

# INVESTMENT OUTLOOK

## Fourth Quarter 2008 Review and Outlook for 2009

by Whitney Brown

- ◆ Stocks finish difficult year on an upswing.
- ◆ Government bonds and gold provide safe haven.
- ◆ Government bailout programs starting to take effect.
- ◆ Market positioned for possible recovery in 2009.

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In the last quarter of 2008, the shaky ground under the financial markets gave way. Concerns over the stability of the banking system, a seizing up of the credit markets and uncertainty over how, and even if, the U.S and other governments would respond, drove investors away from any type of asset with the slightest whiff of risk. Early October marked the height of the crisis when the stock market plunged 25% in only ten trading days from September 29<sup>th</sup> to October 10<sup>th</sup>.

Ongoing doubts about how the U.S. Treasury and Federal Reserve were managing the crisis combined with forced liquidations by hedge funds and

mutual funds to drag the market lower through mid-November. The growing consensus that a deep global recession has become unavoidable added to the downward pressure on the market. By the end of the quarter some of the decline had been recouped, and the market did finish the year on an upswing.



During the last bear market from 2000 to 2002 major U.S. stock indexes bore the brunt of the decline even as other areas such as small company stocks, international equities and real estate stood out as viable alternatives. This time there have been few sure bets in what has been a global shellacking. Most foreign markets have been hit worse than the U.S., and the various equity categories differentiated by market capitalization or style such as large cap or small cap and growth or value have all suffered similarly. Other favored alternative assets for diversification such as commodities and real estate have offered no relief. Corporate bonds, including many high quality issues, have taken a beating as well.

Gold and government bonds have been two rare bright spots. As a commodity, gold has no earnings, pays no dividend and is worth only what the market says it is worth. Yet, as a hard asset, it is seen as a safe haven in times of financial distress. Alternatively, it is also considered a reliable hedge against high inflation. Investors seeking safety have forced

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<u>Market Measures</u>		<u>4<sup>th</sup> Qtr</u>	<u>YTD</u>
S & P 500		-21.9%	-37.0%
Dow Jones Industrial Average		-19.1%	-33.8%
NASDAQ Composite		-24.6%	-40.5%
Russell 2000		-26.1%	-33.8%
MSCI EAFE		-19.9%	-43.1%
Barclays Capital Aggregate Bond Index		4.57%	5.24%
	<u>12/31/08</u>	<u>6/30/08</u>	<u>12/31/07</u>
10-Year Treasury Bond Yield	2.24%	3.98%	4.04%
Three-month Treasury Bill Yield	0.13%	1.90%	3.23%

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Treasury bond prices up sharply, but yields on shorter maturity government notes are so low now that, considering inflation, investors are paying the government to keep their money safe. The yield on 4-week U.S. Treasury bills is essentially zero.

Undoubtedly, the seizing up of the credit markets has tipped the balance to global recession. The U.S. economy is set to deteriorate further with unemployment rising and GDP continuing to contract. Governments around the world are rolling out enormous fiscal stimulus programs to reverse the contraction in spending and restore economic growth.

In the early stages of the crisis, the efforts of the Treasury and Federal Reserve at times gave the impression of being half-baked or haphazard. While having very broad authority but not knowing which policies would be most effective or feasible, the government has launched a sweeping array of programs to stabilize the banking system and get credit flowing again. Some of the efforts are starting to get results. Rates for commercial paper, corporate bonds and residential mortgages have all receded from the crisis highs.

There have been hopeful signs in the housing market where the sales volume of existing homes has begun to pick up. Although prices have not bottomed, historical trends indicate that increasing volume leads to increasing prices. Also, inflation will not be a problem for the near future. Some policy makers and economists have voiced concerns that the massive amounts of monetary and fiscal stimulus being unleashed will create rampant inflation. But, the deflationary forces at work as consumers and businesses reduce debt and curtail spending indicate inflation will not be an issue until much further down the road.

A positive assessment of the stock market's current situation is that the November low marked the bottom for this downturn. The October-November decline pushed numerous indicators of volatility, sentiment and valuation to levels seen only at previous bear market lows. In other words, it is probable that rampant fear and pessimism among investors has depressed stock prices below what would be considered

fair value, and that the great majority of investors who would sell out have already done so.

If historical precedent is a guide to what we can expect going forward, the depth and breadth of the market decline has most likely set the stage for a strong and widespread recovery for the stock market over the next few quarters. Analysis of similar market declines and subsequent recoveries favors a significant market advance in 2009.

There is evidence that the market has been through the worst. Indicators of basic supply and demand in the stock market show that the pressure to sell has contracted significantly since the November low. In addition, more comprehensive models considering both market data as well as external factors have turned positive for stocks on a longer term basis after having been negative for over a year. On a more basic level, the market has recently become very resilient in the face of increasingly awful economic news.

Study of past bear markets coinciding with recessions points out a distinct sequence of events that should occur. After an abrupt and severe market decline the market then dwindles to an eventual bear market low some weeks later. This describes the market action from early October through late November. The next stage would be a period of a several months or more during which the market rallies sharply even as the economy continues to deteriorate. This is entirely counterintuitive but demonstrates the leading tendencies of the market in anticipating an eventual recovery in the economy. Through this sequence of market bottom, rally, and recession end, corporate earnings continue to decline and begin to improve only well after the economy is back on a growth track.

The market is most likely at the point where the bear market low has been established, selling has subsided, but strong demand has not yet come into play to drive the market higher. Any recovery in the market will have to be monitored carefully. Failure of the economy to show improvement after a few quarters could put the market at risk of further decline.

In an eventual market recovery, the areas that

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## Bond Update

by Watt Dixon

While the year 2008 saw tremendous volatility in stock prices, it was also a very difficult year for many corporate bond holders. Financial and automotive bonds were some of the hardest hit. Many investment grade corporate bonds continue to trade below their par value. During the past year, investors heavily sold corporate bonds, as well as stocks, to seek the safety of U.S. Treasury bonds. This sudden spike in demand for Treasury bonds pushed prices sky-high and depressed yields to very low levels. Currently the yield on the 10-year Treasury bond is only about 2.5%. It dipped as low as 2% in late December, 2008.

The inflation rate has averaged 2-3% over the past ten years. Obviously, a Treasury bond yielding 2.5% will barely keep up with current inflation rates. Even though investors in Treasury bonds will get their principal back if they hold the bonds to maturity, a rise in rates could depress the market value of the bonds, especially those with longer maturities.

Investors that are willing to take on more risk in the bond market can find some attractive alternatives to the ultra-safe

Treasury market. Thirty-year, AAA rated, Virginia municipal bonds are yielding about 5%. That is about two percentage points higher than the yield on the 30-year Treasury bond. Municipal bonds have traditionally yielded less than Treasuries because of their tax benefits and safety. Currently in Virginia and other top rated states, municipal bonds are in scarce supply. Counties and cities across the state are not issuing as many new bonds as they have in the past.

In addition to the municipal bond market, another area of the bond market that has recently become more attractive is the corporate bond market. While there is more risk inherent in corporate bonds than Treasury bonds, the spread between corporate and Treasury yields is much wider than it has been in recent memory and may justify the extra risk. Until the credit markets return to normal, even the strongest companies will have to offer higher than usual rates to place new debt.

With such low yields on Treasury and agency securities, building a high quality fixed income portfolio with a reasonable yield is more difficult. Even so, it is still

appropriate to diversify among different types of bonds.

Good quality corporate names, U.S. Treasury bonds, government agency bonds, and when available, municipal bonds, all can be a part of most diversified bond portfolios. In a portfolio where taxes are a consideration, a portfolio of Virginia municipal bonds is appropriate. Concentrating on general obligation bonds, which are backed by the State, and high quality revenue bonds from strong cities or counties in the state can reduce risk.

Laddering, staggering bond maturities incrementally over a period of years, can take some of the sting out of today's low Treasury yields. By having bonds maturing frequently, the proceeds can be reinvested at the then prevailing and hopefully higher rates. With rates at historic lows today but the potential for inflation in the years ahead, limiting the maximum maturity of a fixed income portfolio to seven years or less is prudent.



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can be expected to rebound first are those that declined most, perhaps including emerging markets, commodity and resource based sectors, energy and possibly financials. Unfortunately, the upheaval and extent of government intervention in the financial system raises many questions about the business models and potential earnings growth for banks and other financial companies going forward.

The events of the past few months have shaken the confidence of many investors. Our historical perspective reminds us that, however unsettling it seems, the current situation is not without precedent. Bear markets and recessions are painful but necessary to correct imbalances and set the stage for future growth. We have confidence that the market will recover, the economy will restore itself, and a balanced and long-term investment approach will be rewarded.

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TELEPHONE (540) 343-9903

FAX (540) 343-7684

WEBSITE: WWW.DHFB.COM

## IRA Update: 2009 RMDs and Charitable Donations

by Ted Feinour

New legislation approved in early December suspends the required mandatory distribution requirements for individual retirement accounts for 2009. The intent was to not require a taxable distribution from an account which had possibly been reduced in asset value during the 2008 market decline. This provides those individuals not taking a distribution a chance of recovery in value for their account. Unless Congress decides to extend the moratorium, those over the age of 70½, along with individuals who have inherited IRAs or 401(k) accounts will have to resume the mandatory distributions in 2010. If an individual turned 70½ in 2008 and planned to take their first distribution by April 2009, however, they are still required to take it. The law suspends mandatory distributions only for 2009.

If someone becomes age 70½ in 2009, they

will not have to take their first withdrawal in 2009 or by the first three months in 2010. They can skip the 2009 withdrawal but would need to take a withdrawal by December 31, 2010.

As for charitable donations, the Congress renewed the tax break in 2008 for donations coming from an IRA. Under the extended law, individuals age 70½ or older can donate as much as \$100,000 from an IRA to a public charity. No income taxes are due on the withdrawal. The donation would usually count toward the required distribution amount, but of course that would not apply in 2009.

We will be happy to discuss your IRA withdrawal plans for 2009 in light of these temporary provisions.

