KEATING INVESTMENT COUNSELORS, INC.
REGISTERED INVESTMENT ADVISORS FOR INDIVIDUALS, RETIREMENT PLANS, TRUSTS AND FOUNDATIONS

# Investment Strategy

## July 2009

Earlier this year, many economic forecasts were dire, with talk of a possible Great Depression II or even a "lost decade" like Japan had in the 1990s. Since the point of maximum fear and pessimism was reached on March 9th, the S&P 500 Index has recovered 37% and there have been increasing signs that the financial system has stabilized. Looking back to the beginning of the year, one has to wonder if the most publicized predictions were over-blown, if the government's extraordinary efforts kept the economy from going over the edge, or if it was some combination of the two. We believe it was likely the latter, a combination.

Consumer and business sentiment have shown modest improvement and some important economic indicators have gone from negative to neutral and in some cases positive:

- After six months of declines, the Index of Leading Economic Indicators is up more than 1% for two consecutive months;
- Existing home sales increased in both April and May – the first two-month climb since August/September 2005;
- Placement firm Challenger, Gray & Christmas reported that U.S. employers in June announced the fewest job cuts since February 2008.

While businesses are still cautious, access to capital has improved and we are seeing some positive prospects for a resumption of economic growth. Even in the face of worsening global growth projections, the current forecast is for the U.S. to exit its recession in the second half of this year and for modest growth in 2010. Although we believe that the worst appears to be behind us, we still have considerable challenges ahead. In particular, lingering questions in regards to unemployment, the housing market, and inflation still weigh on markets.

Unemployment of 9.5%, the highest level since 1983, is expected to continue to climb to 10% by the end of this year. However, the rate of increase slowed considerably in recent months as companies finished adjusting to the economic shocks of late last year. While unemployment at these levels is uncomfortably high, it is only a few percentage points above the historical full employment level of 5-6% and is still a long way from depression era levels of more than 25%. As the economic stimulus passed by Congress more fully kicks-in, the rate of job losses should continue to slow. Unemployment will likely continue at elevated levels as consumer spending remains muted.

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Because of overinvestment in this past cycle, housing is not likely to lead the recovery, but stabilization in home prices is a crucial component for sustained recovery. Housing still shows signs of stress, with 20% of mortgages "upside-down" and with foreclosures representing a significant portion of homes sold. Continuing employment problems may delay a recovery as job losses by prime borrowers are adding to the foreclosure crisis that began with sub-prime borrowers. In an attempt to jump-start demand, the government has implemented several programs designed to keep mortgage rates low and offer incentives to first-time home buyers. The results of those efforts are beginning to show: home values only declined 0.1% in April from a month earlier and pending homes sales have increased over four consecutive months.

Inflation fears have become a popular topic in the media, due to massive government spending and commodity price concerns. Some have even suggested that these factors could result in rapid, uncontrolled inflation or hyperinflation in the near future. We see a very small risk of this happening. Despite the deficit spending, the U.S. economy is operating at only 68% of its full manufacturing capacity. With slower growth, it could be a number of years before this excess capacity is absorbed, thus muting most inflationary pressures. Additionally, the inflationary impact of rising commodity prices should remain subdued. Demand for raw materials will need to reach prior levels to absorb the commodity production capacity that has been built up during the boom and idled during the slowdown. As an example, the International Energy Agency predicted that world oil demand will not reach 2008 levels until 2012. While we expect inflationary pressures to remain in check in the near term, the Fed's ability to control inflation is less than certain over the longer term. More specifically, we believe inflation will remain controlled for the next two years, but it could eventually reach the 3-3.5% range, slightly higher than the 2.5% average of the past 20 years.

Due to these challenges, the economy is likely to have slower growth over the next few years. Contrary to general assumptions, slower than normal growth has not been bad for stock returns. In fact, periods of less than 3% growth in the 1950s and 1980s produced above average stock returns. Pricing multiples for stocks did well during these periods as long as inflation stayed below 4%. From an investor's perspective, slower growth also means that dividends will once again become a significant part of total stock returns. Historically, dividends represented more than 40% of total stock investment returns. This trend changed in the 1990s, as corporate managements focused more on share repurchases and short term earnings to benefit their incentive stock options. For example, companies historically paid out about 50% of their earnings to investors as dividends. More recently, companies paid out closer to 25%. We believe a reversal to historical dividend payout rates is highly likely and will be demanded by investors.

Going forward, we remain cautiously optimistic. Long-term, we believe quality stocks purchased today will offer above average returns over a 3-5 year period. However, we are concerned that the lowest quality, most speculative stocks have increasingly been leading the rally. After bouncing substantially off the March lows, the stock market has paused and could see a moderate 5-10% short-term correction in which speculators in low quality stocks will be penalized.

In studying stock returns for the past 60 years, it is clear that many high quality companies like we own offer valuations and dividend yields that should result in above average returns. Our recent study of the 41 largest high quality global companies shows they are currently selling at an unusual 10% discount to the S&P 500. As speculation is punished, these high quality companies should return to favor and generate returns in excess of the overall market. Some of our current holdings from these 41 companies include: Abbott Laboratories, AT&T, Chevron, Coca-Cola, ExxonMobil, IBM, Intel, Johnson & Johnson, Microsoft, PepsiCo, Philip Morris, Proctor & Gamble, Verizon, and Wells Fargo. We have been steadfast in investing in high quality, dividend paying leadership companies with strong balance sheets that are less cyclically exposed and we plan to continue that strategy. In any coming market volatility we will look to add these types of leadership companies in client portfolios.

While these are certainly not the best of times, throughout history we have consistently been able to emerge from very challenging times to growth and prosperity. We have no reason to believe this time will be different.

Truly yours,

Keating Investment Counselors, Inc.