumer durable spending tend to lag most economic recoveries. Business investment spending has begun to improve, and given the retrenching in the corporate sector over the past two years, corporate balance sheets and corporate cash flows are actually in pretty decent shape. Keep in mind that corporations have been battling higher energy and other raw material costs for a few years now, so we are now beginning to see the full benefit of prior restructuring activities.

EQUITY MARKET

In our Summer newsletter, we encouraged investors to filter out the noise of the current environment, and to instead look ahead to more normal economic times. The stock market will sometimes dwell on what's happening at the moment, but more often than not valuations will be determined by future cash flows rather than by current cash flows.

Of course, estimating those future cash flows is not an easy thing to do and following a financial crisis as severe as the one we just witnessed, a great many investors will make the mistake of staying pessimistic for entirely too long. Following the trauma of the last two years, many resisted investing in stocks, especially against a steady drumbeat of woeful economic news stories. Those that bought when others were still fearful, however, were handsomely rewarded.

But what do we do now?

Again, we would not be surprised to see a mild pullback in stocks, but from where we sit the long-term outlook for high-quality stocks looks pretty good. We have been actively wringing out the excesses of the past few years, setting the stage for a recovery in worldwide economic growth and corporate profits. This recovery, in fact, has already begun.

The recent market rally has been marked by better-than-expected earnings. Even in the face of significant year-over-year declines in sales, companies' profit margins have remained strong. We see this coming out of every downturn: as companies cut costs and focus on improving their business processes, profit growth outstrips sales growth once the economy improves. The profit growth often surprises many investors, leading to increased optimism and increasing equity prices.

Although at present it is difficult to envision an environment marked by strong economic growth, we need to keep in mind that many parts of the world outside of the United States are still experiencing excellent growth. The emergence of a middle class in many emerging markets is a secular trend that is still on track, in our view, and given U.S. companies' exposure to economies overseas, this will likely benefit domestic investors.

While a good case can be made for the attractiveness of the market as a whole, our optimism also stems from the fact that we continue to see a great many outstanding opportunities in individual stocks.

In the short run, equity valuations can be very subjective. In our view, however, they are still attractive based on normalized economic activity. Using 2010 earnings – which will likely get a nice boost from a reduction in the huge loan losses that plagued the financial sector over the last two years – stocks are now trading in a range of about 15 to 16 times earnings. Given the very low yield available on competing financial instruments and the vastly improved financial situation of most companies, we consider this attractive. Short-term bonds offer only a meager return, and 10-year Treasury bonds are only yielding 3.5%!

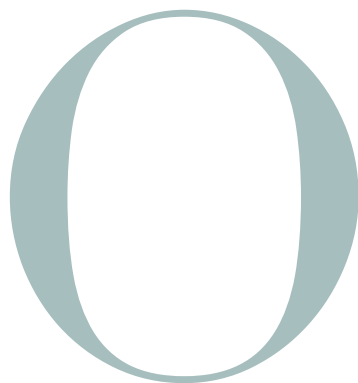
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currently trade at very compelling valuations given their long-term growth prospects. As more and more money moves off the sidelines – there is about \$3.4 trillion sitting in money market funds! – we are convinced that our high-quality investments will pay off handsomely.

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BOND MARKET



One of the biggest challenges today is generating adequate income from fixed-income investments. Given the rise in economic growth that we forecast, along with significant fiscal budget deficits, we expect interest rates to rise over time, especially when the Fed begins to withdraw some of the monetary stimulus that was instrumental in facilitating the re-liquification of the credit markets.

Accordingly, we do not want to venture that far out on the yield curve given the significant interest rate risk we perceive. We don't believe inflation will be a problem in the near term, but we must remain vigilant as the federal government is forced to borrow unprecedented sums to finance the budget gap.

Spreads on corporate bonds have narrowed dramatically, but are still wide by historical standards. This probably has more to do with the unusually low levels of Treasury yields, so spreads could narrow further without a commensurate rise in corporate bond prices.

The secondary market, especially in municipal bonds, continues to be extremely tight as money market and other bond funds are flush with cash and have no need to sell securities to meet redemptions. This, of course, contributes to the low yields we are witnessing. This might not be the best situation for bond investors when it is time to roll over existing maturities, but the increasing availability of credit is certainly beneficial for future economic growth.

In fact, the increasing availability of credit and lower borrowing costs are a good example of how investors have become willing to take on risk. A benign credit environment, in turn, has historically facilitated a good environment for equities.

In summary, although we are likely to experience above-average volatility as investors try to reconcile near-term economic concerns with good long-term growth prospects, we believe that the stage is set for attractive stock market gains over the next several years.

Despite the fact that the recent financial debacle has been painful, much good has come out of it as well, not the least of which is a newfound appreciation of the perils of risk and leverage. Once again, we remind our investors to filter out the noise of the current economic environment, and instead focus on the longer-term outlook, which to us appears very bright given the retrenchment of Corporate America.

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