

# Market View



October 1, 2009

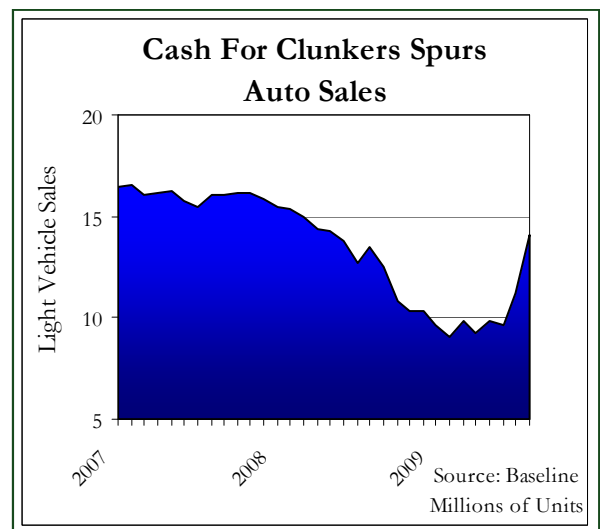
**BIRCH HILL**  
INVESTMENT ADVISORS LLC



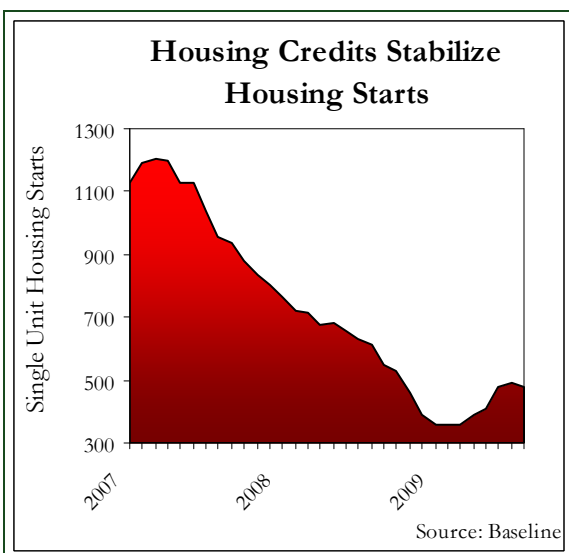
Extraordinary government support of the U.S. economy seems to be working and economic indicators continue to improve. Questions still remain whether the economy will be able to sustain itself as the government withdraws its support. While the Federal Reserve has injected massive amounts of liquidity into the financial sector to avoid large scale bankruptcies, the government has also undertaken more targeted support. Some of the government's targeted plans include the *cash for clunkers* automobile incentive program and a tax credit for first time home buyers. Both of these initiatives have succeeded in producing short term results.

*The government has used many resources to help support the U.S. economy. Targeted stimulus is working, although questions remain whether it can spur longer term growth. Government stimulus has awakened fears of inflation, but additional forces have softened the effect so far. The recent stock market rally has been led primarily by lower quality companies that have rebounded after sharp 2008 declines. High quality companies offer superior risk adjusted prospective returns.*

The *cash for clunkers* program was designed to bolster automobile sales while reducing energy consumption. The program, which began in late July, gave consumers a financial incentive of up to \$4,500 to trade in old cars for newer more fuel efficient vehicles. *Cash for clunkers* was more successful than the government had anticipated resulting in the sale of nearly 700,000 vehicles. The federal subsidy totaled \$3 billion. As a result, the auto sales index surged +11.9% and overall retail sales grew +2.7% in August.



The housing market has also been a beneficiary of targeted support. In an effort to stimulate housing demand, the government offered certain first time buyers a tax credit of \$8,000, a significant amount when you consider the national median home price is \$175,000. It is estimated that close to 40% of all home buyers will qualify. This credit is set to expire at the end of November, but has already had its desired effect. The success of the stimulus is leading many to lobby for an extension. The plan is estimated to cost \$15 billion, which is more than twice original estimates. The program has given the housing industry a sales boost after a multi-year slump. Housing starts rose as builders increased supply to meet expected demand.



Targeted programs have spurred demand in the short term, but can they drive long term demand? Recent evidence suggests that the programs may have simply pulled demand forward. Questions remain about whether U.S. consumers can resume their prior level of consumption without ongoing government support.

## Market Indicators 9/30/09

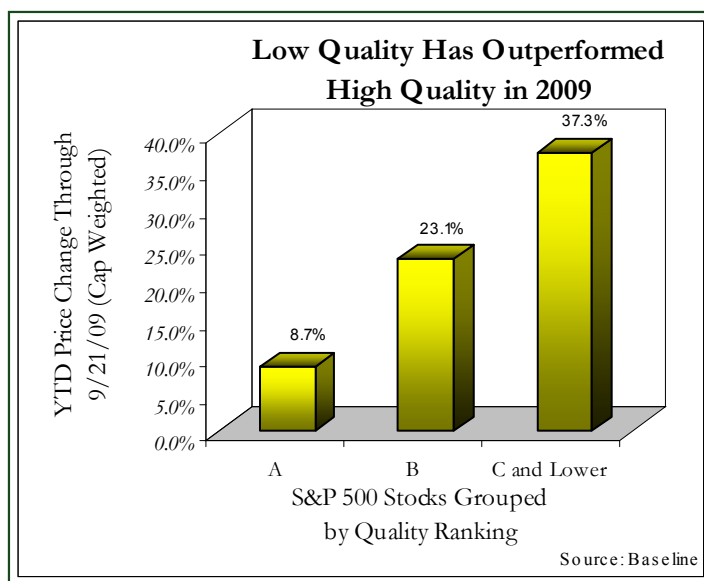
	Total Return	
<u>US Stock Markets</u>	<u>12 Mos.</u>	<u>Year-to-Date</u>
S&P 500 Index	-6.9%	19.3%
Dow Jones Industrials	-7.4%	13.5%
NASDAQ Composite	2.5%	35.6%
<u>International Stock Markets</u>	<i>ETF Returns in US\$</i>	
EAFE Index <i>(Europe, Australia, Far East)</i>	0.5%	24.5%
Japan (MSCI Index)	-5.5%	4.1%
China (Xinhau 25)	20.7%	41.6%
Emerging Mkts Index	15.2%	57.1%
<u>US Fixed Income Yield</u>	<u>12/31/08</u>	<u>9/30/09</u>
6 Mo US T-Bill	0.3%	0.2%
2 Yr US T-Note	0.8%	1.0%
10 Yr US T-Note	2.2%	3.3%

## Inflation- Deflation Tug of War

The common perception is that the stimulus that has pumped massive amounts of liquidity into the U.S. economy will eventually lead to higher inflation. With more than \$800 billion in fiscal stimulus injected into the economy and the federal government running deficits not seen in many generations, the long term risk of inflation is real. So far this fear has not been realized. Recent data showed that the Core Consumer Price Index (without the volatile food and energy component) increased only 0.1% in August and is down 1.5% compared to one year ago. One reason we have not yet experienced inflation is the counter balances of excess capacity that currently exist. Excess capacity takes many forms from empty hotel rooms to idled factories. The excess capacity most evident is in the labor market. In the current environment with unemployment approaching 10%, workers have less power to earn higher wages. This in turn keeps costs down for businesses. In the long term it is very difficult to discern what ignites inflation, but until the excess capacity is used up in labor, manufacturing and numerous service industries, inflation should remain contained.

## Rally in Low Quality Stocks

The stock market has advanced sharply from its March 2009 lows. The current rally has favored lower quality companies with weaker fundamental prospects over higher quality companies. This rebound has also favored companies that declined the most in 2008. Some of these companies snapped back after bankruptcy fears subsided. As the accompanying chart confirms, stocks with a Standard and Poor's quality ranking of C or below (including stocks that are not rated) have appreciated on average over +37% so far this year. This compares to A-rated companies that have appreciated on average +8.7%. We believe that investors in quality companies with reasonable future growth prospects will be rewarded.



## Conclusion

The government's short term stimulus approach has increased demand in certain segments of the U.S. economy. The longer term effects of their programs on economic growth are less certain. The forces of inflation and deflation remain in balance. While lower quality companies have advanced the most in 2009, we continue to believe higher quality companies are better positioned for long term growth.

*Miner A. Cray, CFA*

*Gary R. Mikula, CFA*

*Robert A. O'Neil, Jr., CFA*

*Thomas E. Reilly, Jr., JD*

## Go Paperless

Market View is now available via email. If you would like to receive future copies of Market View electronically, please email [marketview@birchhilladvisors.com](mailto:marketview@birchhilladvisors.com) or contact your portfolio manager.