

Second Quarter  
2009



## Investment Commentary

As we look back on the first half of the year, conflicting signals characterize the investment and economic environment. After a negative 2008 and a continued downturn in the first quarter in 2009, the second quarter saw significant gains – stocks in fact had their best quarter in more than 10 years. Large cap stocks as measured by the S&P 500 gained 15.93% in the second quarter and are up 3.16% year to date. The S&P 400 which measures domestic mid cap stocks returned 18.75% in the second quarter and 8.47% for the year. The Russell 2000 which tracks small cap stocks generated a return of 20.69% in the second quarter and 2.64% year to date. International stocks were the strongest performers as the MSCI EAFE delivered a second quarter return of 23.76% and is up 5.64% for the year. Easing of the flight-to-quality trade by fixed income investors led to lower Treasury prices and higher yields during the quarter. Yields on municipal and corporate debt moved slightly higher as well, though still extremely low by historical standards.

The conflicting signals of the economy include several positives that helped drive the market's rebound from its March low. The prospect of a collapse of the financial system appears past; the government has demonstrated it will employ all financial instruments and capital to positively address the solutions to our problems. And though economic activity continues to decline, it is doing so at a slower rate, which suggests that we are getting closer to an economic bottom. However, the global economy remains in a fragile state as the effects of massive wealth destruction and the unwinding of a huge debt bubble continue to play out. The ultimate result will likely be lower spending by both

consumers and businesses for an indefinite period. While government actions probably allowed us to avoid a financial impasse, the massive bailout and stimulus spending (along with longer-term demographic factors such as spiraling health care and other entitlement spending) are causing the federal deficit to balloon, which could lead to dollar weakness and inflation down the road.

Unemployment, which is nearing 10% as this letter is written, is a critical factor in predicting recovery. Since consumer business defines approximately 65% of our economic activity, the reduction of disposable income is stifling. There really cannot be a recovery without consumer participation. Given the breadth of the downturn, it is believed that significant employment opportunities will be realized very slowly.

Other conflicts are at play that will influence how the environment unfolds in the years

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ahead. One of these is housing, which significantly contributed to the current problems. There have recently been a few positive signs including stronger demand and historically high levels of affordability. But a wave of new supply from foreclosures over the next two years suggests the market will continue to struggle.

There is more than a trillion dollars in adjustable mortgages that are underwater and that have yet to reset to higher payments. A healthy consumer is basic to housing recovery.

Another question is whether we should be worried about inflation or deflation. At present, there is an enormous amount of excess manufacturing capacity and available labor. Therefore, it is unlikely there will be higher costs to pass along. Demand-driven

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inflation also is unlikely because of slower economic growth. Over the intermediate-term there is even some concern that deflation could take hold if the global economy doesn't experience a sustained rebound. However, looking out a few years, the bigger risk is that policy makers' efforts to avoid a deflationary cycle are too successful and trigger a run up in the inflation rate to modestly high levels or worse.



That highlights another issue, which is the tightrope that policy makers have to walk with respect to stimulus. We believe that in aggregate, government intervention possibly saved us from an economic depression. Given the actions to date, the Fed and the Treasury are clearly committed to help the economy stop its decline, reverse and grow again. On the other hand, it will be difficult to know when the timing is right to unwind the stimulus. If it is unwound too early the economy could relapse (as happened in the U.S. in the 1930s and Japan in the 1990s) and if it is extended too long it will add to inflation, decline of the dollar and slowing real growth in the economy. In any event, there will be great political pressure to deal with on both sides of the issue. And, as the voting public increasingly realizes that the stimulus funds come entirely from borrowed money the political pressures will continue to mount.

Normal investment activity will be influenced by investors' willingness to take on risk, which tends to build during bull markets and break down in bear markets. The degree of investor risk aversion is an unknown that will impact positive returns in the years ahead. However, uncertainty tends to be a paralyzing force with investors.

In summary, investors and investment managers probably face the greatest challenges to realizing positive investment returns in the near/immediate future that has

existed for decades. Still, history has recorded investment threats that were almost impossible to see beyond as they occurred. We do not believe that the current threats are insurmountable. In fact, we believe that the Treasury and the Federal Reserve have diagnosed the problems and are supplying the correct medicine to cure them. Time to heal is the largest issue. The challenge to investors is to be ahead of the rebound without taking an excessive risk. We believe that the proper response is to utilize high quality diversified stocks, bonds and alternative investments with visible financial merits. Bond maturities of short to intermediate maturities, until the inflation scenario becomes clearer, are employed. Asset allocations to meet personal goals should be reviewed. It is important that investor goals, not market action, is the considered criteria. We are ready to work with you on that analysis and encourage your questions.

As always, we appreciate your confidence.

Best regards,

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