Schaper, Benz & Wise
INVESTMENT COUNSEL
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18 Jewelers Park Dr., Suite 200 | P.O. Box 628
Neenah, WI 54957-0628 | 920.727.1137

Economic and Market Summary
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The National Bureau of Economic Research declared the recession officially ended over a year ago, but it does not feel that way to the average American. The pace of economic growth has been gradual and uneven. With firms reluctant to hire, unemployment remains high. Hesitancy persists among consumers and businesses, despite their much improved financial condition. While we are encouraged by heightened acquisition activity and a greater willingness by corporations to repurchase shares and hike dividends, overall investment spending remains subdued. Firms hold an abundance of cash, yet large corporations continue to borrow vast sums of money to "save for a rainy day." Corporations (and governments for that matter) have had no problem finding willing lenders. More dollars have flowed into bonds than stocks this year. The most recent economic downturn and market correction have been so damaging that investors would rather lock in today's incredibly low yields than risk principal in the stock market.

The political climate has also contributed to investors' risk aversion and muted economic growth. Consumers delay making decisions when they are not sure what their future tax rates will be. Businesses have difficulty planning and making investments when policy is continually changing. When the government raises taxes or imposes stringent regulations, it reduces the incentive to take risks. Incentives do matter, and our government should be fostering entrepreneurial activity rather than suppressing it. Clarity on both taxes and broader legislative issues following the Congressional midterm elections will be welcome. If significant changes in the composition of Congress come to fruition, legislative policy could become more business-friendly.

The federal funds rate has been near 0% for almost two years. Because traditional policy options have been exhausted, the Federal Reserve is contemplating another round of quantitative easing (i.e. the monetization of U.S. government debt) in an effort to spur economic growth and prevent deflation. The mere announcement of further quantitative easing, dubbed QE2, has already had the effect of bringing down interest rates, lowering the value of the U.S. dollar, stabilizing inflation expectations, and contributing to the market rally. QE2 is not without potential unintended consequences. These include a disorderly decline in the value of the dollar and an escalation of global currency and trade wars. Down the road, the Federal Reserve is confident that it has the necessary tools to remove the unprecedented accommodation. However, bonds are most at risk if the exit strategy is not executed perfectly. It is difficult to engineer an exact dose of inflation, so we remain cautious on longer-term bonds.

Our U.S. GDP forecast is being revised down slightly for 2010, from just under 3% to 2.0-2.5%. Although a more robust economy makes revenue growth easier to garner, most companies we own are not dependent on rapid U.S. economic growth. Multinationals are selling into faster-growing emerging countries such as China and India. Smaller U.S.-centric companies have sustainable competitive advantages, unique and innovative technology, and/or cater to a specialized niche. Our philosophy lends itself to the ownership of well run businesses with strong balance sheets and healthy cash flows. While the larger macroeconomic events are important, we focus the majority of our time on the long-term company fundamentals that ultimately support earnings and stock prices. When stocks fall out of favor, valuations contract and opportunities abound. With still robust corporate profits, low inflation, accommodative monetary policy, and improving fiscal policy, we see substantial value in our high quality, consistent growth companies.

Christi Gromer Salm, CFA