Schaper, Benz & Wise
INVESTMENT COUNSEL, INC.

Economic and Market Summary

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After a protracted global recession, economies worldwide are expanding again. In the United States, economic growth turned positive in the third quarter. Companies started restocking depleted inventories following exceptionally large cutbacks in production. Wide-ranging public policy initiatives supported demand. The Federal Reserve has been buying most new mortgages to keep rates low. Tax credits for first time home buyers also contributed to improvement in the residential real estate market. The extension of unemployment benefits provided a needed lift to incomes in the quarter. Market sentiment and risk appetite rebounded from the lows seen earlier this year, resulting in the Dow Jones Industrial Average recording its best three month stretch since 1998.

With economic prospects improving, investors' attention has turned toward the durability and sustainability of the economic expansion. Household spending remains constrained by ongoing job losses, sluggish income growth, lower household wealth, a relatively high debt burden, and tighter credit conditions. Improvement in consumer spending is predicated on a healthier job market. The pace of job losses has slowed considerably, yet companies remain reluctant to hire new workers. While the household sector faces a more challenging uphill climb, the business sector could be the key impetus to a sustained economic recovery. Companies have rarely emerged from a recession so lean and financially strong. While capital spending is still weak, companies have the wherewithal to invest aggressively. Net debt levels are manageable. Corporate cash flow remains strong. Capital markets have re-opened, and the cost of capital has come down. Evidence of this is the merger and acquisition activity which has picked up in recent weeks.

In the past 12 months, consumer prices have fallen 1.5%, led by a 30% decline in the price of gasoline. Excluding food and energy, "core" prices rose 1.4%. Over the near term, we expect the core inflation rate to remain low due to falling rents, underutilized capacity, and the difficulty of workers to command higher wages in times of high unemployment. Longer term, inflation could become problematic if the record amount of stimulus stays in the system too long. Although we are nowhere near that point, we agree that a plan for withdrawing support should be in place to help keep inflation expectations in check.

The worst of the recession appears to be over, and the financial panic is behind us. This can be seen in corporate bond spreads (i.e. the yield differential over U.S. Treasury securities) which have tightened significantly, making corporate bonds less attractive. Stock valuations remain reasonable in the context of improving economic growth, rising earnings expectations, and subdued inflation. The consensus opinion on Wall Street is that we should expect an anemic recovery. In our opinion, growth has the potential to surprise on the upside. Monetary policy is highly accommodative, and there is plenty of fiscal stimulus in the pipeline. Companies have cut costs aggressively, so earnings can recover quickly once revenue starts growing again. We are concerned about many proposed changes to government policy in the areas of taxes, financial regulation, trade, the environment (cap and trade), and health care reform. However, it is encouraging to see increased levels of debate over these proposals which, if passed uncontested, would likely be detrimental to corporate profitability and economic growth.

Worries about the equity markets are only natural in the early stages of a recovery, especially when economic data may be uneven and contradictory. As Sir John Templeton once said "Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria." The market faces a large dose of skepticism today. Historically, the period ahead has been rewarding for equity investors. This time should be no different.

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To request our SEC Form ADV Part II, please contact Michael L. Wise, Chief Compliance Officer, at the address below.

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