

REVIEW

The term “green shoots” emerged in the second quarter as a way to describe some signs of economic life after months of global economic freefall. Following deep losses, the capital markets’ response to the “green shoots” was positive in the second quarter based on the probability of improving economic circumstances. Equity prices of most every variety rebounded strongly, as did corporate bonds and commodities. Government bonds fell in price as their safe haven value waned.

The “green shoots” appear to be the result of:

- The effectiveness of Federal Reserve actions to neutralize panic in the credit markets and stabilization in this critical part of the economy.
- A gradual increase in confidence that our economic system will not collapse into a depression but rather face only a bad recession.

OUTLOOK

Alan Greenspan recently asked, “Is this the beginning of a prolonged economic recovery or a false dawn? There are credible arguments on both sides of the issue.”

Using backward-looking information, one can easily construct a very pessimistic outlook. The U.S. stock market, as measured by the S&P 500 Index, is down nearly 30% over the last year and down by one-third over the last ten years. Both the U.S. and the global economy remain in the throes of the worst global economic downturn in decades. Extrapolating the past ten years produces a bleak forecast.

Much of that pessimistic outlook appears to have already been discounted by today’s capital markets. Compared to ten years ago (see table), we now have:

- Much lower yields on bonds based on anemic global growth prospects;
- Much higher prices for gold based on general fear of uncertain economic conditions; and
- Much lower valuations for stocks, i.e. levels less than half of those ten years ago.

	Bond* Yield	Gold price Per Ounce	Value Line** Index P/E
June 1999	5.8%	\$260	30
June 2009	3.5%	\$920	13

* Treasury bonds with a 10 year maturity
** An index of U.S. based non-financial companies

Reviewing the past is instructive, but investors must look forward. The key issue is what the growth rate of a global economic recovery will be, and how it will be sustained. Three important factors on this front are:

1. Government Actions and Policies

Many of the Obama Administration’s initiatives are under intense debate at present. We believe that issues of foreign trade matter most because of their potential to affect future economic expansion. For example, “Cap and Trade” legislation makes headlines, but it is the trade provisions/restrictions, within the bill that could have a larger and more immediate effect. Retaliation by other countries would further push global economies into a downward spiral. As we write, “Cap and Trade” legislation is working its way through Congress. Trade restrictions are in the current version of the bill. We are awaiting the final form of the legislation. We are watching other developments closely related to global trade, including the next G-20 summit meeting to be held in September.

2. Collective Confidence Level

People’s confidence level is ultimately more important in determining the sustainability of economic recovery than anything else. A belief that the economy will improve is self-reinforcing. Greater confidence results in fewer consumers hoarding cash and more being willing to spend and invest. Likewise, business leaders will be more willing to take risk by increasing investment in their companies.

On a global basis, people’s response to government policy has been encouraging so far. To cite a few hopeful political signs from diverse places, voters in India, the European Union, and California recently voted in favor of more market-oriented representation and initiatives.

After the severe dislocation of last fall, many areas of the credit markets are currently functioning at pre-crisis levels as financial institutions have become more willing to participate in the credit markets.

3. Demographics

The aging baby boomer population is now a restraint on growth in the U.S. economy. Most developed countries are experiencing similar circumstances due to the increasing proportion of older people relative to total population. Since the early 1980s, when baby boomers began to enter into the workforce *en masse*, they provided a tailwind of economic growth. As they move toward middle age, their wages and spending patterns naturally increased. As they near the end of their careers, wages and spending peak then begin to decline. We are now at the peak. The stimulative effect that baby boomers had on economic growth for three decades is becoming a constraint. It will slow the rate of future economic progress in the U.S. and other developed countries. A potential offset to this are some signs of boomers delaying their retirement due to lack of savings and diminished 401K values.

INVESTMENT CONCLUSIONS

Unarguably, the risks in the capital markets remain heightened. The range of outcomes remains wide. Economic imbalances remain, such as the oversupply of housing, job losses in the private sector, and the explosion of government debt.

Even though stocks have rebounded, U.S. and global stock market indexes remain 40% below their all-time highs reached in the fall of 2007. Equity valuations relative to cash, bonds, and other investments remain much lower than at any other point in the last ten years.

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Due to economic imbalances, some areas perceived as safe in the capital markets appear to have more risk today than in the past. Municipal bonds, for example, generally have been an area with weak economic conditions and ever-higher employee retirement benefits are putting significant strains on state and local municipalities.

Based on valuation and the range of probable economic outcomes, we believe that stocks generally appear to be reasonably attractive investments (especially those with solid dividends and the financial power to operate through a difficult economic environment). Exposure to emerging markets, both directly and through U.S. multinationals like energy companies, is warranted. Emerging market fundamentals have been relatively less affected by this crisis.

Outside of equities, exposure to high quality intermediate/long term bonds and TIPs seems prudent because, the range of outcomes includes deflation and high inflation. Finally, gold serves as protection against everything going wrong.

PORTFOLIO STRATEGY

Despite market appreciation in the second quarter, the consequences of being wrong about an economic rebound necessitate keeping a cushion of stable value investments. Therefore, portfolios will remain conservatively invested as we continue to work through this critical period.