Economic & Market Outlook

- The Commerce Department recently reported U.S. GDP declined at an annualized rate of 5.7% in the first quarter of 2009. Looking ahead, we expect the global economy to contract over the next several quarters, with U.S. recovery coming in late 2009 or possibly early 2010.
- The U.S unemployment rate was 9.4% in May. Although recent data indicates new jobless claims are slowing, we expect unemployment to rise over the next year.
- Although consumer spending improved in the first quarter, we expect spending will be subdued over the coming year. Longer-term, we believe we are in the early stages of a secular trend of reduced consumption, private sector debt reduction and increasing personal savings.
- We are more concerned about deflation than inflation due to slack in the economy. income, production, sales and employment continue to show declines, though at a lessened rate. Much of the Federal Reserve‘s additional liquidity remains at the Fed as excess bank reserves. Inflation could become a problem once recovery begins if the Fed is not successful in removing monetary stimulus.
- Two trends described in April have continued: First, on May 1 regulators placed higher costs on shorting Treasury bills, lowering money market and overnight lending rates. Second, private investors continue to test the Fed’s resolve on managing Treasury rates. Mortgage rate-lock hedging by banks, concerns about increased federal spending, and improved equity market sentiment all contributed to a sell-off in Treasuries, moving the bellwether 10-year note yield back to 3.63% as of May 29, almost exactly its yield on September 15, the day of Lehman’s bankruptcy.
- While Treasury yields have risen in the short term, yield spreads on corporate, municipal and MBS bonds remain wider than historical averages. We favor agency MBS, taxable municipals with A or better underlying credit ratings, and selected industrial and utility corporate bonds. While the situation is fast-moving, we believe regulatory and political risk appears too high to merit purchasing financial bonds at this time.

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- In tax-exempt municipals, Obama's proposed budget includes tax increases and expirations of various tax cuts, which should increase the value of the municipal tax shield. We continue to focus on 11-20-year tax-exempt munis with good call protection, with investment grade ratings independent of private bond insurers' status.
- The U.S. stock market continued to rally in May amid more positive news on the economy. U.S. stocks (measured by the S&P 500) rose 5.59%, and foreign stocks (measured by the MSCI EAFE) were up 13.19%. Both indices have now moved into positive territory for the year.
- We believe the equity markets may take a slight breather over the summer months to digest the recent spike in equity prices. It appears that most of the recent positive news in the economy has been factored in those prices. However, further positive economic "green shoots" could continue this substantial rally off of the bottom. Also, the continued move out of cash and into the equity market, along with stock fund manager window dressing of portfolio holdings by June-end, could move markets higher. The key, as always, will be second quarter earnings season starting in early July.
- Within the equity markets, we remain fully diversified but continue to prefer domestic stocks over international stocks, large cap over small cap and growth over value on a relative basis. Returns year-to-date have followed this hierarchy, however developing markets stocks have been relative out performers on the international side, which we have stressed in our allocations.
- We believe stocks of high quality companies with less exposure to problems in the credit markets should do relatively well in a slowing economy. Companies with significant international sales should benefit if the dollar weakens. We remain conservative and defensive in our outlook. We think it is still too early to stress a more progressive, riskier strategy within equities at this time. Cyclical and lower quality companies outperformed defensive names in April and May.
- We encourage investors to stay focused on their long-term goals in the midst of this current market volatility. It is especially important to stay diversified and to reaffirm that our clients' current asset allocation is consistent with their long-term goals. We advise clients with time horizons less than 3 years to remain cautious toward risky assets.

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