



# BROADWAY INVESTMENT MANAGEMENT GROUP

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## REVIEW AND OUTLOOK *Second Quarter 2009*

### **Market Overview**

The second quarter of 2009 brought investors a pleasant surprise as the global equity markets experienced an unexpectedly strong rally. From early March lows through June 5 the S&P 500 had climbed 38%. The worst performing sector for all of 2008, the financial sector, was the best performing group in the second quarter of 2009 as the S&P Financials Index more than doubled posting a return of 102%. International markets outpaced their domestic counterparts as the EAFE index rose 47% and the Emerging Markets index gained 60%.

While the sharp rise in the equity markets has been a welcomed surprise, some analysts are cautious about the economic data and participants that have driven the performance. Employment and housing data saw improvement over the quarter, but it has been just that, an improvement. We have yet to see signs of growth in these economic data points.

In addition, the rally in stocks has been led by investors buying “low quality” companies that may rebound faster from the slump than bargain priced good quality names. A study conducted by Societe Generale SA showed that buying stocks with poor financial ratios and high price-to-book valuations returned 73% during the rally, while purchasing shares of companies with low valuation ratios yielded 55%. While low quality stocks may outperform at the outset of a recovery, history has proven that they tend to underperform their benchmark index in the long run.

Broadway’s equity portfolios continue to be broadly diversified across all 10 sectors of the market and we continue to search for and purchase stocks that are in sound financial condition with promising growth expectations.

Performance in the commodity and Treasury bond markets during the second quarter also began to indicate an end to the recession may be near.

Commodity prices rallied as manufacturers began to build up inventories in preparation for an economic rebound. The Reuters/Jefferies CRB index (a popular index of 19 commodities) rose 14% in the month of May, which was its biggest monthly rally in 34 years. In other positive news, Dow Chemical Co. reported that its plants operated at 70% capacity in April, up from 45% last December as demand increased.

The 10-year Treasury note yield increased from 2.87% on March 6th to 3.52% as of June 26th signaling decreased expectations of deflation and increased expectations of an economic recovery. The rise in yield also indicates expectations for higher inflation in the future which would be a reversal of the most recent trend. The Organization for Economic Cooperation and Development (OECD) reported that consumer prices in its 30 member countries rose by 0.6% in the 12 months ended in April 2009. This was in stark contrast to the rate in July 2008 that stood at a one-year high of 4.8%.

### **Economic Review**

For the past eight months, the Federal Reserve has executed an expansionary monetary policy of historic proportion by pumping more than \$800 billion into the financial system. Despite concerns for potential future inflation, the primary goal of these policies is to promote economic growth. After posting a 6.3% decline in real GDP for the fourth quarter of 2008, the U.S. economy fell by 5.5% in the first quarter of this year. The improvement over the previous quarter is due to an upturn in Personal Consumption Expenditures. This is a positive signal since consumer spending has historically made up over two-thirds of U.S. economic growth.

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However, since the recession began consumers have significantly reduced their spending habits and have actually been saving aggressively. As a percentage of disposable personal income, the personal savings rate which has averaged less than 1.0% from 2004 to 2007 has climbed to 5.7 percent in April according to the Bureau of Economic Analysis (BEA). Although consumer spending posted a modest comeback there is still uncertainty as to whether that will continue. At least in the near term, economic growth may be hindered as consumers still show signs of reluctance in their spending.

Other headwinds facing economic growth continue to be housing difficulties, lower exports, and lack of business investment -including inventory investment which continued to decline sharply according to the BEA. The decrease in levels of inventories, however, is seen by many economists as a positive sign for future economic activity. With inventories low, manufacturers, wholesalers, and retailers will be in a position to quickly boost production and begin hiring employees when demand returns.

Another glaring challenge facing the U.S. economy is massive unemployment. Although the loss of private-sector jobs is showing signs of slowing, the amount of job losses is still considered significant. In May, the country's jobless rate rose to a 25-year high of 9.4 percent and many, including President Obama, expect it to hit double digits by next year. Perhaps more troubling is a recent report by the U.S. Bureau of Labor Statistics which indicated that more than a quarter of the nation's 12.5 million unemployed workers have been without a job for longer than six months.

Despite these challenges, there have been some minor signs of optimism during the second quarter. The consumer confidence index as measured by The Conference Board rose to 54.9 in May from 40.8 in April marking its highest level in eight months. Another broad measure of economic activity called The Conference Board Leading Economic Index (LEI) also increased in May for its second consecutive month of improvement. The Conference Board also indicated that for the first time in two years the six-

month change in the LEI has turned positive. Among the positive contributors were stock prices, real money supply, consumer expectations, and building permits which more than offset the negative contributions from initial unemployment claims. While these positives are no indication that a definite recovery is underway, perhaps the good news is that some of these key economic measurements are no longer getting any worse.

In summary, the Fed and policy makers have their hands full with regard to making the economy grow again. With the massive amounts of stimulus being pumped into the financial system, the Fed is forced to walk the fine line of balancing the threat of inflation with reassuring that they have no plans to jeopardize the economic recovery. Regardless, there is a growing and legitimate concern about future inflation. Ultimately, it may be a question of when and how fast the Federal Reserve will begin to raise interest rates.

We have received many questions about how we are addressing inflation in our portfolios. Although we believe inflation may eventually be a larger problem that must be reconciled, we feel that its timing and magnitude are still uncertain. In cases where it makes sense within the overall portfolio, we are advising small allocations to inflation-indexed securities known as Treasury Inflation-Protected Securities (TIPS) and international (non-U.S. dollar) bonds to provide some inflation offsets. We are also advising small positions in gold and other commodities to provide inflation protection. We will continue to monitor and assess whether these types of investments warrant greater allocations in the future.

| Index                 | YTD   | 1 Year | 3 Years |
|-----------------------|-------|--------|---------|
| Dow Jones Industrials | -2.0% | -23.0% | -6.3%   |
| S&P 500 Index         | 3.2%  | -26.2% | -8.2%   |
| EAFE*                 | 8.1%  | -31.3% | -7.06%  |

\*EAFE = Europe, Australia, & Far East International Index

|                                            |       |
|--------------------------------------------|-------|
| 2 Year Treasury Bond Yield as of 6/30/09   | 1.12% |
| 2 Year Muni Bond (AAA) Yield as of 6/30/09 | .98%  |