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KEY POINTS

- The Fed holds its course.
- As the markets return to normal, so should an investor's asset allocation.
- We believe the worst of the recession is behind us.
- Inflation, while likely to be subdued in the short-term, remains a long-term concern.

The top news this week was that the Federal Reserve's June meeting produced no big surprises. The three major messages were: rates will remain near zero "for an extended period;" the U.S. economy "is likely to remain weak for a time;" and "inflation will remain subdued for some time." The Fed did not mention deflation as a risk as they have in the recent past, and it appears to be sticking with its plan to purchase bonds in order to keep longer rates down.

Absolute Return Investing on the Rise

After the harsh market of 2008, we've heard growing talk about absolute return investing. Absolute return investors eschew equity benchmarks and seek only positive returns. Cash and very short-term bonds would be a reasonable strategic allocation¹ for an absolute return investor. The problem is that cash doesn't provide a positive long-term return after taxes and inflation. Thus, one must be skillful at judging market movements to achieve long-term goals. Given that virtually everyone missed the near collapse of our financial markets and the severity of the bear market (even conservative hedge funds were down 20% in 2008, according to the HFRI), this is not a strategy that is likely to provide success for most investors.

A lot of investors have raised cash and substantially increased their exposure to bonds either to dampen volatility or to shift toward an absolute return approach. Now that the market has calmed, this is a good time to reconsider that move. Setting an appropriate strategic asset allocation is arguably the most important step in successful investing.

Cash is the comfort food of investing. It makes us feel safe, but offers little nutrition (i.e., growth). Cash is not a core investment of a long-term investor. After taxes and inflation it offers negative returns. It is either a tactical tool or a source of funds when liquidations are expected in the short term. Using cash tactically to offset the spike in stock market volatility was understandable. The VIX, which measures expected short-term volatility, has retreated to 30, a level last seen in September of last year and well

¹ The strategic mix is expected to be a long-run average allocation. Ideally, this allocation will meet one's long-term spending objective and is within the investor's risk tolerance. It is the position an investor assumes when his or her views with respect to various asset classes are neutral (lacking opinion).

below the 60-70 levels at the worst of the market. Our point is that as the market returns to normal, so should one's asset allocation.

The Recession Appears to be Abating but Recovery will be Slow

In our view, we will enter a "new normal" environment. The old normal was characterized by decreasing interest rates, which supported higher levels of asset values, debt, and consumption. Short-term rates cannot decline. If our concerns about inflation over the long-term materialize, then interest rates will increase. At the moment we are at the inflection point.

Initial jobless claims came in at 627K, worse than the expected 600K. In addition, the average work week is at 33.1 hours. Companies are not going to hire until they see sustained demand. Unemployment and a short work week translate into weak consumption, which accounts for about two-thirds of our GDP, making government stimulus vital. We reiterate that employment is a lagging economic indicator and that it will take a long time to recover, keeping the consumer on the defensive.

The GDP shrank 5.5% (annualized) in the first quarter, which was less than the expected 5.7%. The housing slump is showing signs of abating. Single family home starts rose for the third month in a row. Orders for non-defense capital goods (i.e. aircraft) rose in May. Consumer spending rose for the first time in three months as incomes increased by the most in a year. In general, the contraction is slowing. There's broad consensus that GDP growth will resume in the third or fourth quarter. We expect 2010 will compare very favorably to 2009 due to the weak showing this year. While we believe it's clear that we are putting the recession behind us, the recovery is likely to be slow.

In the near term, excess capacity in the economy, for example in labor and rents, indicates that inflation is not a worry.

Slow Growth and Long-Term Inflation still a Concern

The two items that seriously concern us are slow growth and long-term inflation. The government's fiscal and monetary stimuli have kept consumption stable. The replenishing of inventories later this year may provide the GDP growth the market is expecting. One worry is that as government support wanes, consumers may continue to be tightfisted given their debt levels. It's possible, but not probable, that we could see a double-dip recession.

The ability of the private sector to create capital was severely damaged by asset devaluation and deleveraging. While the government stepped in and prevented a much worse, self-reinforcing contraction, we do not expect the resumption of normal private capital creation. Private capital creation requires the combination of institutions with capital to lend and credit-worthy borrowers. The balance sheets of financial institutions are not as strong as they once were. The stress tests relieved concerns on selected banking institutions, but the industry is not out of the woods. Commercial real estate remains a dark cloud. Most analysts are still expecting losses in the neighborhood of \$400-500 billion. This is a reason why the financial services sector of the corporate bond market trades at 150-180 basis points spreads above the industrial and utility sectors. Consumers are also struggling as their home equity has fallen faster than their debt. Thus the government will likely need to be a source of capital for some time. It's probable that when growth resumes, after an initial spurt, it will not be the old normal 3-3.5%, but

perhaps more like 2%. As we revise our capital market forecasts, estimating the long-run growth rate occupies much of our effort.

Long-run inflation is the other risk that concerns us. Currently, the massive stimulus is offsetting deflationary forces as evidenced by the return of oil to 70 after hitting 40. However, as the economy grows and the slack is removed over the next year or so, we worry that inflation will come in fast. Fresh in our minds was our ability to recognize that assets were overvalued in 2007, and our inability to forecast the timing or magnitude of their devaluation. Similarly, we recognize the threat of future inflation, but still have difficulty predicting the timing or magnitude of its resurgence.

Pros and Cons of the Asset Classes Today

As we look at the investment landscape today, all asset classes have their blemishes and their attractions. Cash and nominal bonds are dampening volatility but promise little appreciation, and expose us to the potential ravages of future inflation. Equities continue to be more volatile than usual, but look reasonably priced and offer the promise of doing well when growth resumes, although we do worry about their behavior over the summer. Real assets (inflation protected securities, real estate-related securities, and commodities) can offer us protection from future inflation. Commodities in particular can offer protection against a weakening dollar. Hedge funds, currently being shunned for their illiquidity, their vague association with Madoff, and their failure to produce positive returns last year, appear to offer excellent opportunities because the competition for profitable trades is vastly reduced as a result of continued market dislocations and the shrinking of assets allocated to hedge funds and proprietary trading desks. Security prices are reasonable by historical standards, although government bonds still look expensive. We do not believe this is the time to make drastic allocations away from a well thought out strategic plan. In sum, this brings us to our earlier point, we believe that diversification is the best position today.

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