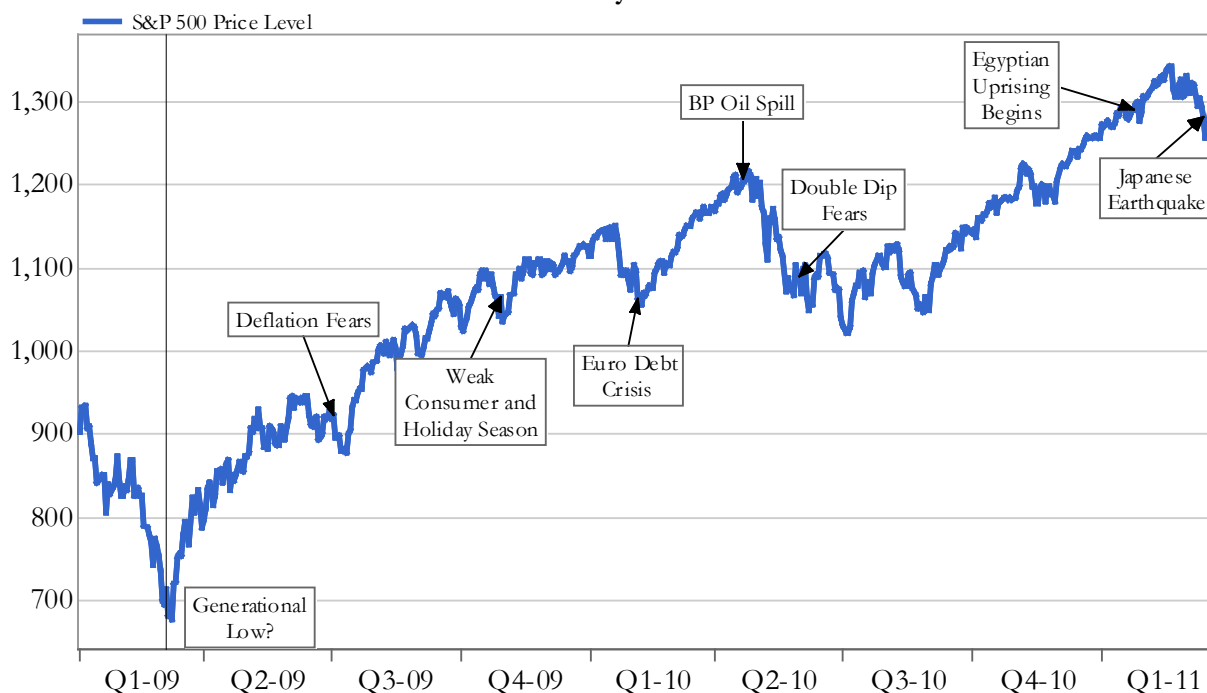


# HAVERFORD OUTLOOK



Recent world events have caused many investors to question their resolve as fear has once again entered their psyches. This is certainly understandable. The extent of the damage in Japan and its effects on world economic growth is still not fully understood, while the unrest in the Middle East remains a dynamic and frightening situation. At a time when economic recovery may appear to be in its infancy, a new global crisis seems to emerge each and every week. But when one cuts through the negativity and fear present in the 24-hour news cycle, it becomes clear that the economy has been steadily improving, the financial environment is significantly stronger and that we are well on our way to a self-sustaining economic expansion.

## The Market has Climbed the Wall of Worry

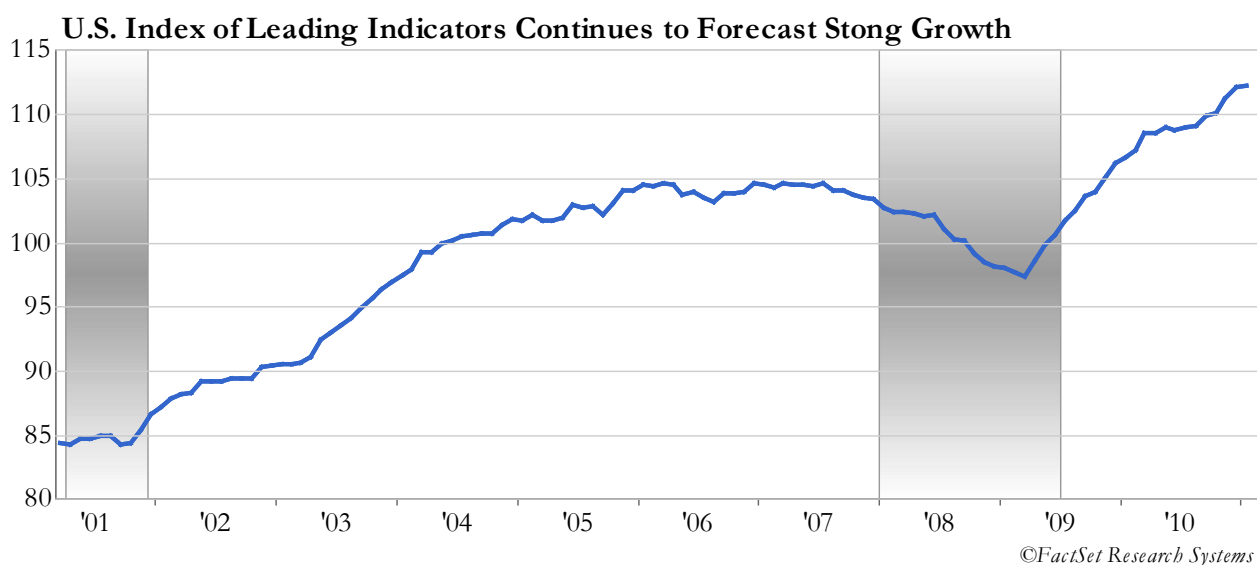


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## Economy – Crossing the Bridge from Recovery to Self-Sustaining Expansion

A great deal of debate centers on whether the economy can continue to grow after the Federal Reserve begins to remove the extraordinary stimulus implemented following the financial crisis. With the Fed's second round of quantitative easing, known as "QE2," slated to end in June, this debate will likely grow louder over the next several weeks.

Regardless of this debate, we firmly believe that we have crossed the bridge from cyclical recovery to a sustainable economic expansion. The economy has a great deal of momentum that should withstand the gradual removal of monetary stimulus. Unfortunately, we will still be dealing with the lingering effects of the recent recession as well as natural disasters and geopolitical strife. But on balance, the preponderance of the evidence – best illustrated by leading economic indicators – points to continued economic gains ahead.

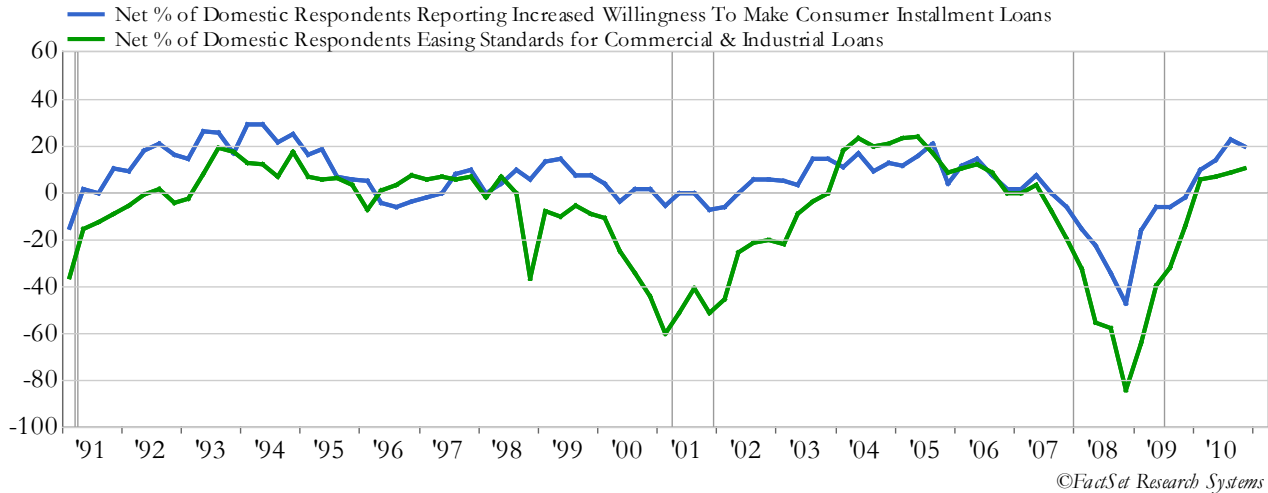


*Leading Indicators: index of supplier deliveries, interest rate spread, stock prices, real money supply, index of consumer expectations, building permits, manufacturers' new orders for nondefense capital goods, average weekly manufacturing hours, average weekly initial claims for unemployment insurance (inverted), and manufacturers' new orders for consumer goods and materials.*

One of the primary underpinnings of our bullishness stems from the improvement in the credit creation process. The financing environment has improved substantially. Credit spreads, an excellent barometer of financial stress, have narrowed dramatically. Banks, in much better financial shape and encouraged by a reinvigorated securitization market, are now much more willing to lend.

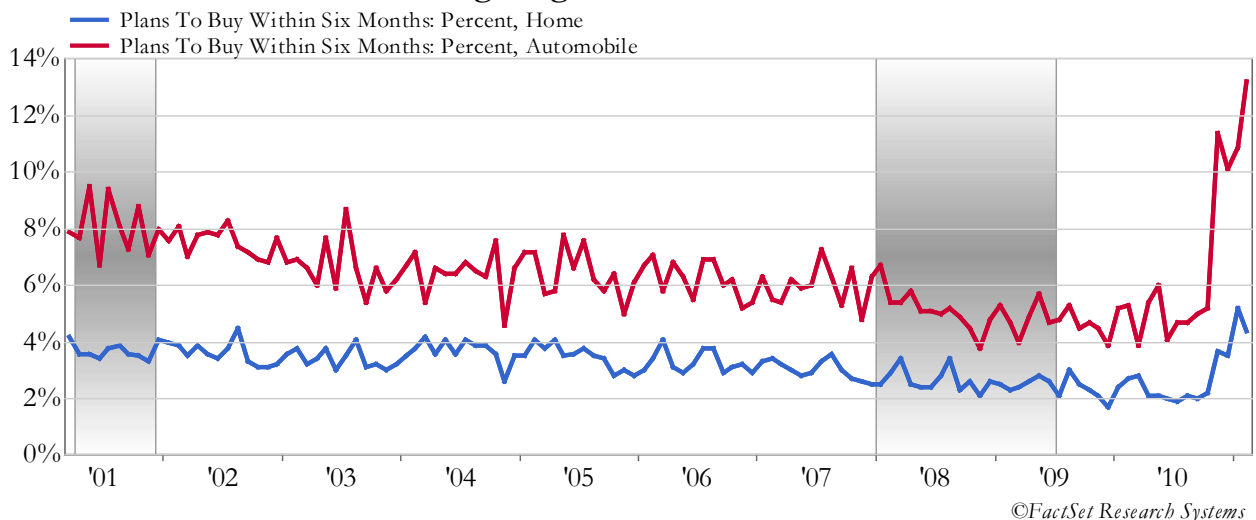
Consumers are in better financial shape as well, as they have improved their personal balance sheets and lowered their borrowing costs via mortgage refinancing. Consumer debt servicing costs have declined significantly and the resulting extra disposable income has boosted consumer spending. Accordingly, most of the sizable gains in GDP have been driven by consumer spending, resulting in gains along the entire economic food chain.

## Banks are More Willing to Lend

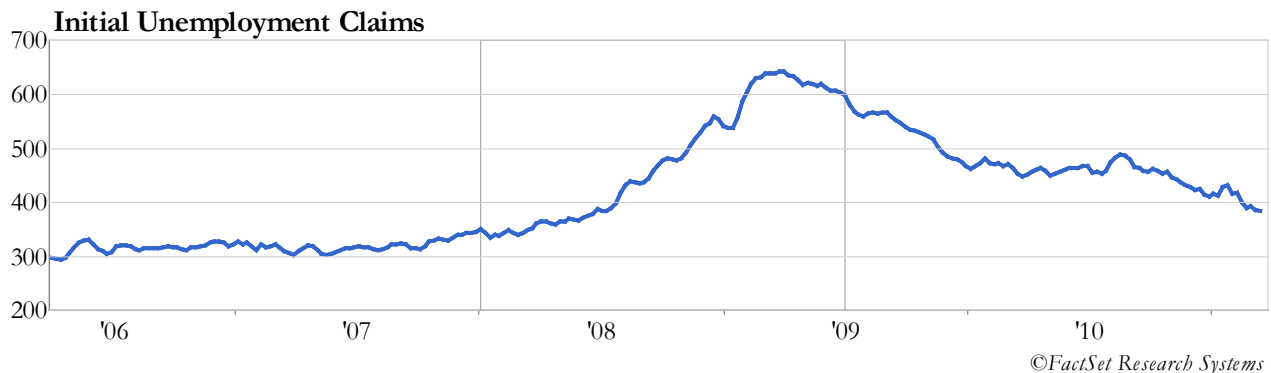


We believe the recent uptick in consumer spending will continue, driven by pent-up demand for durable goods and a gradual reduction in the unemployment rate. We discussed this in our previous *Outlook* and the thesis is worth repeating. A good example of pent-up demand is in the auto sector. For much of the last decade, U.S. consumers bought about 16 million vehicles per year. At the height of the financial crisis, automobile sales fell to nine million units, which is well below the annual scrappage rate of approximately 12 million units per year. We also see the potential for improved demand in the housing sector, where housing starts have been below the level of household formation for several years. Consumers are increasingly interested in making purchases of autos, homes, and high-priced durable goods. We believe we will continue to see auto sales trend higher and industrial production increase as a result. The housing market, which is more highly dependent on rising employment, will take longer to return to “normal.”

## Consumer Interest in Making Large Purchases has Increased



Job creation is still lackluster compared to previous cycles, but the upward trend is encouraging. Early indicators of an improvement in employment have been very positive as job losses have stabilized and the country adds new jobs each month. Corporations were loath to hire permanent workers in the face of economic uncertainty. Instead, they utilized overtime and temporary workers to increase production. They are now at a point where it makes sense, from a cost perspective, to hire permanent workers. Statistics measuring temporary workers and hours worked are consistent with prior periods of burgeoning job growth, so we expect continued gains in the months ahead.



Although we are bullish on the economy, we would be remiss if we didn't specifically discuss the challenges. The most obvious problem stemming from turmoil in the Middle East is higher oil prices with crude up more than 20% since the beginning of the year. Higher energy prices act as a tax on the consumer, reducing the disposable income available for purchases of other goods and services. At a time when food prices are trending higher and unemployment remains elevated, it will prove difficult for consumer and business confidence to continue to improve. Consumers, especially lower-income consumers, are getting squeezed.

That said, consumers and businesses have learned to adapt to higher energy prices, so the recent rise has not been as large a negative shock to the economy as what we witnessed in the 1970s. Energy expenditures as a percentage of personal income were much higher back then, and the oil price spike of 2007 and 2008 ushered in a new, modern-day wave of energy conservation. While the recent increase in energy prices will likely extract its pound of flesh from GDP growth, we do not believe it will break the back of the economic recovery. The U.S. is much better prepared this time around.

The Middle East remains in a state of flux and much depends on future events that are extremely difficult to predict. Libya represents only 2% of the world's oil production, so it is safe to say that a good portion of the spike in oil prices is indicative of fear – fear that problems in the Middle East will continue to spread and further threaten the world's oil supply. Saudi Arabia is the world's second largest producer of oil behind Russia and thus the biggest concern. Based on our analysis and discussions with experts on the region, we are confident that there will be no regime change in Saudi Arabia. In fact, Saudi Arabia has increased oil production to make up for lost Libyan shipments.

Meanwhile, Japan continues to grapple with the damaged nuclear power facilities in Fukushima and the resulting fear level associated with a nuclear meltdown. In the near term, the Japanese disaster will likely reduce world GDP growth, since Japan is the world's third largest economy. Their economy has essentially ground to a halt, and supply chain disruptions, particularly in the technology sector, will cause a deferral of shipments across the globe.

Looking forward, the Japanese economy will likely rebound strongly in the third quarter as the rebuilding process gets underway. There will be a tremendous amount of new capital injected into the Japanese economy. Businesses worldwide will likely benefit from increased demand for the products and services related to restoring property and infrastructure. Consequently, we believe that any economic slowdown resulting from the Japanese earthquake will likely be moderate and quickly reversed.

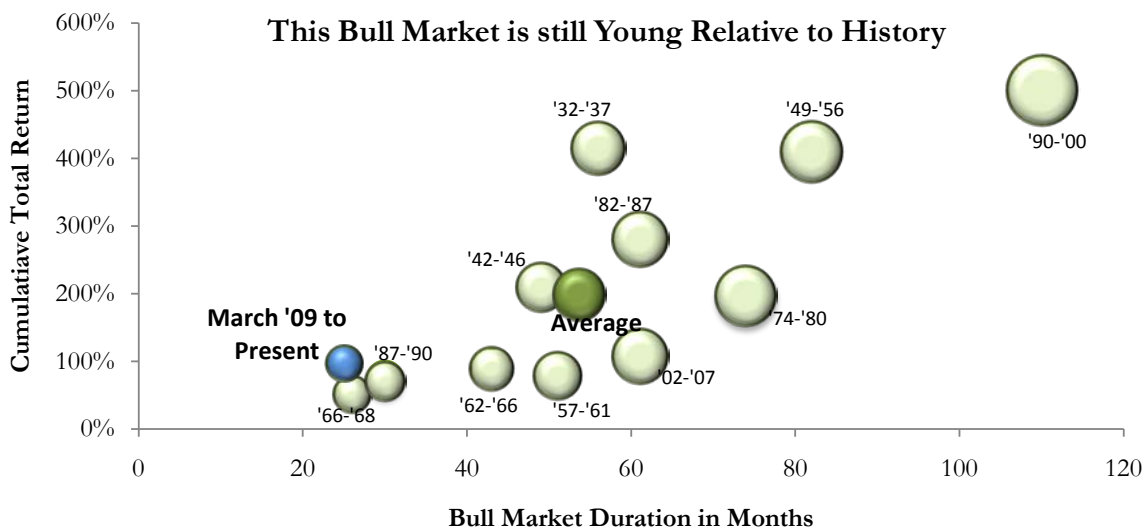
European sovereign debt issues are still in play, although this has moved from “crisis” status to more of a lingering problem. Austerity measures have helped, but it is the strength of several European countries that has allowed investors to breathe a sigh of relief. We believe it is unlikely that countries such as Germany would endanger their own robust economic growth by discontinuing support for bailout measures toward their weaker Euro-brethren.

Here in the United States, the budget deficit tops the list of long-term domestic concerns. Much needs to be done to reduce the budget gap. We are somewhat comforted by a sense of urgency among newer members of Congress to address the problem. In addition to potential legislative action, we are optimistic that higher economic growth will help increase tax receipts and lower the expenditures needed for social programs such as unemployment insurance. Put another way, we believe that the cyclical component of the budget deficit will improve markedly in the coming quarters.

After weighing the positives and negatives, we remain convinced that the economic recovery has morphed into a sustainable, self-reinforcing economic expansion. Many of the economic headwinds will certainly temper economic growth, but the economy has gathered enough momentum to overcome the many obstacles to growth.

### Equities – Still Positive for 2011 and Beyond

An injection of fear into the investment landscape can be a positive, insofar as complacency among investors is a dangerous thing. After a stellar start to 2011, markets sold off mid-quarter as global events caused investors to seek the safety of the sidelines. A correction wasn’t unexpected after the market’s torrid run, but it’s never fun when it actually occurs.



As we go to press, the market has recovered all of its losses from February and March. More importantly, we believe it is well positioned for further gains. We are in the early stages of what could be a protracted economic expansion, interest rates remain conducive to economic growth, and valuations are attractive.

High on the list of catalysts for market growth is the fact that there remains a tremendous amount of money on the sidelines following the financial crisis, and this cash has just begun to find its way back into the equity market. The last three years have been marked by outflows from equities into bond funds, and this trend has only recently reversed. Dividend yields on stocks remain very attractive relative to the paltry yields offered in the fixed-income market, and recent interest rate volatility has called into question the “safety” of longer-dated bonds. Many companies in our portfolios continue to provide equity dividend yields comparable to the yields on their corporate debt. It is this relationship that leads us to believe that, in the battle between asset classes, equities will be the winner over the next several quarters and for years to come.

Corporate America’s earnings outlook remains bright. The current bottom-up analysis of S&P 500 2011 earnings is an EPS consensus estimate of \$97 (16% year-over-year growth), which is likely to decline given current events. Higher input costs associated with the rise in energy and other commodity costs will cause some companies to temper their expectations of margin and profit growth. Inflation in emerging market economies is forcing central banks to raise rates in an effort to slow growth, which will likely pressure sales. Finally, potential disruptions in the technology supply chain resulting from the Japanese earthquake could cause some short-term profit dislocations. This list of concerns is by no means exhaustive, but we feel that the positives far outweigh the negatives. Even after applying a reasonable hair-cut to earnings expectations, double digit earnings growth is the most likely outcome.

The quality of earnings is high and accompanied by prodigious cash flow. S&P 500 companies show more than \$1.2 trillion in cash on their balance sheets. Valuations, especially for high-quality large-cap stocks, appear especially attractive at 13 times 2011 anticipated earnings. The broad uptick in mergers and acquisition activity also provides additional evidence of the attractiveness of equity valuations. In most cases, corporate managers are willing to pay a *significant* premium over current market valuations for strategic assets. This speaks to how bullish they feel about current valuations and the future of their businesses.

As mentioned in our previous *Outlook*, we are in the third year of a presidential election cycle, which is historically good for the stock market. The Obama Administration has recently struck a conciliatory tone with the business community, extending tax cuts and providing other pro-growth measures.

#### Equity Yields are Comparable to Corporate Debt Yields

	10-Year Bond Yield to Maturity	Stock Dividend Yield	5-Year Dividend Growth
Abbott Laboratories	4.1%	4.0%	9.9%
Altria Group Inc.	4.8%	5.9%	9.1%
AT&T Inc.	4.2%	5.7%	6.1%
Bristol-Myers Squibb Co.	3.7%	4.9%	8.8%
Chevron Corp.	4.5%	2.7%	10.1%
Coca-Cola Co.	3.8%	2.9%	9.6%
ConocoPhillips	3.9%	3.3%	12.1%
Consolidated Edison Inc.	4.1%	4.7%	0.9%
E.I. DuPont de Nemours & Co.	4.3%	3.0%	2.8%
Exelon Corp.	4.8%	5.2%	6.8%
GlaxoSmithKline PLC ADS	3.7%	5.3%	4.6%
Johnson & Johnson	3.7%	3.6%	10.4%
Kimberly-Clark Corp.	3.9%	4.3%	7.8%
McDonald's Corp.	3.8%	3.2%	26.8%
Merck & Co Inc	4.0%	4.6%	0.0%
Procter & Gamble Co.	4.1%	3.1%	12.1%
Verizon Communications Inc.	4.3%	5.1%	4.0%
<b>Average</b>	<b>4.1%</b>	<b>4.2%</b>	<b>8.3%</b>

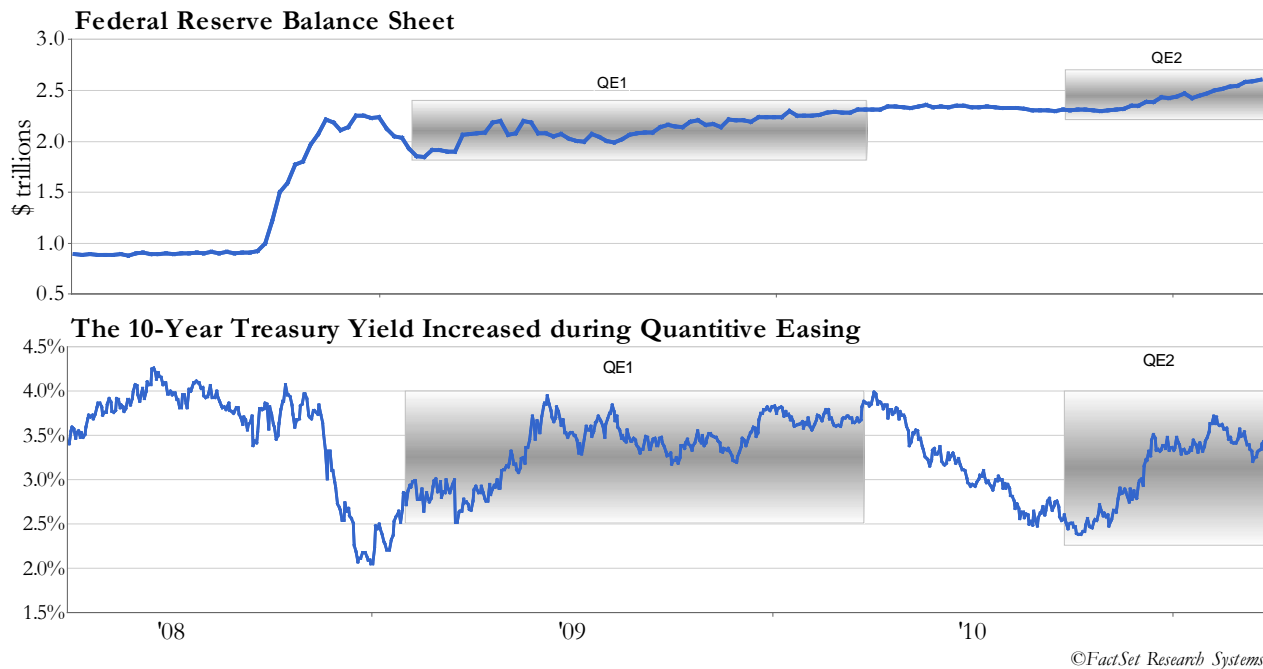
as of March 29, 2011

## Fixed Income – Look for Interest Rates to Rise in the Coming Months

At the beginning of the year it appeared that the long-awaited bear market in bonds had begun. Bond prices, which move inversely with interest rates, were moving lower as evidence mounted that the economic recovery was gathering steam. However, the upward trajectory of interest rates stalled as many around the world used U.S. Treasury securities as a safe-haven investment and questions arose regarding the sustainability of economic growth in the midst of surging energy costs.

Despite the recent flight to safety, we reiterate our view that interest rates will rise for the balance of the year and into 2012. The second round of quantitative easing is slated to end in June, and it is doubtful that an additional round will be considered. Once again, we believe that we are well on our way to a sustainable economic expansion, which will preclude the need for more quantitative easing and other extraordinary monetary policy initiatives.

Conventional wisdom holds that as the Fed stops its purchases of Treasury and mortgage-backed securities, interest rates will likely rise. We believe this will be the likely outcome, but the magnitude of the increase will be dictated by the extent to which the U.S. Treasury bond is used as a safe haven for global investors. It is interesting to note that Treasury yields meaningfully increased during the Fed's previous easing campaigns, indicating many factors can influence Treasury yields beyond Federal Reserve policy. We believe economic strength will likely push the 10-year Treasury back to its recent historical average, indicating a yield slightly above 4%.



Given the slack in employment, the Fed is not likely to increase short-term interest rates until the end of 2011 at the earliest. Although commodity cost pressures could increase headline inflation in the near term, the Fed's inflation concerns will likely continue to center on wage inflation, which currently appear rather benign.

We see considerable improvement in municipal finances, although every municipality is different. Tax revenues could well surprise on the upside and costs associated with social programs should move lower as the economy improves. Budget austerity in many state and local municipalities is proving to assuage the fears of many municipal bond participants. A lack of significant supply of new municipal bonds has also helped to improve municipal bond spreads.

Overall, we continue to advocate investing in high-quality bonds with an intermediate duration. We see significant interest rate risk in longer-dated securities, so we believe it is prudent to stay shorter with the potential to increase yield as interest rates move higher in the coming quarters.

## Conclusion

It is easy to get distracted given all that is occurring in the world today, especially since the trauma of the recent financial crisis and its lingering effects are still fresh in our minds. Nevertheless, we find many positive trends within the steady drumbeat of negative news. It is our view that we are still in the nascent stages of a sustainable expansion in the capital markets, and that longer-term investors will be generously rewarded.

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