Davidson Trust Company

QUARTERLY REVIEW

SPRING 2009

ECONOMIC COMMENTARY

The economic decline has been front page news for some time with 24-hour news networks inundating us with woeful stories of layoffs, foreclosures, bankruptcies, bailouts, and congressional hearings. What's missing in most of the headlines, however, is the emergence of data that suggests that the economy is beginning to show signs of stabilization, albeit at lower levels of activity.

Of course, signs of stability should not be confused with full-fledged recovery. Given the severity of the economic decline and the continued fragility of the world's financial institutions, we believe that it will take some time before we see a meaningful and sustainable upturn in economic growth. Corporations are still cutting costs as they align production with lower levels of demand, and that will likely equate to lower capital spending and further layoffs in the months ahead. Unemployment has now reached 8.5%, and we agree with the growing consensus that the jobless rate will get worse before it gets better.

Gross Domestic Product (GDP), which fell a precipitous 6.3% in the fourth quarter of 2008 as the financial crisis worsened, probably fell an additional 5% during the first quarter of the new year. We believe the economy will likely contract for much of the rest of 2009, but the rate of decline should gradually slow as the year unfolds. The economy should begin to grow again in early 2010, but given the de-leveraging that still needs to occur on the part of consumers and financial institutions alike, the recovery will likely be muted compared to previous economic upturns.

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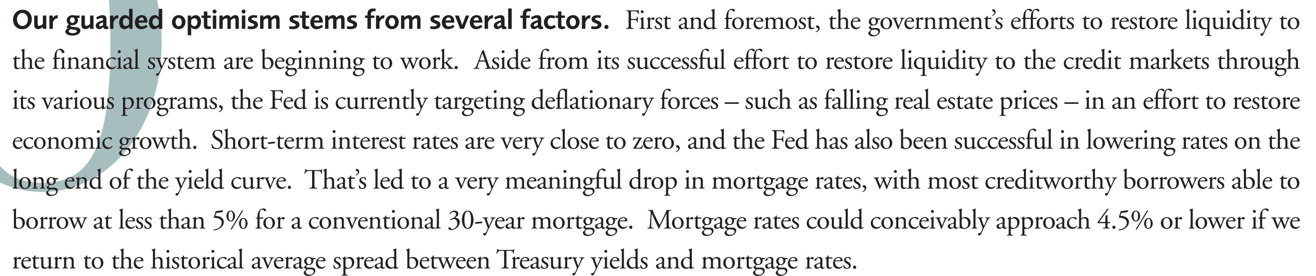
"In our seeking for economic and political progress, we all go up – or else we all go down." Franklin D. Roosevelt



Our guarded optimism stems from several factors. First and foremost, the government's efforts to restore liquidity to the financial system are beginning to work. Aside from its successful effort to restore liquidity to the credit markets through its various programs, the Fed is currently targeting deflationary forces – such as falling real estate prices – in an effort to restore economic growth. Short-term interest rates are very close to zero, and the Fed has also been successful in lowering rates on the long end of the yield curve. That's led to a very meaningful drop in mortgage rates, with most creditworthy borrowers able to borrow at less than 5% for a conventional 30-year mortgage. Mortgage rates could conceivably approach 4.5% or lower if we return to the historical average spread between Treasury yields and mortgage rates.

This is obviously good news for the real estate market, which has been the root cause of many of the economic problems we face today. Real estate affordability is very dependent on the cost of financing, so lower mortgage rates – combined with far more reasonable home prices and significant tax credits for first-time buyers – should go a long way to clear the current glut of unsold homes. Indeed, home affordability is now approaching historical highs.

Lower mortgage rates will not only benefit first-time buyers, but existing homeowners and the overall economy as well. Given that most outstanding fixed-rate mortgages carry interest rates in excess of 6%, the recent boom in refinancing activity should continue apace, effectively increasing consumers' disposable income. This will allow households to pay down debt, save more, and to spend more, adding to the benefits already felt by the sharp decline in energy prices.

While the seeds are being planted for a recovery in the consumer sector, a sustainable uptick in business spending will likely take longer to materialize, regardless of the effects of the fiscal stimulus package passed earlier this year. Industrial capacity utilization has dropped significantly, and faced with lower end demand and a glut of capital goods, corporations will likely continue to spend less, not more. Exacerbating the difficult situation is the uncertainty regarding President Obama's ambitious agenda, which if implemented will likely result in significant changes across a wide swath of industries, including health care, oil and gas, and utilities, among others. The prospect of significant changes in the corporate tax code will also likely contribute to the uncertainty and a restrained level of capital investment.

Of course, we would be remiss not to contemplate the longer-term consequences of an unprecedented increase in the budget deficit and the enormous expansion of the Fed's balance sheet. These actions would normally be very inflationary given that we are essentially printing more money to pay for current consumption. Market-based inflation expectations remain rather subdued, however, and interest rates have not shot higher, and the dollar has not been damaged much at all.

This indicates that deflation – not inflation – is the primary worry right now, and the government is doing everything possible to fight it. That will likely change as the economy improves and capacity is more fully utilized. But for now, the government's mission is to stem the decline of prices of nearly every asset class.

FIXED INCOME

Credit markets have not yet fully recovered, but substantial progress has been made in restoring confidence in our lending system. With the support of numerous government programs such as the Treasury Asset Relief Program (TARP), the Temporary Liquidity Guaranty Program (TLGP) – and most recently the Term Asset Backed Lending Facility (TALF) and Public Private Investment Program (PPIP) – credit is once again beginning to flow. This is in stark contrast to credit conditions following the collapse of Lehman Brothers last fall, in which many sectors of the fixed-income market essentially froze.

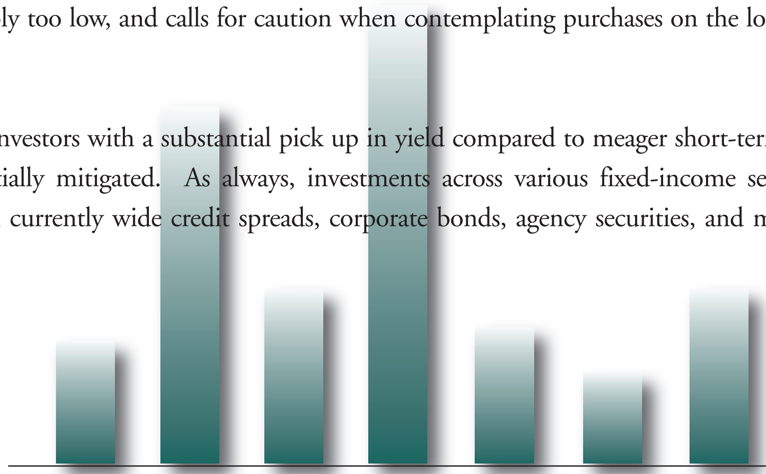
Despite the improvement, much work remains to be done. Credit spreads – a measure of the amount of additional yield an investor demands for taking on additional risk – remain very wide, with industrial manufacturers, for example, paying more than 9% over prevailing Treasury rates. This indicates that investors still expect a slow economic recovery and an increased rate of default from current levels.

In addition to stubbornly high credit spreads, liquidity within the fixed-income markets remains challenged. For example, bid-ask spreads, which is the difference between the price a buyer and seller of a bond is willing to pay, remain abnormally wide. Finally, the market remains extremely volatile, with large one-day movements in Treasuries and other sectors becoming more and more common.

Looking forward, we believe that credit conditions will steadily improve, building on recent gains. Extremely low Treasury yields have "forced" yield-hungry investors to consider riskier assets, which is exactly what the Fed wants to accomplish. A good example of this is the recent mammoth bond offering by the state of California. Despite highly publicized fiscal troubles, California was able to issue approximately $6.5 billion in municipal bonds in an over-subscribed deal. Investors, enamored by the large spread over comparable-maturity Treasury yields, were willing to look past the state's current fiscal woes.

As credit conditions and the economy improve, we expect investors to stop worrying about deflation and to begin to price in higher rates of inflation. The Fed's balance sheet alone has now surpassed $2 trillion and there will be an enormous amount of new Treasury securities issued in the coming quarters to finance the ballooning fiscal deficit. The Treasury Inflation Protected Securities (TIPS) market reveals that investors are only expecting inflation of about 1.3%-1.4% per year over the next ten years. This is probably too low, and calls for caution when contemplating purchases on the longer end of the yield curve.

Intermediate-term maturities provide investors with a substantial pick up in yield compared to meager short-term yields, and interest rate risk will be substantially mitigated. As always, investments across various fixed-income sectors are necessary for diversification, and given currently wide credit spreads, corporate bonds, agency securities, and municipal bonds remain attractive.



MARKET COMMENTARY

Despite a torrid rally of about 20% off the lows of early March, stocks posted their sixth consecutive quarterly decline. The rally that began in late November of last year proved very short lived as we moved into the new year and it became increasingly apparent that the credit crisis had caused significantly more damage to economic growth and corporate profits, which were already suffering as a result of declining consumer spending and higher energy costs.

Financial stocks led the way down, as many investors worried about the viability of the world's surviving financial institutions. The losses on loans and mortgage-backed securities have been mind numbing, and even with huge injections of capital from the government, the losses threaten to overwhelm the increased profitability that usually stems from a steeper yield curve, lower interest rates, and higher fee income. Confidence eroded further as Congressional leaders and others – wary of further bailouts – began talking about the "nationalization" of at least part of the banking system.

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Further complicating the situation was the transition of power in Washington. Wall Street was anticipating a coherent and comprehensive plan to tackle the banking crisis, but it became clear that the new administration needed more time. Meanwhile, investors were quickly disappointed by the much-touted and long-awaited fiscal stimulus plan, which turned out to be not as stimulative as many had hoped. Finally, the new administration presented a budget proposal that not only promised to greatly expand the role of government, blowing out the budget in the process, but threatened to dramatically change the economics of many different industries. The resulting uncertainty regarding future corporate profits – in the face of a severely contracting economy – led investors to seek the shelter of safer investments.

Fear was pervasive and quite palpable during much of the quarter, culminating in a sell-off that brought the S&P 500 down 56% from its mid-2007 peak. As noted, the market has improved greatly since early March. The Fed and the White House have gone a long way to instill confidence in the banking system and to jumpstart economic growth. Recent signs of stability have convinced many investors to begin to look over the current economic valley toward better times ahead.

Despite the recent run in equity prices, we believe valuations remain attractive, especially when viewed on the basis of earnings generated in "normal" economic times. The companies we own generate significant amounts of free cash flow, even after taking into account substantial investments in capital equipment and research and development. This cash flow should grow over time as the economy improves, and profit margins will likely expand as a result of the cost-cutting initiatives implemented over the past eighteen months.

There is currently a huge amount of money on the sidelines – about $3 trillion in money market mutual funds. These funds are earning a minimal amount of interest, and investors are hard pressed to generate any significant level of income from Treasury securities of any maturity. (The 10-year Treasury note now yields only 2.7%.) Should fear continue to dissipate, much of that money will move into riskier assets such as corporate bonds and stocks.

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DAVIDSON TRUST COMPANY

20 North Waterloo Road Devon, Pennsylvania 19333 *telephone* 610.975.9700 www.davidsontrustcompany.com