

Economic and Social Outlook: *October 2009*

We continue to expect a V-shaped recovery on the order of 4% growth in the US economy in 2010. That would be enough to get employment and corporate earnings on the upswing again, and keep stocks climbing.

Market Overview: A Moonshot

The powerful rally in stocks that began in March continued through the third quarter, lifting the S&P 500 56% from its March 9 low to its September 30 close. As we said many times during the dark days of late 2008 and early 2009, when stocks turn up after the end of a bear market their first rally tends to be explosive.

The current moonshot sent the S&P ahead 19% for the first nine months of the year. To be fair, that still leaves the S&P down 32% from the high it made in the fourth quarter of 2007. But stocks have now recovered nearly half of the epic decline they suffered over the 16 months leading up to the March 9 low.

Interestingly, the index's gains were not evenly distributed across the market. Three of the ten S&P economic sectors drove the overall benchmark returns: technology (+45%), basic materials (+36%) and consumer discretionary stocks (+28%). Happily, we have emphasized technology and consumer discretionary stocks all year and materials stocks since June.

Why did these sectors do so well? Because their earnings are highly sensitive to the economic cycle. Consequently their share prices rise in anticipation of economic recovery, which is precisely what we're seeing unfold around the globe today.

Economic Overview: Turning the Corner

The economic recovery is developing pretty much according to the script we've followed all year. The worst of the recession hit in the fourth quarter of '08 and the first quarter of '09, both of which saw the economy slow at a near-6% rate.

In the second quarter the economy continued to slow but at a negligible 0.70% pace (that's 7/10 of 1%). We expect the third quarter just ended to show positive economic growth on the order of 3% with a similar pace of expansion in the current fourth quarter. While that isn't torrid growth, it's respectable and would be most welcome.

You may be scratching your head about this economic recovery we're seeing given the headlines you read every day about rising unemployment. It's an unfortunate truism of economics that employment is a "lagging" indicator of general economy activity. Which means that the economy, as measured by the totality of goods and services sold, picks up well before employment does. This makes sense as employers quite naturally wait to make the commitment to hire new employees until they have concrete signs that business is getting better. As business is, we believe, getting better we expect employment to turn the corner either late this year or early next year.

Reheating the Alphabet Soup

At this point few doubt that an economic recovery of some sort is underway. The question is: what sort? As we noted last quarter, the shape of the ultimate recovery is debated with letters of the alphabet. An "L" recovery is no recovery at all; just a cessation of decline followed by a stagnant economy. A "U" is a tepid recovery that only gradually gains any steam. A "V" is a sharp rebound following the deep recession. And a "W" is a "V" that falls back into recession (also known as a "double dip") before recovering a second time.

continues on reverse

Major Market Performance 2009

	3rd Quarter 2009 % chg.	1st Nine Mos 2009 % change
Dow Jones Indus. Average	15.82	13.49
S&P 500 (large cap)	15.61	19.26
S&P 1000 (small/mid cap)	19.57	26.61
S&P 1500 (all cap)	16.05	20.09
NASDAQ	15.66	34.58
Barclays State G.O. Muni Bond	6.80	10.61
Barclays Gov/Credit Intermediate Bond	3.25	4.92

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Alphabet Soup (cont.)

Through their monetary, fiscal and tax policies governments around the world have thrown an unprecedented amount of stimulus at the global economy. It will revive. Indeed, it already has as demonstrated by second quarter expansion throughout both European and emerging economies (China, India, etc.) The US is an integral part of the global economy and it too will revive. So the “L” is off the table.

Proponents of the “U” school argue that any recovery will have to fight a strong headwind of deleveraging on behalf of consumers, whose personal balance sheets are burdened with debt while their collateral asset values have sunk, specifically housing and stock values. While we agree that this is a headwind, we would argue that the powerful tailwind of global governmental stimulus will prove the stronger of the two.

So, as noted last quarter, we continue to expect something of a “V” recovery. Were it not for the headwind of deleveraging noted above, the recession we’ve just had would typically be followed by a barn-burner recovery—GDP growth on the order of 8%-9% in the first year. Giving these headwinds their due, we expect something on the order of 4% growth in the US economy in 2010. That would be enough to get employment and corporate earnings on the upswing again, and keep stocks climbing, albeit at a slower pace.

What Could Go Wrong

To be fair, we should acknowledge that every “W” begins with a “V.” That is, while the US economy could enjoy a moderately strong recovery, it could still fall back into recession later—for example, when the governmental stimulus is exhausted or withdrawn. This is a major point of contention among economists and market watchers. Those of the Republican, free-market persuasion tend to expect a “W,” in part because they don’t believe government intervention works, ever. Democratic Keynesians, on the other hand, think we’ll have a “V” recovery, demonstrating the crucial role government can and should play in the economy.

While there’s little doubt on which side of this fence we fall, we admit it’s an open question. But we would point out that you can’t tell if a “V” is going to turn into a “W” until much further into the future. We think this question won’t be settled until 2011. Until then, we think the stock market will respond quite favorably to what walks and talks and squawks just like a “V.” We’ll worry about 2011 a couple quarters down the road.

Opportunity

We find it very promising that the background to every discussion of economic recovery is doubt. Doubt that it will happen. Doubt that it will be strong. Doubt that it can last. Despite a nearly 60% gain in stocks in six months, investors remain traumatized by the recent bear market and fearful of stocks. This is good.

You know what we’re going to say here: Bull markets climb a wall of worry. Worry, fear, doubt keeps cash on the sidelines. Today there remains a veritable mountain range of cash parked in T-bills, money markets and other super-safe vehicles, which happen to be paying almost nothing. (Have you looked at your money market yield lately? Don’t.) As the economy recovers, corporate earnings begin to climb, and stocks continue to advance, then, as surely as day follows night, investors’ fear will begin to give way to their desire for gain. This has yet to happen. And that spells continued opportunity in the stock market.

What We’re Doing

As the economy moves through its business cycle from recession to recovery to expansion and back, different sectors of the stock market take a leadership position in terms of performance. We positioned our equity holdings for economic recovery in January by increasing our exposure to consumer discretionary and technology stocks. These sectors are the canaries in the coal mine of economic recovery, sniffing out the first whiffs of revival before other cyclical sectors. This paid off as the both sectors are among the top three performers year-to-date.

At this point in the business cycle, with recovery underway and expansion at hand, we’re sticking with our technology emphasis, dialing back a bit our consumer discretionary exposure and continuing to expand our energy, materials and industrials holdings. The consumer discretionary space should still do well but not as well as the latter three sectors just noted. These tend to do best once an economic expansion is underway.

Compounding this advantage is the fact that energy, materials and industrials along with technology stocks enjoy huge demand from the emerging economies of China, India, Russia, Brazil, *et al.* If a global economic recovery is underway, emerging economies will grow faster than the US. Much faster. So we want to own companies that sell into these burgeoning markets.

Farnum Brown
Chief Investment Strategist

Social Advocacy Highlights

Community Accountability and Environmental Justice – Trillium continues to lead an investor coalition pressing for greater corporate accountability in Mossville, Louisiana, a portion of “Cancer Alley” choked by a high density of pollutants from 14 industrial facilities. During the summer we wrote to ConocoPhillips urging them to take steps to engage community members and provide an accounting of the long-term environmental impacts of their operations. Companies with poor stakeholder engagement plans subject shareholders to added investment risks.

Corporate Governance Resolution at Whole Foods – In October, Trillium co-filed a binding bylaw resolution at Whole Foods Markets. The proposal would mandate the election of an independent board chair. The position is currently filled by CEO John Mackey, whose leadership has been called into question by Internet postings in 2007 that led to an SEC investigation, and more recently, by his authorship of an op-ed piece in the Wall Street Journal attacking healthcare reform that has prompted a widespread boycott of the company.

Shareholder Proposals: the “stick” of shareholder activism – A group of investor representatives, pension funds, and unions, including Jonas Kron of Trillium, were invited to meet with Securities and Exchange Commission (SEC) staff at the end of September to discuss how they review shareholder proposals. Under the Bush administration they had excluded proposals, contrary to common sense and the rules, on some of those most important issues we must confront – climate change, health care reform, and financial reform – because they focused on the “ordinary business” of the company. This area of our advocacy may be a bit wonkie, however, SEC regulations are the “plumbing” that allows us to use shareholder proposals for our advocacy. And as with our homes, it is critically important to keep the plumbing working. So while some of what we heard from the SEC was positive, it was very clear that we still have a long way to go in advocating for fair treatment of our proposals by the SEC. We will continue to press the SEC with our allies in the investor and labor communities in the year to come.

OpenMIC: A Free and Open Internet - The biggest new shareholder campaign in the human rights arena in the 2009 shareholder season is the Open MIC campaign on freedom of speech and privacy on the Internet. Open MIC, the Trillium initiated organization, is coordinating Trillium and the \$100 billion New York City pension funds shareholder proposals on this issue.

OpenMIC (cont'd...) - At CenturyTel, the nation’s fourth largest internet service provider, the vote received a remarkable 30% of the vote – a clear expression of shareholder concern. Last years proposals asked the companies to confront how their network management practices have an impact on freedom of speech and privacy. In this coming year we will expand our list of targeted companies and hone in on censorship concerns.

Water Footprinting – Earlier this summer we filed a shareholder proposal with Costco asking the company to do greater reporting on climate change issues and its water footprint through its supply chain. We were able to withdraw that proposal after getting a commitment from the company to have a substantive conversation about its impact on watersheds around the nation and globe. Concern about water, the most tangible expression of climate change, continues to grow in the investor and NGO communities. Our advocacy will be focusing on the use of water in agriculture – approximately 70% of the water used in the United States.

Hydraulic Fracturing – Trillium is pursuing actions to address an emerging water quality issue for shareholders associated with natural gas drilling. Hydraulic fracturing – known as “fracking” – is a widely employed technique used to pressurize natural gas from shale formations. It uses massive volumes of water, sand and chemicals, and the waste effluent has been linked with explosions and contamination of water sources. This fall, Trillium has begun to engage with several natural gas drillers and service providers to the industry to inquire about their ability and willingness to transition to safer fluids, disclose the chemicals used, and take other safety precautions.

Sustainability Reporting – We withdrew our resolution at Darden Restaurants (owner of the Olive Garden and Red Lobster chains) after the company agreed to publish a substantive report in the next 10 months that will address greenhouse gas emission goals and targets, and other social and environmental impacts pertinent to the restaurant industry. In August, we met with Darden’s Director of Sustainability to discuss their progress. In addition to reporting on energy, water and waste reduction efforts, the company will disclose seafood sustainability initiatives and animal welfare policies, both integral to their supplier standards program.

Jonas Kron
Senior Social Research Analyst