

INVESTMENT OUTLOOK

Third Quarter 2009 Review and Outlook by Whitney Brown

- ◆ Stocks post strong 3rd quarter gains.
- ◆ Economy exiting recession.
- ◆ Inflation not a near-term problem.
- ◆ Challenges remain for the economy and financial system.

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The stock market delivered excellent returns for the July-to-September period. After taking a breather in June, stocks moved up throughout the quarter with only two minor pullbacks. To date, all major markets, both in the U.S. and abroad are showing surprisingly robust gains for the year. What began as a snap back from the extreme lows in March now appears to have moved into a sustainable uptrend. Of course, the market is still well off the peak levels of 2007, but the strength of the now seven-month long rally bodes well for further gains.

Relief that the global financial system did not completely self-destruct and anticipation of the economy exiting recession have brought the broad market up over 50%

from early March. At the low, stocks were priced for a worst possible case that did not materialize. Subsequently, a powerful rebound brought stocks back to a level more in line with the economic reality of recession, not depression.

Much of the market recovery has been based on *expectations* that the economy would return to growth. With corporate earnings in the dumps, the market rally has stretched valuations in the form of price-to-earnings ratios. While cost cutting has allowed companies to manage earnings to some extent, future growth of earnings will depend on a pick up in business revenue.

And, the economy does appear to be coming back to life. More signs of global activity are turning positive. Inventory replacement and some level of pent up demand should generate positive growth in the next few quarters. A recent surge in merger and acquisition activity indicates that big businesses see opportunities for growth ahead.

Unfortunately, there are substantial concerns about how sustainable the recovery may be, given the underlying problems of unemployment and debt reduction by households and small businesses. Currently, unemployment is still rising and may top 10% before starting to improve. In prior downturns, unemployment has not peaked until well after the end of the recession, so the trend is not surprising but still troubling. Not reflected in the unemployment figures, many businesses have reduced work hours to avoid layoffs. Until wages and income start to improve, consumers will not be a driving force in the economy. Household debt reduction and increased savings will ultimately support long-term economic growth, but create a significant headwind in the near term.

To a great extent, the emerging global
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<u>Market Measures</u>	<u>3rd Qtr</u>	<u>YTD</u>	
S & P 500 (price)	15.0%	17.0%	
Dow Jones Industrial Average	15.0%	10.7%	
NASDAQ Composite	15.7%	34.6%	
Russell 2000	18.9%	21.0%	
MSCI EAFE	18.8%	25.5%	
Barclays Capital Aggregate Bond Index	3.7%	5.7%	
	<u>9/30/09</u>	<u>12/31/08</u>	<u>9/30/08</u>
10-Year Treasury Bond Yield	3.32%	2.24%	3.83%
Three-month Treasury Bill Yield	0.12%	0.13%	0.90%

Third Quarter 2009 Review and Outlook (continued)

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economies will be leading the way out of recession. Economies of countries such as China, Brazil and India are much less encumbered with debt and have rapidly growing middle classes who will buy automobiles, housing and consumer goods. The developed economies of the U.S., Europe and Japan will find their technological and industrial exports in demand in these high-growth countries. They also benefit from low cost consumer goods produced in those countries.

In the U.S. the Federal Reserve will keep short-term interest rates low for the foreseeable future, certainly until a self-sustaining recovery is firmly established. After the aggressive policy response to the crisis last fall, cutting interest rates to near zero and flooding the economy with money, they will not risk snuffing out a budding recovery by raising rates too soon.

The Fed's easy money policy has caused concern that high inflation is our next major problem. At least for the near future, those fears may be misplaced. Consumers are, of necessity, returning to thrift after borrowing and spending beyond their means for years. Tightened credit conditions and reduced demand are forcing businesses to hunker down as well. In this climate of thrift and deleveraging, inflation is a concern for much further down the road. Perhaps most significantly, bond yields are low and stable, not yet signaling higher inflation.

Relative to bonds and cash, stocks should offer better returns over the coming months. Bond yields are low and should remain so until economic growth is firmly established. Money market yields are negligible in most cases. By comparison, the dividends and potential for appreciation from stocks are much more attractive than they were at the market highs of two years ago. Investors are understandably gun shy

about stocks, and recent data detailing the flow of money to mutual funds indicates an overwhelming preference for bond funds. This only serves to keep bond prices up and yields down. In addition, when interest rates do begin to rise, bond fund investors may be unpleasantly surprised by declining values of their fund holdings.

Looking ahead, the market advance may likely have further to run, but we are due for a correction or at least a lengthy pause. From the standpoint of the objective market data we follow, there is little to suggest that stocks are headed for a major fall in the near future. Many market commentators are saying the market has gone too far, too fast and must come down substantially. Others are more bullish. Such skepticism and lack of consensus is usually a positive for the market because when everybody thinks it's going up, there's little money left on the sidelines to drive it higher.

Though the run up from March has offered encouragement to intrepid equity investors, this is not the time to get complacent. There are too many question marks regarding the economic recovery and the future of the financial system. A return to a primary bull market such as the 1982 to 2000 period is still some years away. Stocks never got as undervalued at the March lows as we would have expected for a true long-term bottom. We will need to monitor the market very carefully in coming months and be ready to shift to a more defensive posture when the time comes.

Considering where we are now compared to a year ago, it is hard to remember that there were real concerns about the world economy collapsing into a major depression. No one will know what might have happened if policy makers and central bankers had not acted as rapidly and aggressively as they did. The storm has passed but there are monumental challenges ahead to reform and re-regulate the financial system and, most importantly, to restore fiscal restraint.

Dollar Under Pressure

by Stebbins Hubbard



During the global financial crisis, the U.S. dollar strengthened notably against other currencies as foreign investors sought safe haven in the dollar's status as the world's reserve currency. Although the U.S. was at the center of the crisis, investors believed that the scale and dynamism of the U.S. economy and its capital markets made dollar-based assets, especially U.S. Treasury securities, the safest place to

hide. Renewed global growth is now whetting investors' appetite for risk, and we are seeing much of the dollar's recent strength unwind.

Actually the declining dollar is not a new story. The dollar has been in a long-term decline since we went off the gold standard in 1971. Despite our status as a debtor nation, the size of the U.S. economy relative to the world has allowed the dollar to continue as the world's

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New Rules for Roth IRAs

by Jonathon Grace



Under the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), taxpayers will be able to convert all or some of their traditional IRAs into a Roth IRA, *regardless of income*, starting in 2010. This change in the Roth conversion rules represents an

excellent opportunity to pay taxes now as a way to avoid paying potentially more taxes later.

[A Review of Roth IRAs](#)

A Roth IRA is different from all other types of retirement plans in that (1) contributions to a Roth IRA are never tax deductible; (2) a rollover from a traditional IRA to a Roth IRA is taxable; (3) qualified distributions from a Roth plan are income tax-free; (4) there are no minimum required distributions (RMDs) from a Roth IRA until after the owner's death; (5) there is no age requirement or limitation governing contributions to a Roth IRA [contributions can be made to a Roth IRA even after age 70 ½]; and (6) taxpayers can contribute to a Roth IRA even if they are covered under other retirement plans.

In 2009, taxpayers are eligible to make a regular contribution to a Roth IRA if they have taxable compensation and their modified adjusted gross income (modified AGI) falls below certain maximum levels: \$120,000 for individuals and \$176,000 for married couples filing jointly. For 2009, the maximum amount of a regular contribution to all of a taxpayer's IRAs is the lesser of \$5,000 (\$6,000 if age 50 or older) or taxable compensation. If a taxpayer's income exceeds the modified AGI limit for his or her filing status, then the Roth IRA regular contribution limit is gradually phased out. Contributions may be made for non-working spouses.

[Rollover Conversions into Roth IRAs in 2010](#)

Until now, there have been income limits governing who was eligible to convert a traditional IRA to a Roth. Beginning in 2010, those limits have been eliminated. Income recognized from conversions in 2010 will be pro-rated between years 2011 and 2012, *unless the taxpayer elects to recognize it all in 2010*.

Example: Jane has a traditional IRA with a value of \$50,000 consisting of deductible contributions

and earnings. She converts the traditional IRA to a Roth IRA in 2010, and as a result of this conversion, has \$50,000 in gross income. Unless she elects otherwise, \$25,000 of the income is included in her taxable income for 2011, and \$25,000 is included in income in 2012.

[Five-Year Rule](#)

When you convert assets to a Roth IRA, you have to hold those assets in a Roth for five years or until you turn 59 ½ years old, whichever comes first, in order to make penalty-free withdrawals of your converted amounts. Each conversion has its own five-year timeframe. But if you are already 59 ½ when you convert traditional IRA assets to a Roth IRA you can withdraw the assets you convert at any time without worrying about a five-year deadline or penalties. The rules are different for *earnings* on those assets. You have to have held a Roth IRA for five years to withdraw any earnings tax-free.

[Other Considerations](#)

Roth conversions may not be advantageous for everyone. If you expect your income to be lower in retirement – and tax rates to be the same or lower – then a Roth conversion might not make sense. It certainly behooves everyone to make the calculations.

The total value of all your IRAs and the pro rata share of deductible and non-deductible contributions must be considered when converting all or a portion of any IRA. For example, if you have a total of \$500,000 in more than one IRA and one of them has \$50,000 in after-tax contributions, you only pay tax on 90% of the amount converted.

In addition to a traditional IRA, certain other qualified retirement plans may also be converted to a Roth IRA. If asset values drop significantly after conversion, Roth conversions can be undone – if you follow the rules and time requirements.

We have only provided a brief overview of some of the ins and outs of converting to a Roth IRA. As with all tax matters, the rules are complicated, so seek professional advice from your tax adviser before taking any action. We would be glad to help you consider whether a Roth conversion could make sense for you.

DIXON, HUBARD, FEINOUR & BROWN, INC. *investment counsel*

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Dollar Under Pressure (continued)

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reserve currency. There is no obvious alternative, but pressure is mounting for the U.S. to bolster the value of the dollar.

Other nations, particularly those who are growing faster and those who are heavy exporters and users of commodities, fear that the weak dollar will create dangerous imbalances in the global economy. For the U.S., swelling budget deficits and very low short-term interest rates make the dollar a poor investment relative to other higher yielding currencies. In turn, it drives commodities prices higher and makes other countries' exports more expensive in the U.S. Some nations are concerned that because of their rapidly appreciating currencies, they will experience bubbles in housing and other assets much as the U.S. did. Australia, a major commodity exporter, has recently become the first nation to raise interest rates to tamp down inflationary pressures there.

It is in no one's interest to see the dollar collapse. China, for example, is the largest foreign holder of U.S. Treasury securities. The U.S. is also their largest export market. A dollar crisis would severely erode the value of their Treasury holdings and wreak havoc on the economy of their largest customer. Recently, foreign governments have conducted currency interventions, buying dollars to dampen the appreciation in their own currencies.

Some nations have proposed a basket of multiple currencies as an alternative to the dollar for global commerce. China and others are finding ways to avoid doing business in dollars. The stability in the bond markets indicates that the issue has not reached a boiling point yet. However, it will be very important in the next several years for the U.S. to demonstrate our commitment to restoring value to the dollar through deficit reduction and policies to promote economic growth. Political reality may make that a tall order.