CHATHAM CAPITAL GROUP, INC.

CHATHAM CAPITAL GROUP INC.

Quarterly Newsletter Third Quarter 2009 Volume 6, Issue 3, Page 1

THIRD QUARTER REVIEW

The third quarter was one of strong recovery across a wide variety of global asset classes.

Stocks continued their strong rally off the March lows. Stock markets around the globe registered gains of 15% to over 20%. Growth has resumed faster in the emerging markets than elsewhere and the returns reflected that.

Bonds continued to do well in the third quarter as interest rates fell. The Federal Reserve continued its zero-interest rate policy for the short term rates it controls. Investors, facing money market fund yields of essentially zero, bought longer maturities. Yields on municipal and corporate bonds fell as risk aversion receded in those markets.

Real estate prices finally showed some tentative signs of bottoming in the third quarter. Although issues remain, problem loans are getting resolved. New residential construction has slowed to a crawl. Nationally, prices are still negative compared to last year, but are now flat to slightly positive on a monthly comparison basis. Historically low interest rates and a variety of government subsidies are helping to nurse real estate back to health.

Gold rose by over 8% in the quarter, importantly, driven by the weakness in the dollar.

ECONOMIC OUTLOOK

The data we review suggests that the crisis environment that we lived through for the last twelve months is now fading away. The economy and the capital markets are moving back to a more normal environment. Credit markets continue to heal and volatility continues to fall.

In fact, the recovery may be robust. The Economic Research Cycle Institute is the oldest economic forecasting service in the U.S. and has been one of the most accurate. Their research is pointing to a strong recovery – stronger than the recoveries that followed the 1991 and 2001 recessions, and on par with the vigorous recovery after the 1982 recession. Their research also indicates that, consistent with almost every other period of recovery, there will be no "double-dip" move back into recession any time soon.

If this is so, why is the mood so grim? Simply put, it is because the *psychology* of recovery always follows the *reality* of recovery. GaveKal Research, an investment service, recently made the following remarks about emerging from recession:

- First, commentators state that the fiscal and monetary stimuli are not sufficient and won't work. When the markets start up and the economic forecasts begin to be revised up – where we are now – the refrain is that it is only inventory restocking, and once it is over the economy will stall or we may even have a double dip.
- Next, once the economy begins to improve, the worry is that profits will not recover enough to justify stock prices.
- Finally, when profits recover, commentators state that the recovery will be jobless; and when the jobs start being created, the fear is that this will not be sustained.

Beyond the initial recovery, there exist many long term headwinds. These include the large budget and trade deficits, high levels of consumer debt, and aging populations in the developed countries which account for about two-thirds of global economic activity. Additionally, there will be some period of adjustment in high export countries, mainly emerging markets countries, because they must replace the source of growth from OECD (developed country) consumers.

In short, beyond the next few months, future global economic growth is apt to be more like a Toyota than a Jaguar – not as fast or appealing on the surface, but more stable and less prone to breakdowns – a "new normal" of economic growth.

We see four primary risks to our economic outlook:

1. <u>Deflation Risk</u> – While this risk has diminished, the possibility remains that a self-reinforcing path of "deleveraging" (debt repayment) and falling consumer confidence could unleash a protracted period of deflation.
2. <u>Inflation Risk</u> – This risk has also diminished, but inflation could be a by-product of large deficit spending by governments around the world, as they have an incentive to deflate the value of their debts through inflation.
3. <u>Policy Risk</u> – Domestic policy initiatives and trade protectionism are especially tempting to lawmakers after an economic downturn.
4. <u>Exogenous Risk</u> – Exogenous risk is always with us and is virtually impossible to quantify.

PORTFOLIO STRATEGY

Based on our economic outlook, equity weightings in portfolios should continue to edge back towards normal policy weightings.

Valuations on stocks are no longer especially cheap after the recent rally, but valuations have historically tended to expand (or at least not contract) as an economic expansion gets underway. Relative to other investments, stocks remain attractively valued. The risks identified above are partly reflected in asset prices, with "safe haven" investments such as gold and U.S government bonds at historically high prices.

500 Stephenson Avenue, Savannah, GA 31405 ■ (912) 691-2320 ■ www.chathamcapitalgroup.com

It is tempting to go back to the winners of the last bull market. The most notable of these winners were commodities and commodity stocks. Shouldn't these soar once global growth resumes? Actually, history suggests the winners of the last cycle are usually not the winners of the upcoming one. It is doubtful that demand for commodities will be as robust as it was last time around. OECD countries, which still consume more than half of the world's resources, will not be growing as fast as they were. Neither will the emerging markets. On top of this, many commodities are now selling for twice the price than they were at the beginning of the last expansion.

More specifically:

- EQUITIES – **We continue to favor high-quality stocks, particularly those that pay dividends and have the wherewithal to raise those dividends**. These companies tend to have above-average financial strength. We are oriented toward companies that can benefit from an increasing demand from the growing global middle class. High-quality, dividend-paying multinationals are particularly attractive for individuals in or near retirement. We consider them "purpose-driven" portfolio holdings in that they meet the client's need for stable and rising income.

  Telecom is a new area that appeals to us. Driven by both growth in demand for wireless and developing country growth, these companies should generate solid earnings growth at a relatively low level of risk. The stocks also pay high dividends that we think can be raised going forward.

  The emerging markets are doing well, and we still want some exposure. While many of these countries and stocks are commodity-related, many are not. Going forward, we plan to focus our emerging market investment in areas that have relatively little sensitivity to commodities prices – with telecom as an example.

- ENERGY MLPS – **MLPs are also appealing at the present time.** These securities have dividend yields of 7% or more. Growth in this business is driven more by increasing pipeline volumes than by increasing oil prices. MLPs can do well in an environment of steady economic growth and flat oil prices.

- BONDS – Combining our economic outlook with interest rates as low as they are, bonds are unlikely to provide attractive enough returns to be serious competition for stocks. The "safety premium" imbedded in bond yields is likely to fade as the economy continues to recover. In our view, investors are paying too much for the safety of Treasury bonds (other than Treasury Inflation Protected bonds).

  Bonds continue to have a place in portfolios as a way to generate income and provide stability. This is especially true for shorter-term bonds and other "stable value" securities. Fixed income investments provide the wherewithal for client withdrawals over the upcoming few years, and they provide the peace of mind necessary to stick with economically sensitive investments such as stocks when they are down in price.

- GOLD – **The relative attractiveness of gold has diminished.** Gold is essentially an insurance policy against inflation and/or severe economic dislocation. The need for this insurance has lessened as the odds of the two extreme outcomes – deflation and rapidly rising inflation – have declined. Gold has almost quadrupled in price over the last ten years. This divergence – an increasing price despite falling risks – will not continue forever. Furthermore, gold is hardly an undiscovered asset class any more. Just listen to all the television and radio ads touting gold on a daily basis. Ten years ago, when the price of an ounce of gold was a bit more than $250, there were no such advertisements.

SUMMARY

With each day that passes, the probabilities of a protracted deflationary period or an extended period of rising inflation declines. Consumer and business confidence is returning around the world as we gain experience in dealing with the new realities. Given that backdrop, our portfolio strategy remains one of conservatism relative to history, but with less need for insurance against extreme outcomes and a more opportunity-focused equity position.

Although the economic and investment case laid out above is our "most likely" case, the range of potential outcomes remains wider than in many years. Thus, we will maintain an open mind to respond to circumstances that might change both significantly and quickly.

ABOUT CHATHAM

Chatham Capital Group, Inc. is a privately owned investment advisory firm. The firm provides comprehensive financial counseling and investment management services to individuals, trusts, endowments, and foundations. Chatham is registered with the Securities and Exchange Commission under the Investment Advisors Act of 1940. The operating principals own the firm and have over 150 years of combined investment experience. The investment management fee on the Chatham Trusts and Partnerships is 1% on all amounts.

INVESTMENT SERVICES

- Separately Managed Accounts
- Pooled Trusts (for tax-exempt retirement funds and IRAs): Small Cap Trust, Balanced Trust, and Distressed Equity Opportunity Group Trust
- Pooled Partnerships (for taxable accounts): Small Cap Partnership, Balanced Partnership, and Distressed Equity Opportunity Partnership
- Asset Allocation Consulting for Retirement Plans