

Monthly Investment Commentary



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When the dust settled on one of the most eventful and upended years in memory, investors had generous gains in stocks and certain segments of the bond market to salve the wounds of a disastrous 2008 and first quarter of 2009. Stocks finished the year strongly, continuing their powerful run that began in early March. Large-cap stocks, based on the Vanguard 500 Index Fund, gained about 6% in the final quarter, and finished 2009 with a 26.5% gain. In both the quarter and the full year, growth sharply outpaced value, but between larger-caps and smaller-caps, returns were pretty similar. Midcaps were a different story; while the iShares Russell Midcap ETF posted fourth-quarter returns in line with the overall market, full-year returns were just north of 40%.

On the domestic fixed-income side, returns varied widely in 2009. The Vanguard Total Bond Market Index Fund gained 5.9% for the year, but the iShares Barclays 7-10 Year Treasury ETF was down 6.4% and the iShares Barclays Credit Bond ETF gained more than 14%. High-yield bonds, which normally exhibit hybrid characteristics of stocks and bonds, instead crushed both, with Merrill Lynch U.S. High-Yield Cash Pay Index gaining 56% gain for the year.

Heading overseas, the story was emerging markets. Both equity and debt of emerging-markets countries left their developed-market counterparts in their dust. Vanguard's Emerging Market Stock Index Fund tacked on 8.2% in the fourth quarter to bring its full-year gain to 76%, versus a gain for the predominately developed market Vanguard Total International Stock Index of 3.2% for the quarter and a still impressive 37% for the year. For bonds the pattern was tighter but the same: emerging-markets bonds (JPMorgan GBI-EM Global Diversified Index) gained 2.8% and 22% for the quarter and year, while developed-nation sovereign bonds (Citigroup World Government Bond Index) lost 1.9% in the fourth quarter and gained only 2.6% for the year.

As we note in the commentary that follows, our expectations for stock and bond returns are muted this year compared to last, however we believe there will be several opportunities for us to add incremental return via timely asset allocation shifts, strong security selections and the use of alternative strategies. The incremental value of these opportunities may be much lower than it was this past year, where absolute returns were unusually high, but in a low-return environment they can make a material difference.

Odds, Payoffs, and Patience

We've enjoyed strong absolute and relative returns this year after a harrowing 2008. But, we head into 2010 and beyond knowing that there's no time to enjoy the good feeling of a successful year—the world and the markets don't give us that luxury. As we look ahead over

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the next several years, despite the beginnings of an economic recovery that at this point has been mostly government supported, we continue to believe that the weight of the evidence has the potential to create a tough road for the economy and the financial markets. How this will play out over the shorter term of the next year is less clear, with a wide range of possible outcomes, from positive to negative.

Debt, Debt, and More Debt

We continue to believe that we are in the midst of a major debt-driven transition in the economy that may keep risks elevated, result in continued economic headwinds, and have longer-term consequences due to the acceleration of the buildup of our public (government) debt.

Household Debt:

Households have hit a debt wall and are in the process of deleveraging. Despite the huge government stimulus, this process is not close to being over. Household debt levels doubled in the last decade on an absolute basis and were 50% higher when compared to the overall economy (GDP). At 99% of GDP, household debt is barely off its all-time high. Debt levels along with sizable wealth destruction (due to declining home equity and stocks), high unemployment, and uncertainty about the economic future have triggered a reality check. Private debt levels are being paid down at a faster rate than we've seen since the mid-1960s and probably for many years before that (our data only goes back to 1966). However, debt levels that expanded over decades can't be taken down to more prudent levels in a few quarters. It will take time. Moreover, though interest rates are low, debt is generally less available for those who want or need to borrow as lenders have shifted from almost nonexistent underwriting standards to a world of highly cautious lending.

Consumer Spending Headwinds:

Because consumer spending is 70% of the economy it is hugely important to overall economic growth. The desire among households to rebuild balance sheets, along with high unemployment and low perceived job security, makes it very likely that consumption growth will be subpar compared to what we've been used to. Personal consumption expenditures contracted for several quarters before rebounding in the third quarter, largely thanks to the surge in auto purchases triggered by the Cash for Clunkers program. Prior to hitting the wall, consumers had made a habit of borrowing in order to spend, but that is no longer the case. Not only are households in aggregate no longer borrowing to spend, they are now actually paying off debt. This is a big swing factor that directly impacts spending levels. Even if debt growth resumes it will be a long time before it grows at the rate it did over the past decade. This does not bode well for spending, which affects overall economic growth, and then ultimately, jobs.

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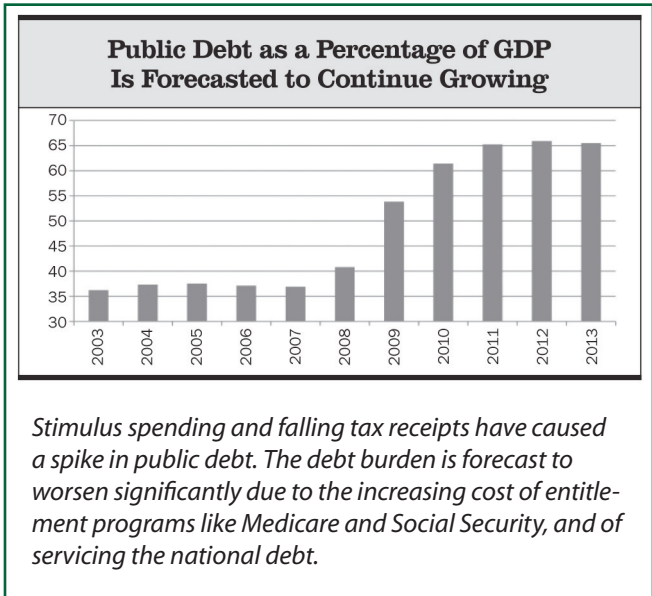
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U.S. Government Debt Explosion:

Governments around the world have been filling the vacuum created by the consumer retrenchment with extremely expansionary monetary and fiscal policy. The U.S. government has been particularly aggressive and in aggregate its actions probably saved us from a 1930s-type depression. However, the resulting leap in the government deficit comes at a terrible time. This increase, coupled with a coming explosion of Social Security, Medicare, and Medicaid benefits to retiring baby boomers, means that the United States faces extremely challenging times in coming years.

The financing of our public debt has not been a problem so far because the financial crisis created a surge in investor demand for U.S.-backed debt and contributed to rock-bottom interest rates. But it will get more challenging. It's estimated that the U.S. government will need to borrow \$3.5 trillion over the next three years. Additionally, over the next year about \$1.6 trillion of debt is maturing and will have to be rolled over. Now, with much of the developed world facing similar problems and needing to borrow, and increased risk appetites resulting in less demand for government paper, borrowing rates are likely to rise at least a bit over the next couple of years. A recent New York Times article stated that a 1% rise in the average interest rate will cost U.S. taxpayers \$80 billion in additional debt service costs—equal to the combined budgets of the departments of energy and education.



But, it is in the intermediate term that financing the public debt gets scary. U.S. government debt is now \$12 trillion. More troubling is the estimated present value of future unfunded liabilities—mostly Medicare and Medicaid—which is a difficult-to-comprehend \$60 trillion (equal to about five times annual GDP). As debt continues to grow, at some point it will become difficult to get investors to lend to a fiscally challenged United States in the amounts needed, without paying a significantly higher interest rate. Though some increase in borrowing costs is likely soon, the risk of a sharp increase in rates is not imminent if the recovery is subpar (as seems very likely). Also, even though government spending will stay high while the economy is weak, it will decline at the margin and coupled with the improvements at the margin in the economy, the annual deficit will decline in the near term. But looking out over

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the next 10 years and beyond, the math is impossible to ignore. There is little question that taxes will have to increase and spending will have to decrease. If this doesn't happen in a significant way, and maybe even if it does, there is a great risk of both a dollar and an interest-rate crisis that could be extremely painful for the United States and global economies. Dealing with these coming problems can't be put off much longer. It is quite possible that the U.S. government will begin to face financing pressure within our five-year investment time horizon. There are still many variables in play that relate to the above-mentioned overriding concerns, and it is too early to determine how they will all play out.

Often the bearish case (above) is the easiest to make, however it is important to not lose sight of the positive factors that support a more optimistic outlook:

- This is the largest global stimulus ever to occur in peace time.
- The strength of the emerging-markets economies feeds back into the global economy and is a positive for exports and manufacturing.
- Corporate balance sheets, outside of financials, are in good shape including the best liquidity in 50 years. Some believe this will support investment.
- Inventories are low and a rebuilding cycle is beginning, which will support some growth.
- The severity of the economic contraction and corporate cost cutting may mean that businesses overreacted and will need to aggressively increase investment and hiring (not likely in our view).

We don't dismiss the positives as they explain why a modest recovery is likely to be sustained. However, we continue to believe that the weight of the evidence makes a strong case for a sustainable but subpar economic recovery, with a risk of falling back into recession at some point in the next two years as the stimulus is unwound. As we balance the pro's and con's of today's environment it is important that we develop strategies that can provide us with good risk-adjusted returns in this uncertain environment. Below is a summary of some of the strategies we are utilizing to give our portfolios an edge:

- Buy Large Cap Quality Stocks– the valuation of high vs. low quality stocks is the most attractive it has been in a long time; we like quality for the long-term
- Buy Pricing Power– with the potential for deflation and tepid end market demand we like companies that have the ability to raise prices
- Many foreign markets are growing faster than the U.S. (especially Asia/emerging markets)- we recommend exposure to these markets directly (on sell-offs) and via high-quality large-cap companies that export to them
- We are neutral on growth vs. value stocks
- Large-cap is priced to outperform small-cap over the next few years, near-term small-cap may continue to lead if a strong recovery gets priced in

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- Investment income strategies- with interest rates relatively low we like investments that can produce and grow solid yields (stocks, bonds, preferred, etc.)
- The corporate credit (investment grade & high-yield) rally should continue; however it is probably on its last leg
- We recommend alternative asset positions that have the potential to improve risk-adjusted returns in this market
- Municipals are attractive relative to taxable alternatives
- We are evaluating fixed income strategies that may perform well in a rising interest rate environment

Overall, we are confident that our disciplined approach to asset allocation and security selection (stock, bond, funds, etc.) is well suited to guide our clients through these uncertain times and is likely add considerable value over their respective benchmarks the next several years. As always, we appreciate your trust in us and we look forward to helping our clients achieve their financial goals.

- CB&T Investment Team 1/2010

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