

Fixed Income Comments

In 2008, the *debt markets experienced levels of volatility most have never seen*. The past year was plagued with entire sectors of the debt markets collapsing, larger-than-life corporations declaring bankruptcy, and the freezing of credit markets worldwide. The Federal Reserve employed all means of conventional monetary policy to reduce the severity of the current recession. At the December FOMC meeting, the Federal Reserve reduced its key interest rate to 0.00% - 0.25%. Not only was the Fed Funds rate now at its lowest level ever, setting a range was unprecedented. It still remains uncertain as to whether all the liquidity infusion and backstop provisions designed to protect investors and the entire financial system will prove beneficial, but the Federal Reserve is committed to using non-traditional means to return the economy to positive growth and price stability. At this point economic conditions have not shown much improvement, with consumer spending and business investment declining and labor markets deteriorating. *Of course, we did not get into this situation overnight and it will take time, probably more than initially expected, for the economy and global markets to return to more normal operations.*

The safety of fixed income investing came into question as credits that were once thought rock-solid suffered substantial price depreciation. Yield spreads (the difference between government and non-government debt) widened as investors, worried about the next casualty, demanded adequate compensation. *The fact that spreads not only widened for financial services companies, but also in higher quality, straight-forward industrial debt only proved the depth of this financial crisis.* All the volatility kept investors moving into Treasuries, and in spite of the government's heavy new issuance, yields on notes and bills reached new lows.

Even though these are unprecedented times, and it is almost impossible to put this in a historical perspective, *there are some factors that may signal an imminent shift in direction.* Liquidity benchmark rates, which indicate an institution's willingness to lend, have come down from their historic highs. Corporate debt issuance has increased and has been well received due to their attractive yields and relative value. Spreads, although still historically wide, have narrowed somewhat, due in part to the support of the Federal Government. These indicators signal that debt markets are trying to regain stability and run efficiently. Once investors begin to grow impatient with the low yields of Treasury debt and realize the value of other asset classes, funds will move out of U.S. Treasuries into other sectors, such as corporate bonds. We are beginning to see this take place, albeit slowly. As this process proceeds, *investor confidence will be restored and markets will begin to function more normally.*

The past year has shown just how important and prudent conservative bond management is. Disclosure and transparency of securities is paramount and should never be compromised. *Concentrating on higher quality bonds with above average yield advantages over Treasuries should be a primary consideration.* There is always a certain amount



of interest rate risk associated with fixed income investing, but there should never be unnecessary credit risk. *In the current environment, capitalizing on inefficiencies in the market place and maintaining high standards will reduce portfolio volatility and enhance overall performance.*

Elizabeth D. Swartz

Senior Vice President, Fixed Income Manager

Market Comments

I believe we used some of the same descriptions in the aftermath of the difficult markets of 2000 and into 2002 – *good riddance*, and just get us to at least some period of market stability.



As we all look back over 2008, the first thought we are struck with is just how few saw this coming – actually I am not sure we could name any-

one of note who was in a position to forecast or adequately gauge the extent of damage that would ultimately descend upon markets worldwide. We do recall those in policy making roles in the U.S. who suggested that the sub-prime lending crisis would be “contained” – and that the early difficulty in credit markets would not spread to other markets. Wow – that was shockingly inaccurate, to say the least. *In the end, the not-so-perfect storm of sub-prime lending/housing weakness/credit crunch was sufficient to literally paralyze economic activity, and plunge world markets into the most severe decline since the Depression.* We now know just how severe - \$30 trillion erased from world market values, with U.S. markets losing 38%, international markets almost 43%, and emerging markets 52%.

We still like the comment made by Dr. Jeremy Siegel, Professor of Finance at the Wharton School, in summing up the

period as simply that we live in an economy that is capable of booms, and most all booms result in excesses, and most all periods of excess lead to busts. What Dr. Siegel didn't say in as many words is that we seem to do very poorly in learning from busts. Ben Stein calls most of the reason for all the pain the world has experienced as just *unimaginable foolishness* – foolishness on the part of governments, bankers, mortgage originators, investment bankers, hedge funds, and yes, investors. Over the last hundred years we existed in a world economic environment made possible by credit, and today, at least temporarily, financial markets are still facing the reality of the absence of credit across much of the system. By the way, the machinery for the creation of credit will slowly be rebuilt, but the ultimate return of the most important ingredients in those markets – trust and confidence - may in fact take longer. We shall see.

In the aftermath of all the events of 2008, we have two overriding thoughts: *(1) apparently the necessary medicine to forestall some possible economic Armageddon has been applied, and (2) the ultimate consequence of the application is yet to be determined.* In the first instance, governments and central banks have applied the thought-to-be-needed emergency funds in an attempt to ward off a total collapse of credit markets and, in turn, other financial markets. We can now measure the extent of this rescue in terms of trillions of dollars – in the form of loans, equity participation, and outright grants. The question at this writing is probably (a) was it necessary, and (b) has it worked? If one wants to believe markets, the answers seem to be yes and yes – markets seem to be stabilizing after declining for some 14 months, and spreads across credit and debt markets also seem to show that these markets are beginning to improve.

In spite of the historic magnitude of the events of this past year, *there are signs of improvement and there are certainly reasons for some, albeit muted, optimism.* Yes, it is true that the structural threats to credit markets and the accompanying lack of liquidity has brought on economic contraction around the world. GDP is shrinking around the world, job loss and wage stagnation is real, and consumption continues

to slow. Having said that though, there are still reasons to be mildly optimistic. Zachary Karabell of River Twice Research recently pointed out that despite the threat of major crisis around the globe, we have had no revolution or collapse of government or states. He also points out that in spite of the crisis levels of both individual and government debt, and the evaporation of assets, *there are some pockets of good news*. About a third of all households do not have a mortgage in the U.S., and there are still “saver” nations – China being the most obvious with an astonishing rate of some 50%. Consumers have also reacted to the crisis by paying down debt and paring back purchases – at some point this will leave consumer balance sheets much improved. Also, lower energy prices and an almost zero rate of inflation are longer-term stimulants which will have a very positive impact in years to come.



So, what about the longer-term consequences of the massive infusion of money by government into the private sector?

Well, the fact is that nobody can possibly know just what the impact might be – again this massive transfer is an experiment of sorts and

the outcome in financial markets longer-term is very difficult to forecast. The analogies between the Great Depression and the current recession are understandable, but in fact, they are not very comparable. The Depression of the 1930s lasted for years and was made worse by policy missteps. Further, the levers of monetary and fiscal policy available today did not exist in the 30's. Finally, the reality of information technology and globalization which facilitate the ease and speed of money movement around the world further negates these comparisons.

What may well prove most ominous will be *the long-term impact of government's life lines to the financial industry and others – specifically, the leveraging of the Fed's balance sheet in order to supply the*

private sector with bailout funds.

Two weeks ago, the Fed announced that in addition to steps taken thus far, it would use its



own balance sheet to “further

support credit markets and economic activity”. This simply means that the Fed is willing to print money in unlimited volume and cut the Fed Funds rate, if necessary to zero, to achieve its goal of stabilizing credit markets and the financial system. On the day of the announcement, equity and debt markets celebrated, but of course not so for the value of the U.S. dollar. It remains to be seen just how successful policy makers will be in dealing with future inflationary pressures.

As for current levels of markets – we continue to view expected earnings, valuation levels and current prices as much more reasonable. Any positive view of markets for the next 12 months is predicated upon a U.S. economy that would likely begin to trough as early as the summer, and perhaps as late as the fall. Should those forecasts prove accurate, we would expect markets to begin to discount that eventuality very soon. Six months ago, 2009 estimates for S&P 500 earnings were in the \$90 range. Today, analysts have reduced those expectations to around \$63 for this year, and that number seems closer to reality and to be achievable. This current level prices the index at about 14 times those estimates - certainly not excessive, but not particularly under-priced either. *Again, if earnings estimates for this year are now close, we are optimistic that 2009 will likely be one of at least single-digit returns*.

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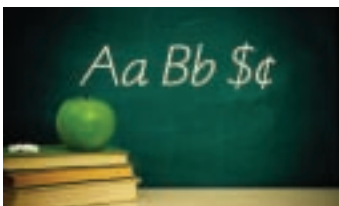
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Free-Market Clarity and Lessons We Should Have Learned - Douglas A. Nunn, CEO

Below are a few comments I think bear repeating:

Political interests outweigh economic ones when governments have some ownership of private companies... when the trade off between risk and reward is obscured by an implicit government guarantee - as exemplified by Fannie Mae and Freddie Mac securities - the consequences can prove extremely damaging.

*Gary S. Becker,
1992 Nobel Economics Laureate
University of Chicago*

They should not be recapitalizing firms that should be shut down. Rather, firms that made wrong decisions should fall... once that's established as a principle, I think the market recognizes that it makes sense. Everything works much better when wrong decisions are punished. The particular asset varied from one boom to another but the basic underlying propagator was too-easy monetary policy and too-low interest rates...

Anna Schwartz, Economist co-authored with Milton Friedman, "A Monetary History of the United States"

How odd that all those boring lessons from our grandparents turn out to be true in the globalized, hip 21st century: Save your money. Don't borrow what you can't pay back. Look first at a man's character, not his degrees. And if a promised return on an investment seems too good to be true, it probably is.

*Victor Davis Hanson
Hoover Institution*