

INVESTMENT OUTLOOK

Second Quarter 2010 Review and Outlook by Whitney Brown

- ◆ Stocks down in the second quarter.
- ◆ Market action consistent with normal correction.
- ◆ Economy continues to expand, but at slower pace.
- ◆ Federal Reserve will maintain low interest rates.

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In the second quarter, the stock market experienced a sharp reversal. After a year-long advance with little more than a few minor pullbacks, stocks entered a full-blown correction. For the quarter, all the major indexes, both domestic and international, endured double-digit declines. Stocks have given back the gains from the first quarter, plus some, and are in the red for the year. As safe havens, gold and government bonds were the only asset categories that gained for the quarter.

A significant correction has been expected, since the market made a stunning run of 80% in a little over a year. The depth and duration remain to be seen, but the causes have more to do with worry about what may happen rather than what is

happening. Considering the level of angst and uncertainty pervading the global financial news, the degree of market correction so far seems fairly tame. If the sky were really falling, the market reaction would be much more intense. In fact, the market action has been well within the norm for a typical correction within an ongoing cyclical bull market.



Investors have been preoccupied with fiscal troubles in Greece and how the austerity measures taken there and in other countries, with similar but less severe problems, will impact the economy of Europe and the rest of the world. While extremely unlikely, the chance of a so-called double dip recession in the U.S. has also spooked the markets as GDP growth and labor market indicators have begun to moderate.

The economy, both at home and abroad, continues to expand, although the rate of improvement has slowed from the early stages of the recovery. While a mid-cycle slowing is very much in line with the pattern of prior recoveries, the generally subdued nature of this recovery is a legitimate cause for concern. Consumers have little choice but to refrain from spending and reduce debt. And, the housing market has shown few signs of sustained revival, merely bumping along the bottom. Given the excesses of the prior cycle, any recovery could justifiably be expected to come in fits and starts. On the brighter side, businesses are increasing capital spending which bodes well for continued recovery.

The recent bout of worry has not only driven stocks down and gold up, but government bond yields have been driven back down to crisis levels. The Federal Reserve will remain on hold with regard to any tightening of policy. With interest rates and inflation low, valuations reasonable, and sentiment far from euphoric, conditions for further market advance are in place. Market action will probably remain choppy for a while longer, but the correction should run its course in due time and allow stocks to move higher later in the year.

<u>Market Measures</u>	<u>2nd Qtr</u>	<u>YTD</u>
S & P 500 (price)	-11.9%	-7.6%
Dow Jones Industrial Average	-10.0%	-6.3%
NASDAQ Composite	-12.0%	-7.1%
Russell 2000	-10.2%	-2.5%
MSCI EAFE	-14.9%	-14.7%
Barclays Capital Inter US Gov't/Credit Bond Index	3.2%	4.8%
	<u>6/30/10</u>	<u>12/31/09</u> <u>6/30/09</u>
10-Year Treasury Bond Yield	2.94%	3.84% 3.54%
Three-month Treasury Bill Yield	0.18%	0.05% 0.19%

Demographic Trends Impact Health Care Stocks

by Jonathon Grace



A combination of forces are converging that may portend a great future for health care stocks. First, spending on health care in the U.S. is higher than ever and set to move even higher. For example, the U.S. spent 16.2% of its GDP on health care in the year 2008, a new record. Secondly, the Census Bureau projects that by the year 2050, more than 20% of the U.S. population will consist of persons 65 years of age and older. By contrast, that segment made up only 12.8% of the population in 2009.

These trends are important because the elderly spend up to ten times more on health care than other age groups. In addition, as Americans reach the age of 65, they will increasingly switch to government-run insurance programs such as Medicare. Although health care spending increases with age, the increase in spending thus far has less to do with demographics and more to do with the accessibility of benefits from government sponsored plans. For example, the U.S. government now foots the bill for about half of all health care spending. Before Medicare was enacted in 1965 and became

effective in 1966, the amount was only 25 percent. Those aged 65 and older receive 5 to 15 times the health care benefits than younger population segments.

Medicare Part D is a prime example of a costly benefit that many older Americans have grown accustomed to and will be reluctant to give up. Thus, as more people age, spend money on health care, and participate in government insurance programs, they will resist any attempt to rein in the cost of those programs if it means a reduction in benefits. This resistance will arise from the growing political clout of the soon-to-be largest demographic class of the era.

As a result, the long-term investment opportunity in health care stocks is favorable. The valuations of stocks in the health care sector bottomed in February 2009 and are currently deemed reasonable. Many companies within the sector tend to be both large-cap stocks and dividend payers, adding to their appeal. The industry beneficiaries of increased spending and aging trends are hospitals, professional services (doctors, dentists, and the like), and prescription drugs; and to a lesser extent, nursing homes, home health care, and medical products.

Water in Demand

by Watt Dixon



As economies of developing nations continue to improve and grow, water usage can be expected to increase. While the consumption of drinking water will continue to rise, the usage of water for crops is growing at a very fast rate. Europeans and Americans have had high proportions of meat in their diets for many years, but now this trend is catching on in emerging markets as incomes rise. Meat production requires ten times the water withdrawn per calorie by plants. The average daily diet in the U.S. requires some 6,000 liters of water in agriculture, compared with 3,000 liters in less developed regions.

In addition to this growing demand for water by developing countries, politicians have added another drain: biofuels. It takes up to 9,100 liters of water to grow the soy for one liter of biodiesel, and up to 4,000 liters for the corn to be transformed into bioethanol. What was meant to help curb climate change is making an even more serious problem (water shortage) worse.

Hydraulic fracturing or “fracking” is a new method natural gas companies are using to extract more natural gas from the earth. Fracking uses chemicals mixed with water and

shot through ultra high pressure hoses to break up rock layers, thus releasing the natural gas. Tremendous amounts of water are needed for the process.

If these trends continue, the world will need to find ways to use water more efficiently or face some potentially serious consequences. Ninety-seven percent of the world’s water is salty; another 2% is frozen in icecaps; and of the remaining 1%, the vast majority is underground. Knowing these facts about water, there could be potential investment opportunities in water over the next several years, if not decades. Water is a natural resource that has a limited supply and no true substitute.

Investment opportunities in water might encompass companies that are involved in exploring, digging, purifying and transporting water, as well as building water treatment facilities. There are several exchange traded funds (ETFs) that invest in companies engaged in these activities. Desalination of water appears to be showing some promise in areas of the Caribbean and Saudi Arabia. While investing in water utilities is an option, these are highly regulated entities and governments could always cap what they charge, thus limiting their profitability.

Deflation Threatens Euro Zone Recovery

by Stebbins Hubbard

Deflation (a prolonged fall in prices) is a real possibility in some euro zone countries. Others could face years of very weak inflation. Such an outcome could make it even harder for the euro zone's weakest economies to escape the economic downturn, and for their governments to repair their budgets and reduce their public debts as collapsing housing bubbles continue to ripple through their economies.

The combination of high debt and falling prices on the once fast-growing fringe of the euro zone would complicate hopes for a wider recovery in the euro zone. Spain and other countries on the bloc's periphery have been key drivers of the region's growth in the past decade.

Manufacturers in Portugal, Ireland, Italy, Greece and Spain ("PIIGS") have been cutting prices for well over a year, as heavy competition continues to restrain manufacturers' pricing power. Overall, euro zone manufacturing output has picked up, fueled by exports and domestic restocking.

Consumer prices are already falling in Ireland. They risk doing so in Spain, many economists say, where unemployment is at the highest level in the euro zone. Consumer prices in Ireland are down 2.6% from a year ago,

the biggest drop in the euro zone. Irish consumers' spending is in retreat, after the country's recession pushed the jobless rate up by almost two-thirds to over 13% at the end of 2009. The "PIIGS" were the only euro-zone members to see a decline in average consumer prices in 2009 from the previous year. Retailers have responded by slashing prices of clothing, furniture and house wares. Consumer prices are expected to fall again in 2010, according to the European Central Bank (ECB).

For businesses, lower prices of consumer goods and services often mean lower profits. For governments, they mean less tax revenue, especially in European countries where sales or value-added taxes make up a large share of tax receipts. That could complicate the already fragile calculations of the "PIIGS" as they try to rein in budget deficits.

Deflation occurs when falling prices become embedded in the mindsets of households and businesses, causing them to delay spending, investing, and hiring

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Confusing Times for Estate and Gift Taxes

by Ted Feinour



In previous years, Congress passed a number of tax cuts. Recently the battle over raising revenue has slowed down the process to extend many of these cuts. Congress has yet to address several major Bush administration tax breaks due to expire after this year. This has caused great confusion and uncertainty regarding estate taxes and the amount of gifts that individuals may make.

Under the Bush Administration tax cuts, the estate tax expired as of January 1, 2010, but returns January 1, 2011 with only \$1 million in assets exempt from tax. Many in Congress want to restore the exemption to the 2009 level of \$3.5 million, but this has not been approved.

All the uncertainty surrounding the estate tax makes it important to consider making gifts while one is alive as long as one does not need the assets. Any individual this year may give another individual \$13,000 in cash or assets without having to worry about gift taxes. This means that an individual and his or her spouse may give \$26,000 to a child, grandchild, or anyone, this year.

It is also possible, in addition to this gift, to pay education expenses or medical bills for any individual. The payment, however, needs to be paid directly to the educational institution or medical provider. Each person currently has a lifetime gift tax exemption of \$1 million, but once the estate tax returns, gifts made under this lifetime exemption will reduce the amount of estate tax exemption. Above the \$1 million, gifts are currently taxed at the 35% rate which could certainly increase if Congress reinstates the 2009 gift tax rate of 45%.

Many clients have inquired about the tax free contributions from retirement accounts made to charitable organizations and whether Congress will reinstate those provisions that had been in place for several years. Congress is now considering reinstating those provisions as part of the new spending bill in the Senate, which would renew some tax breaks and introduce several tax hikes.

One thing for sure is that some changes will occur in the near future. People may want to be prepared to reconsider their estate plans once the changes have been adopted.

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

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Deflation Threatens Euro Zone Recovery (continued)

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because they believe goods, services and labor will cost less in the future. Such expectations and the cautious behavior they lead to can trap an economy in a kind of malaise.

Economists generally agree that a bit of inflation is a good thing. In moderation, rising prices help fill government coffers through greater tax revenues, and can make it easier to pay off public debts by shrinking them as a share of government revenue. More than a little inflation, however, is a menace, most economists and policy makers say, based on bitter experiences like the 1970s, when inflation in many industrialized countries undermined economic growth and employment, and required a painful spell of high interest rates to curtail the rising prices.

The ECB says it has avoided both inflation and deflation: Annual inflation in the 16-nation euro zone is running at about 1%. The ECB argues that the medium-term expectations for inflation that guide the behavior of businesses, labor, and consumers are more important than short-term movements in prices. The ECB cites survey data showing professional forecasters expect inflation to be right around the central bank's target of just below 2% in five years' time.

That's true for the euro zone overall. However, the roughly 20% of the euro zone made up by the "PIIGS" could

face much lower inflation than the euro average, and possibly declining prices in coming years due to their need to make their industries more internationally competitive, which may require staff and wage cuts for some years.

A weaker euro helps to a degree (it has fallen 9.6% against the dollar since March), but it is not sufficient to address the fundamental competitiveness problem that the "PIIGS" now face. They are not expected to get back to their pre-crisis levels of activity until 2014. Overall, the long-term outlook for the euro is not good. The average value of the euro since its inception is 1.19 against the dollar. Thus, despite its recent decline to 1.24, the euro is still trading above its long-term average. Moreover, most models still show the euro as somewhat overvalued against the dollar on a Purchasing Power Parity basis. This suggests that there is still downside to the euro, even at these levels.

With respect to the broader equity picture in the euro zone (Euro Stoxx Index, down 10.3% year-to-date), the market has declined a reasonable distance towards pricing in the risk of a fiscal crisis in the region. The earnings season went well, with more than half of companies beating first quarter estimates by more than 5%. Euro zone stocks are now trading at a P/E of 9 times 2011 earnings estimates making them relatively cheaper than U.S. stocks, trading at 11 times earnings.