



## Investment Commentary

When the dust settled on one of the most eventful years in memory, investors had generous gains in stocks and certain segments of the bond market to salve the wounds of a disastrous 2008 and first quarter of 2009. Stocks finished the year strongly, continuing their powerful run that began in early March. Large-cap stocks, based on the Standard & Poor's 500 Index, gained about 6% in the final quarter, and finished 2009 with a 26.5% gain. In both the quarter and the full year, growth sharply outpaced value, but between larger-caps and smaller-caps, returns were pretty similar. Mid-caps were a different story, providing returns approaching 40% as measured by the S&P Mid-cap 400 Index.

On the fixed-income side returns varied widely in 2009. The Vanguard Total Bond Market Index Fund gained 5.9% for the year, but the iShares Barclays 7-10 Year Treasury ETF was down 6.4% and the iShares Barclays Credit Bond ETF gained more than 14%. High-yield bonds, which normally exhibit hybrid characteristics of stocks and bonds, posted returns in some cases that exceeded 50% for the year.

Heading overseas, the story was emerging markets. The performance of both equity and debt markets of emerging countries far exceeded that of their developed-market counterparts. Vanguard's Emerging Market Stock Index Fund tacked on 8.2% in the fourth quarter to bring its full-year gain to 76%, versus a gain for the predominately developed market Vanguard Total International Stock Index of 3.2% for the quarter and a still impressive 37% for the year.

Looking forward, despite the positive results for 2009, we continue to believe that much of the evidence suggests a challenging road for the

economy and the financial markets. Nevertheless, there are certainly bright spots for investors to consider.

**Household Debt:** Households have accumulated a massive amount of debt after years of unrestrained borrowing and are in the process of deleveraging. This process of paying off debt and increasing the level of savings will take time and will result in lower levels of consumer spending going forward. Because consumer spending is 70% of the economy, it is hugely important to overall economic growth. This desire among households to rebuild balance sheets, along with high unemployment and low perceived job security, makes it likely that consumption growth will be subpar compared to what we've been used to in prior recoveries.

**U.S. Government Debt Explosion:** The U.S. Government's actions in aggregate certainly saved us from a more severe economic downturn than what we have experienced. However, the resulting leap in the government deficit comes at a difficult time. This increase, coupled with a coming explosion of Social Security, Medicare, and Medicaid benefits to retiring baby boomers, means that the government faces extremely challenging times in terms of funding entitlement programs in the coming years.

Some increase in borrowing costs is likely soon, though the risk of a sharp increase in rates is not imminent if the recovery is not robust. But looking out over the next 10 years and beyond, the math is impossible to ignore. There is little question that taxes will have to increase and government spending will have to decrease. If this doesn't happen in a meaningful way, there is a

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likelihood of both a lower dollar and higher interest rates that will provide a challenging environment for the U.S. and global economies.

There are still many variables in play that relate to these concerns, including a slower than anticipated recovery for the labor market; the continued high levels of foreclosures; small businesses suffering from weak demand and a larger decline in profits than bigger firms; states and municipalities suffering from the steepest decline in tax revenue on record; and loan delinquency rates continuing to increase.



The Federal Reserve and the Treasury face challenging policy decisions as relates to the unwinding of the stimulus at the right time and at the right pace.

There are several positives, however, that provide reason for optimism. This is the largest global stimulus ever to occur in peace time. Strong emerging-markets economies are

feeding back into the global economy, which is a positive for exports and manufacturing. Corporate balance sheets, outside of financials, are in good shape with the best liquidity in 50 years. Inventories are low and a rebuilding cycle is beginning, which will support growth. And, the severity of the economic contraction and corporate cost cutting may mean that businesses overreacted and will need to aggressively increase investment and hiring.

As we enter 2010, the economy seems to be showing sufficient strength and momentum to continue the recovery phase. Corporate earnings have generally been better than projected as companies have benefited from aggressive cost cutting. Stock market valuations, though perhaps not cheap by historical standards, are not

excessive and we therefore still see value in the market. Given the higher projected economic growth in international economies relative to the U.S., we expect international stock markets to provide superior returns. The Federal Reserve has continued to signal to the markets that an increase in interest rates is not imminent. Investors will be paying close attention to how they handle any signs of inflationary pressures. The housing market continues to face difficulties and low mortgage rates will be critical to any significant recovery in housing.

We can all take solace in the fact that the financial storm of 2008 and early 2009 is past and our economy and financial system have not only survived but have shown meaningful signs of returning to normal function. As in past periods of market volatility and uncertainty, our adherence to a well disciplined approach to investing has proven to be valuable. We appreciate your confidence and trust and wish for each of you a healthy and prosperous year.

Best regards,

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