



It is often difficult to look positively upon the stock market given the backdrop of myriad economic woes. Indeed, unemployment continues to rise, the housing market remains challenged, and given the big-government ideology of our newly elected leaders and the financial straits of many state and local municipalities, tax increases appear imminent. As the negatives pile up, the naysayers grow increasingly vocal, and in some cases even scornful of those that might have a more constructive view of our economic future.

One of the most difficult things an investor must do is *filter out the noise* of the current environment, instead looking ahead to what might lie in store. In this day and age of instant information – not to mention our growing demand for instant gratification – this is no small feat!

That said, we believe we are actively wringing out the excesses of the past few years, setting the stage for an eventual recovery in worldwide economic growth and corporate profits. Given the breadth and depth of our economic problems, the recovery will most certainly be uneven and at times, the market might seem unforgiving. During this period, however, a longer-term perspective must be maintained.

This longer-term view becomes much easier when we free ourselves from the shackles of U.S. centrism, and instead focus on the broader worldwide economic scene. The secular trends that marked the beginning of the new millennium – the emergence of a middle class that has fueled superior economic growth – are still in place in countries such as China, India, and other emerging markets. Our country has and will benefit from these trends. It is important to remember that it is not unusual for a U.S.-based company to derive half of its sales from sources abroad!

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## ECONOMIC OUTLOOK

Turning to the more immediate future, we find ourselves in the grips of one of the most severe recessions experienced in decades. Faced with declining demand and higher energy costs, companies have been cutting costs for the better part of the last two years. The pace has picked up in recent months, however, as the financial crisis has further curtailed end demand, forcing businesses to reduce production and conserve cash.

This has led to much higher unemployment, with more than seven million people losing their jobs since the start of the recession. The unemployment rate, now at 9.5%, has risen substantially from the 5.6% level at this time last year. Such an incredible climb underscores the severity of the downturn, leading even the most optimistic to question their bullish thesis.

**The problem is somewhat obvious: Declining consumer income and the fear of unemployment prompts consumers to save more. As consumption declines, production must as well, leading to a further reduction in demand for labor. This vicious cycle is difficult to break, and is one of the primary reasons many believe that both fiscal and monetary stimulus is necessary.**

While most of us are still waiting for the benefits of the recent massive fiscal stimulus to kick in – most now agree the stimulus package could have been better conceived – the positive effects of monetary stimulus are already being felt. Lower interest rates have resulted in lower mortgage rates, and together with new tax breaks associated with purchasing a home, this has gone a long way to clear some of the excess supply of homes on the market.

**The end result is stabilization in real estate prices, albeit at much lower levels.** Lower mortgage rates have also enabled many to refinance their existing mortgages at lower rates, and in an environment in which households need to retrench and save more, this could not have come at a better time. Also helping consumers are greatly reduced energy costs. Lower gasoline prices are probably saving the average household approximately \$1,000 per year compared to when oil was at its peak, and lower natural gas prices will likely result in far lower home heating bills as we move into the winter.

So while much has been made of the consumer's sorry financial state, the retail sales numbers – while off substantially from year-ago levels—have not proven to be as apocalyptic as the more pessimistic prognosticators had predicted. Retail stocks, believe it or not, have performed relatively well over the last six months!

All in all, after experiencing a contraction in Gross Domestic Product of 6.1% and 5.7% in the fourth quarter of 2008 and first quarter of this year, respectively, the rate of decline should begin to subside for the balance of the year. We forecast GDP to fall in a range of -2.5% to -3.0% for the full year, and to grow modestly in 2010.

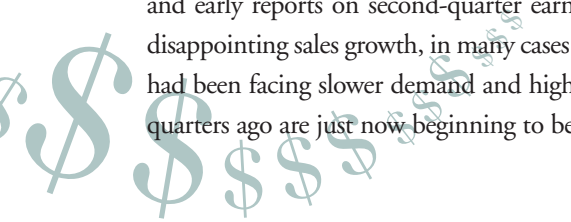
## EQUITY MARKET

**It would be foolhardy to underestimate the problems we currently face,** or to ignore the risk that it will take longer than expected to once again achieve a positive trajectory of economic growth. That said, we shouldn't be blind to the opportunities that are presented to us given that the market is still about 40% lower than it was two years ago. Based on "normal" economic times, valuations in many cases appear compelling.

We see several reasons to be optimistic regarding future returns. First, and probably most importantly, the financial system is in much better shape than it was just five months ago. Following the panic-ridden lows of early March, banks and other financial stocks have done extremely well. The government stress tests identified those companies that needed additional capital, and the banks were able to take advantage of their recent higher stock prices to issue substantially more equity to shore up their balance sheets. A healthier banking system is a necessary prerequisite for a return to normal economic times, and in this regard we have made a great deal of progress.

**Some of the more traditional indicators have also begun to favor a return to normalcy.** Corporate credit spreads – the amount of compensation that investors demand for taking on additional risk of investing in corporate bonds – have narrowed dramatically in recent months after reaching historically wide spreads at the height of the credit crisis. This indicates that investors are forecasting fewer defaults than were originally anticipated. In addition, a positively sloped yield curve, such as the one we have now, has historically been a good predictor of future economic growth. (It is also good for banks' lending spreads.)

One of the silver linings of the unemployment situation is that companies have taken a great deal of cost out of their operations, which of course is positive for corporate profits. We've already seen the benefits of this in first-quarter earnings, and early reports on second-quarter earnings are telling the same story. Although many companies have been reporting disappointing sales growth, in many cases profits were actually better than expected. It is useful to remember that companies had been facing slower demand and higher energy prices for some time already, so restructuring programs initiated several quarters ago are just now beginning to bear fruit.



Interest rates are at historic lows, which of course is a result of the Fed's quantitative easing and investors' perception that inflation – for now – is not a problem.

#### BOND MARKET

**T**urning to the bond market, we look for continued compression in credit spreads, but remain wary about committing to longer-dated bonds. By looking at the spread between the yield on Treasury notes and that of Treasury-Inflation Protected securities (i.e., TIPS), we get a good idea of market participants' expectations of future inflation. Currently, investors are forecasting annual inflation rates of 1.3% and 1.7%, on average, over the next five and ten years, respectively.

While this is somewhat higher than it has been, it is still relatively tame compared to modern history. It appears that we have accomplished what we have set out to do: we have conquered deflation. With that in mind, we must remain vigilant regarding future inflation. Given the large fiscal deficits that we are currently running, inflation will likely become a problem, especially when one considers the implicit devaluation on the US Dollar.

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 jump-start economic growth. Recent signs of stability have convinced many investors to begin to look over the current economic valley toward better times ahead.

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# Variable Rate Demand Bonds: An alternative to low-yielding money market funds

In the interest of caution, many investors currently hold a higher-than-normal percentage of cash or cash equivalents in their portfolios. Unfortunately, money market instruments and bank deposits offer meager yields, often resulting in a negative real rate of return once income taxes and inflation are factored in. Variable Rate Demand Bonds (“VRDBs”) offer a good alternative or complement to money market investments, preserving the liquidity and credit quality that investors demand.

**VRDBs are bonds, often issued by municipalities, that have a long-dated final maturity and a floating interest rate.** They are unique in that they have a “put” feature that allows an investor to return the bond to the selling broker or trustee with seven day’s notice. The bondholder then receives cash (par value) and accrued interest in return for the bonds. On rare occasions the bonds are called back by the issuer with thirty day’s notice, with the cash being received on the call date.

VRDBs have multiple layers of credit strength or cash sources, beginning with the underlying issuer. Many are insured and/or have letters of credit or other types of guarantees attached to them. Among other viable entities, those guarantees or supporting credits could include the Federal Home Loan Bank, Federal National Mortgage Association, bank letters of credit, or possibly the revenues from a well known university or municipal taxing authority.

The liquidity of these securities is derived from the “put” feature embedded in the bonds. This gives them an effective 7-day maturity at par and qualifies the securities as an approved money market instrument in which many money market funds participate. There are other variations of this security with a 1-day or monthly “put” feature back to the broker or trustee. The Dreyfus and Morgan Stanley funds we typically use as cash sweep vehicles hold these securities.

Our clients benefit from investing in VRDBs in a variety of ways. Most of these securities pay interest on a monthly basis, can be put back at par generally within seven days, have several layers of credit and liquidity, and can be purchased on a taxable or tax-free basis. Perhaps most importantly, VRDBs typically have significantly higher yields than money market funds. The minimum investment in a VRDB is \$100,000. We suggest diversifying a portfolio by substituting some or all cash reserve balances in money market funds with VRDBs. It is also possible to create a diversified portfolio consisting entirely of VRDBs for cash management purposes. At present, the average yields offered on VRDBs, which are reset on a weekly basis, are 75 to 150 basis points above money market rates.

In summary, our approach to the purchase of all fixed-income securities, short- or long-term, is consistent. We always look through to the quality of the underlying issuer and to the structure of all instruments which are considered for purchase in our clients’ portfolios. Most importantly, we tailor every security and portfolio to the specific goals, objectives and risk parameters of each client. **If you would like to discuss VRDBs in greater detail, please contact your portfolio manager or Mary Talbutt-Glassberg on our fixed income desk.**

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