Godsey & Gibb Associates
Investment Watch
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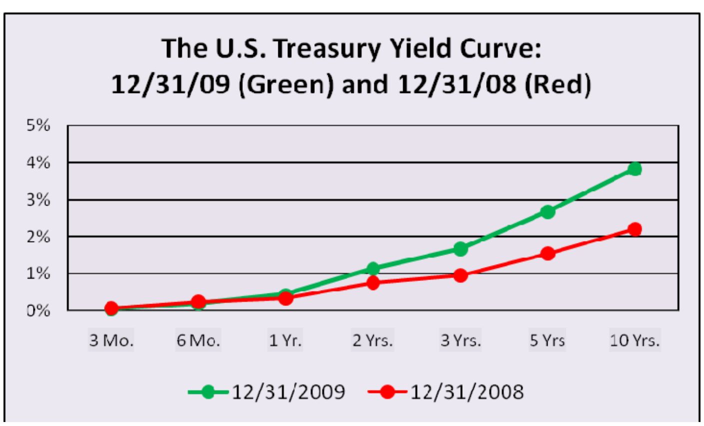
# Bonds' Record Steepness Signals Recovery, Employment and GDP Estimates Improve, Stocks Transition to Late Expansion Phase; Risk Management Perspective for 2010

Amid better than expected economic data in recent weeks, a closely watched measure of investor optimism, the difference between short-term and long-term interest rates for government bonds known as the yield curve, hit a record in December. The difference in yields between 2- and 10-year U.S. Treasury notes widened to 288 basis points from near 145 basis points at the beginning of the year (a basis point is equal to 1/100$^{th}$ of a percentage point). The yield curve steepens when the Federal Reserve (the Fed) keeps its short-term policy rates low while bond market investors sell longer-term government bonds with the expectations of a resumption in economic growth, along with the possibility of inflation, sending bond prices down and bond yields up.

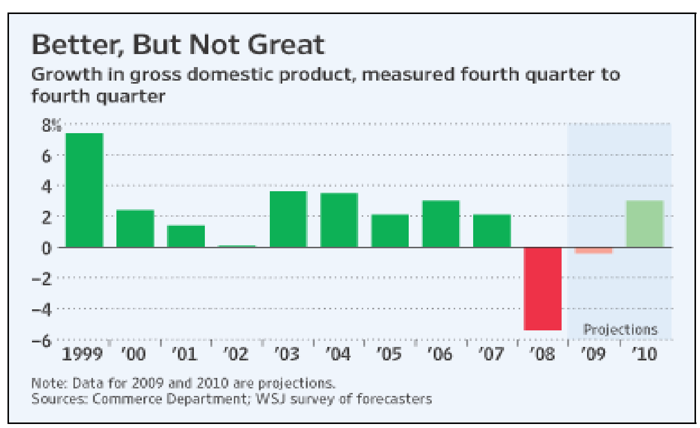
The yield curve was last near the current levels in 1992 and 2003, both instances when the economy was pulling out of a recession. With the Fed on hold for an "extended period" and an unprecedented amount of federal government borrowing, $7.7 trillion in debt, up from $6.4 trillion a year ago, the yield curve may continue to steepen as the economy improves. The Fed's recent comment that "economic activity has continued to pick up and that the deterioration in the labor markets in abating" appears to support this notion. Given our expectations for intermediate and longer-term interest rates to continue rising, we are maintaining a focus on the short-end of the yield curve for our fixed-income and balanced clients. In the current environment, we prefer essential purpose revenue and general obligation municipal bonds for use in tax-sensitive portfolios. Due to record supply and relatively low yields of U.S. Treasury obligations, we continue to avoid new exposure in this sector.

Labor markets, while historically weak, are showing signs of improvement. In November, the unemployment rate unexpectedly declined from 10.2% to 10.0%. For the fourth quarter of 2009, losses in nonfarm payrolls averaged 69,000 per month, compared to 691,000 a month in the first quarter of 2009. Moreover, weekly jobless claims have registered under 500,000 since mid-November and the four-week moving average of new unemployment claims declined for the final 17 weeks of 2009 to the lowest level since July 2008.

Although U.S. unemployment could remain persistently high and therefore reduce the pace of the recovery, the economic contraction that produced four straight declines in quarterly gross domestic product (GDP) ended with the third quarter's positive 2.2% reading. Consensus estimates for GDP in the fourth quarter of 2009 have been steadily rising, from 2.0% at the end of August, to over 4.0% currently. With credit markets stabilizing and the effects of massive monetary and fiscal stimulus, as well as rising inventories and exports, the U.S. economy could be on track for its best performance since the first quarter of 2006 in the final quarter of 2009. As leading indicators, early expansion equity sectors and lower quality issues rose sharply starting in March in anticipation of the economy's recovery. We believe that financially healthy, late expansion stocks in the globally exposed Technology, Materials, Energy, and Industrials industry sectors will be rewarded going forward as the markets transition from an early to a late expansion phase with a focus on both quality and global economic growth, led by emerging countries which have both under levered governments and consumers.




Sources: Bloomberg and Godsey & Gibb Associates




Source: The Wall Street Journal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After the recovery in many global economies, U.S. leading indicators and with the stock market, measured by the S&P 500 Index, posting its best annual performance since 2003, it is hard to remember that just over a year ago the financial system itself was on the brink of collapse due the bankruptcies of large investment banks and government sponsored enterprises. We continue to believe that overall economic activity has reset at a lower base as a result of the recession, especially for 'big ticket' items like new vehicles and new homes, and we therefore expect moderate, below long-term trend, economic growth to continue in the U.S. in 2010. As investment managers with an emphasis on risk management, we are always watching out for potential 'red flags' to our base case expectations. Below, we outline several potential risks for 2010 and our related portfolio positioning for each:

<u>Rising sovereign debt levels:</u> The soaring borrowing and rising spending levels by governments around the globe brought sovereign credit risk to the forefront of the financial markets in the fourth quarter with news from both developing and developed Europe and the Middle East. With rising budget deficits, even the U.K. and the U.S. face the possibility of eventual credit risk. Moody's projected that the interest payment burden in the U.S. could approach an "adverse scenario" such as an eventual credit downgrade as a result of the highest debt to GDP ratio since World War II. The federal government has also agreed to unlimited guarantees for Fannie Mae and Freddie Mac debt as well as the future costs of its pending health care entitlement. As a result of the current deficit environment, we continue to avoid long duration U.S. Treasuries, as well as securities issued by government sponsored enterprises like Fannie Mae and Freddie Mac.

<u>Exit strategy missteps</u>: The federal government has injected record levels of fiscal and monetary stimulus to help revive the financial system and the economy. As signs of recovery emerge, we will be closely monitoring the Fed's exit strategies to insure its policies remain consistent with continued economic recovery. For example, the Fed is currently expected to begin raising the federal funds target rate in the second half of 2010. As such, we continue to maintain a short duration emphasis in order to manage the risk of both rising policy and market interest rates and overall bond market volatility.

<u>Persistently high unemployment</u>: Recent trends in employment, such as fewer workers being laid off, as well as more temporary jobs and hours worked, are encouraging, but for the recovery to be sustainable companies will need to begin hiring again. While Congress and the administration are working on a jobs bill that could include increased unemployment benefits, more aid to states and localities, and additional funds for small businesses, the timing and impact of its eventual passage are uncertain. Given the risk of a jobless recovery, we remain underweight the more economically cyclical Consumer Discretionary sector and maintain overweight exposure to defensive areas such as the Health Care, Consumer Staples and Utility industries.

<u>Commercial real estate (CRE) weakness:</u> Not unlike the boom-and-bust cycle in residential real estate, commercial real estate investors used easy money and excessive leverage to purchase and build properties to the point of overvaluation. Of the estimated $3.5 trillion in total CRE mortgage debt, all asset classes – office, industrial, and retail –are suffering, evidenced by price declines of 45% in some areas. These declines create risks for commercial banks, insurance companies, private equity firms and other mortgage lenders due to the impending defaults and foreclosures. CRE is expected to remain an economic drag in 2010, and as such we maintain an underweight exposure to the diversified Financials sector.

<u>Residential real estate weakness</u>: After peaking in mid-2006, the housing sector fallout was ground zero for the recession. While house prices remain down 7.3% from October 2008, the drop appears to have stabilized. The S&P/Case Shiller 20 Index, a broad measure of national house prices, has been rising on a seasonally adjusted, month-over-month basis since June 2009. Moreover, existing home sales are rising, up 10.1% in October, helped by the government's extension of the home buyers' tax credit through April 2010. However, rising delinquencies forced regulators to seize 124 banks in 2009 and 552 remain on the FDIC's problem list. Therefore, in addition to our overall underweight to the Financials sector, we maintain a zero weight to regional banks.

<u>Business spending sustainability:</u> Many businesses appear to have overcut discretionary spending in the face of Depression-like conditions a year ago. Non-financial corporate balance sheets and profits have improved and productivity is strong. These factors should lead to higher levels of corporate spending and eventually to higher employment. Any deviations from this trend could negatively impact economic growth. As such, we maintain a bias to financially strong, cash flow positive corporations with stable earnings growth.

<u>Rising inflation expectations:</u> With historically high spare capacity in resource markets for industrial capacity and labor, we believe core inflation, outside globally oriented commodity markets, will remain benign in the near-term, evidenced by November's personal consumption expenditures reading of 1.4% year-over-year, below the Fed's targeted range of 1.5% to 2.0%. However, to protect against and participate with the potential for global commodity based inflation, we maintain exposure to a diversified group of global basic materials producers, and an allocation to precious metals through gold miners.