AFM ABBOT FINANCIAL MANAGEMENT

July 1, 2009

Halftime Report

After a dismal first quarter, the stock market staged a strong rebound in Q2 and the S&P 500 now stands a scant 1.8% above the level at which the index began the year. While new signs of growth we alluded to in our last newsletter continue to look promising, it is clear that many need additional time to develop into full-fledged flowers of economic recovery. Massive injections of stimulus into the economy through a variety of programs by the federal government over the last six months has resulted in a stabilization of many important indicators, and a slight uptick in others. What are missing are signs of a clear bottom that give investors the confidence to return to the market with some of the cash now sitting on the sidelines.

Government spending in targeted areas can provide a needed stimulus to the economy, but over-spending also has its consequences. The US Treasury 10-year note this year has risen in yield from 2.1% to 3.5%, most likely due to beliefs by bond investors that all of the spending coming out of Washington will result in inflation somewhere down the road. Certainly one recent unintended consequence is that mortgage rates have also risen, and although still at historical lows, this threatens to stall a recovery in residential housing. Tax credits have boosted sales of both new and existing homes, although at much lower prices than a year ago. It is widely believed, and we concur, that the housing market must stabilize and take a turn for the better in order for the overall economy to improve. Another sidebar to stimulus spending is the extraordinary amount of “pork” included in spending bills, with literally thousands of earmarks for legislator’s pet projects that are unrelated to economic recovery.

Given this spending background, it should be no surprise to anyone that interest rates have risen. What can the Federal Reserve Bank do about it? Continue to buy treasuries and agencies for their own account is about all. The recently announced FOMC (Federal Open Market Committee) statement on June 24 confirmed that the Fed will purchase a total of up to $1.75 trillion in agency mortgage backed securities, agency debt, and US Treasury securities by the end of 2009. These actions by monetary authorities are a clear and tangible effort to bring down interest rates and boost the residential housing market. Thus far Fed actions have helped restore liquidity in the banking system, but have not resulted in widespread recovery in the housing market that got us into the current mess we are in. As we go into the summer months, the housing market will be closely watched for signs of higher sales and prices, both necessary for a better economy.

What are corporations doing in the current environment? Plenty, and the unemployment rate reflects what is most on the mind of executives. At the end of May the national unemployment rate stood at 9.4%, well above earlier estimates for all of 2009. The June rate will be announced on July 2, just about the time you will be receiving this newsletter. Forecasts are for another increase, perhaps to about 9.6%, with further increases later. To us, it appears that companies are committed to defending profitability, largely at the expense of the workforce. The average hourly workweek and business inventories have also been reduced, further bringing down costs. Perhaps of greater importance is that companies have also used the recession to strategically reallocate capital spending to areas they believe will provide a strong return on their investment in the months ahead.

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We expect that many companies will exit the recession, and it will end, leaner and in a position to capitalize on market opportunities. Even though the eventual recovery is expected to be tame by past standards, those that spend wisely now will profit most over time. We strongly believe that investors will benefit greatest by ownership of these financially strong companies, most of who have significant sales in global markets. In spite of what is taking place here at home, many other economies in developing countries are showing excellent growth characteristics.

Finally, we must acknowledge the tenacity of this recession, now about 18 months old, the longest since WW II. The excesses of the financial bubble have spared few, and the pols are hard at work trying to design safeguards to prevent a reoccurrence. Let's all hope that they don't go too far and impose regulations that constrain the free market in the future. We expect the second half of the year will bring better news that will allow for continued signs of growth, and we will position portfolios to benefit from a stronger global economy.

We hope that everyone has a great summer, and as always, if you have any questions or concerns, call anytime.

Andrew Novelline – Bob McLemore – Bill Novelline
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1st Half Scoreboard 2009

Dow Jones: -3.8%
S&P 500: +1.8%
Nasdaq: +16.4%

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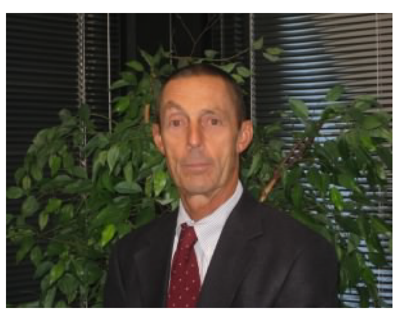

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