

March 5, 2010

Rex Macey, CFA®, Chief Investment Officer  
Wilmington Trust Investment Management

## *Remarkably Calm*

### **KEY POINTS**

- *We like stocks and corporate bonds for the time being—which may be quite short.*
- *An inflation or deflation crisis looms in the long term; future government policy and timing will determine which.*

The U.S. stock market has been remarkably calm since our last missive two weeks ago. It's been up in each of the last six trading sessions, and the absolute value of movements has been slight. The CBOE® Volatility Index, a measure of short-term expected volatility, has fallen below 19, slightly less than its average of 20.3 since its establishment in January 1990. While we are comfortable for the moment, we could to be jolted from our tranquility in the not too distant future.

The recent economic data continues to support our view that we are in a recovery, and that growth will be tepid. For those who prefer the forest to the trees, we see the recent spurt of economic activity as being the result of inventory replacement and fiscal stimulus. It is too early to declare we are in a self-sustaining recovery. Housing and employment remain weak. For those who like the trees, we summarize on page 2 recent economic releases, some of which may have been dampened by bad weather.

### *“Easy money” will be available for a while longer*

In recent testimony before Congress, Federal Reserve Chairman Ben Bernanke reiterated that the Fed's target for short-term interest rates will be low for an extended period. The Fed released its “beige book,” a survey of regional economic conditions, in which it noted that layoffs have slowed but hiring remains soft. We expect the Fed to be slow to tighten monetary policy, given the soft economy, especially on the employment front.

We believe unemployment will remain high for some time. We've heard the familiar explanation that companies are slow to hire. We think there's another reason, which hasn't been voiced lately. Companies are continuing to shift employment from the United States to India and China, where labor is less expensive. The recent recession has provided cover, allowing companies to blame the recession for the reduction in their workforces. When they increase production, they will likely choose the low cost source. Many of the jobs lost in the recent recession were in the construction and manufacturing areas, including the automotive sector. The continued weakness in the housing market and commercial real estate means that construction jobs are not coming back soon. Lower demand, tighter financing requirements, and the collapse of the asset-backed lending markets is expected to prevent the automobile industry from returning to peak production levels for several years. Many auto workers at that point will require considerable retraining before returning to work, which could keep unemployment and “underemployment” high for the foreseeable future.

# MARKET NOTES



<i><b>“The trees”: Recently released economic statistics</b></i>		
<i><b>Indicator (period covered)</b></i>	<i><b>Reading</b></i>	<i><b>Comment</b></i>
Pending home sales (January)	-7.6% from prior month	
New-home sales (January)	309,000 units, annualized	The worst sales pace on record (47 years)
Consumer confidence (February)	46.0, down from 56.5 in prior month	Lowest reading in 10 months
Durable goods (January)	+3.0% from prior month	Strong orders for aircraft
Real gross domestic product (4Q 2009)	+5.9%, annualized	
Existing-home sales (January)	5.05 million units, annualized	Below the 5.5 million consensus estimate
Personal incomes (January)	+0.1% from prior month	
Real personal spending (January)	+0.3% from prior month	
Manufacturing ISM Report on Business® (February)	56.5%	Reading above 50 suggests growth; this was seventh consecutive month of growth
Non-manufacturing ISM Report on Business® (February)	53.0%	Reading above 50 suggests growth; this was second consecutive month of growth
Output per hour, nonfarm businesses (4Q 2009)	+6.9%, annualized	Revised up from +6.2%
Factory orders (January)	+1.7% from prior month	Up in nine of the last ten months
ADP National Employment Report® (February)	-20,000 nonfarm, private-sector jobs from prior month	Declines in manufacturing employment offset gains in service sector
Nonfarm payrolls (February)	-36,000 jobs, private-sector and government combined, from prior month	Consensus expectation was -68,000
Unemployment rate (February)	9.7%	Better than expected
Consumer credit (January)	+\$5.0 billion from prior month	First increase in a year, confounding a -\$4.5 billion forecast, though December's figure was reduced by \$3 billion

Sources: *National Association of Realtors*® (existing-home sales and pending home sales); *The Conference Board* (consumer confidence); *U.S. Commerce Department* (durable goods, gross domestic product, factory orders, new-home sales, and personal income and spending); *U.S. Labor Department* (output per hour, nonfarm payrolls, and unemployment rate); *Board of Governors of the Federal Reserve System* (consumer credit); *Institute for Supply Management* (manufacturing and non-manufacturing Reports on Business)

## *\$55 trillion in debt, and counting*

The debt problems of Greece are being worked out. A default there would damage the entire euro zone and could be the first in a series in countries with weak finances. However, Greece's problems are illustrative of the issues facing nations deep in debt. Eventually, investors will punish fiscal mismanagement. The question is when. Is Greece the canary in the coal mine that shows the time is near? Countries may be unable to support their economies through monetary stimulus in the event of future weakness.

There is much consternation about the enormous debts owed by governments around the world. In its Feb. 22 edition, *Bloomberg BusinessWeek* reported that these debts total \$55 trillion—more than twice the level of a decade ago. The problems may include: currency devaluation (if not relative to other currencies, then relative to gold and other commodities); higher taxes; higher interest rates; the crowding out of private debt, which would reduce economic growth; and the inability to respond to a new crisis because there's no more ammunition. In short, fixing the worldwide mess of national indebtedness may well choke the global economy.

Regarding the effect of these debts, there are two almost diametrically opposed camps. The “debt deflation” camp expects massive contraction as governments get their fiscal houses in order by spending less and taxing more. The inflation camp predicts that governments will print money to pay off their debts, reducing the value of fiat (paper) currencies and igniting inflation. Much depends on what courses of action governments choose, and when. While we agree that these are potential problems, we submit that we've heard warnings about enormous debt levels for decades. People are lending to the U.S. government for 30 years at an annual rate of 4.5%. They are lending to us for 10 years at an annual rate of 3.6%. These modest rates do not suggest that investors see a U.S. debt crisis as imminent.

## *Risky assets could continue to appreciate, courtesy of low interest rates and inflation*

As we've said, we expect a sustained but muted U.S. economic recovery. Due to excess capacity and an overhang of real estate, headline inflation should remain low. Weak employment is expected to keep interest rates low. Low inflation and low interest rates will allow the prices of stocks and corporate bonds to inch along. This is our basis for staying the course with stocks and corporate bonds. We continue to see relative strength and growth in the emerging equity markets.

All of this could change, and quickly. We recognize that future security prices may be driven by issues not on the radar screen, or at least far from the center. The geo-political clouds are ever present. Closer to home, one item that caught us by surprise was a Bloomberg story that Senators Ron Wyden of Oregon and Judd Gregg of New Hampshire introduced legislation to kill the tax exemption on municipal bonds as part of a tax overhaul bill. After a brief consideration of the impact that would have on the municipal bond market, we started to think about Washington, specifically Congress. There seems to be universal agreement that Congress is unable to act absent a crisis. The Democrats want health care. The Republicans will not raise taxes. Both decry deficits and debt but do nothing about it. The point of this observation is that we expect Congress will continue this conduct, leaving the debt issues to fester for the foreseeable future. Investors must live with the uncertainty as to how persistent deficits and mountainous debt ultimately will be addressed.

We continue to closely watch corporate earnings expectations, valuation measures, and technical market signs. Should we conclude the recovery is off track, we would likely reduce our allocations to developed international and emerging market stocks and increase our exposure to high-quality U.S. stocks, short-term bonds, and cash equivalents.

*Investment Products: Not FDIC Insured | No Bank Guarantee | May Lose Value*

### **Disclosure**

***The information in Market Notes has been obtained from sources believed to be reliable, but its accuracy and completeness are not guaranteed. The opinions, estimates, and projections constitute the judgment of Wilmington Trust and are subject to change without notice. This publication is for information purposes only and is not intended as an offer or solicitation for the sale of any financial product or service or a recommendation or determination by Wilmington Trust that any investment strategy is suitable for a specific investor. Investors should seek financial advice regarding the suitability of any investment strategy based on the investor's objectives, financial situation, and particular needs. Diversification does not ensure a profit or guarantee against a loss. There is no assurance that any investment strategy will be successful. Past performance is no guarantee of future results.***

***Any investment products discussed in this publication are not insured by the FDIC or any other governmental agency, are not deposits of or other obligations of or guaranteed by Wilmington Trust or any other bank or entity, and are subject to risks, including a possible loss of the principal amount invested. Some investment products may be available only to certain "qualified investors"—that is, investors who meet certain income and/or investable assets thresholds. Investing involves risk and you may incur a profit or a loss.***

***CFA® and Chartered Financial Analyst® are trademarks owned by CFA Institute.***

***Other third-party marks and brands are the property of their respective owners.***



***Wilmington Trust is on Twitter. Follow us @ [twitter.com/wilmingtontrust](https://twitter.com/wilmingtontrust).***