

Hillman Capital Management Q3 2009 Market Commentary

In a 1942 speech delivered by Sir Winston Churchill he remarked “Now this is not the end. It is not even the beginning of the end. But it is perhaps, the end of the beginning.”¹ Churchill’s remarks on the status of World War II reflect our beliefs on the current stage of the economic predicament. After one of the swiftest declines in economic activity experienced since the Great Depression, the United States’ economy showed early signs of stabilization in the third quarter. GDP is widely expected to have increased during the past quarter and Federal Reserve Chairman Ben Bernanke made public his belief that “the recession is technically over”.²

Despite early signs of stabilization and a “technical” end to the recession, we believe it is important to recognize that the United States’ economy still faces significant longer-term challenges. Employment dropped by 263,000 jobs and the unemployment rate reached 9.8% in September.³ The Congressional Budget Office (CBO) estimated that the federal budget deficit will reach nearly \$1.6 trillion in 2009, \$1.4 trillion in 2010 and will maintain levels in excess of \$500 billion through the end of its ten year forecasting period.⁴ In the near-term, deficit spending may provide needed economic support. Over longer periods, deficit spending can be self defeating. At some point, if continued, large budget deficits will likely have unwanted implications for domestic interest rates, asset values and real economic growth.

We believe that near-term economic recovery hinges on the ability and willingness of U.S. consumers and businesses to shift behavior from acute saving and deleveraging to rational consuming and investing in future growth. We believe that, in aggregate, consumers have a modest ability and a growing willingness to increase spending. For U.S. businesses a general improvement in credit conditions has somewhat restored their ability to increase capital spending. Though many business leaders remain cautious, we believe that tight inventory levels and improving sentiment among small business leaders are likely precursors to sequential improvement.

Our supposition is that U.S. consumers have an ability to increase spending on smaller discretionary purchases though credit availability for larger purchases remains tight. We believe that elevated savings rates paired with a reasonable relationship between financial obligations and disposable personal income are indications that consumers have an ability to consume. Over the twelve month period ending August 2009, the monthly personal savings rate averaged 3.9% versus 2% over the prior twelve months.⁵ Despite the large face value of consumer debt, low interest rates have pushed the Federal Reserve’s Financial Obligations Ratio (computed by adding required payments on outstanding debt, automobile lease payments, home rental payments, homeowners insurance and property tax payments then dividing by disposable personal income) downward. As of the end of June, consumers’

¹ Sir Winston Churchill, Speech in November 1942

² Ben Bernanke, Question and Answer Session, Brookings Institute, September 15, 2009

³ U.S. Bureau of Labor Statistics, [Employment Situation Report](#), October 2, 2009

⁴ Congressional Budget Office, [Budget and Economic Outlook](#), August 2009

⁵ Thomson Baseline, Source: U.S. Bureau of Economic Analysis

financial obligations as a percentage of disposable income had fallen to levels last seen during 2004.⁶ For those pursuing large purchases, tight lending standards may persist for some time. That said, recent surveys of loan officers suggest that increasingly fewer banks foresee a need to tighten credit standards beyond current levels.⁷

Trends in the personal savings rate suggest that U.S. consumers increasingly chose to spend more and save less during the third quarter. The savings rate peaked at 6% in May of 2009 and has since declined steadily to 3% in August.⁸ Consumer behavior has likely been influenced by a positive wealth effect related to increasing equity and fixed income values, as well as expectations of slowing job losses and stabilizing home prices. Note that we believe that the resumption of consumers' willingness to spend is largely predicated on their expectations of economic improvement. An unforeseen shock to employment, equity and fixed income markets, or housing could have a materially negative influence on aggregate consumer behavior.

Capital spending initiatives by U.S. businesses have been among the largest casualties of the financial crisis. The uncertain demand environment and frozen credit markets were likely causes of reduced capital spending. During the height of the liquidity crunch in the first quarter of 2009, the commercial paper markets seized, the interest rate spread between AAA corporate credit rates and U.S. Treasury securities increased to 174% of its prior 10 year average, and spreads between BAA and AAA corporate debt rose to 292% of their ten year average.⁹ In the Federal Reserve's April Senior Loan Officer Opinion Survey, 80% of respondents indicated they were tightening standards for Commercial and Industrial (C&I) loans¹⁰. Amidst these adverse circumstances, capital spending versus prior year levels fell by 15.4% and 19.3% in the first and second quarters, respectively.¹¹

We believe that the credit environment affecting U.S. companies is normalizing, thereby increasing the availability of credit. Triple A credit spreads and the spread between BAA and AAA debt have regressed toward historical means (resembling their ten year averages). The availability of C&I loans appears to be improving. In its July survey, the Federal Reserve indicated that only 30% of senior loan officers expect to further tighten C&I lending standards, a significant improvement from the 80% level in April. Demonstrating the diminished relevance of restricted credit on business spending, a recent National Federation of Independent Business (NFIB) survey found that only four percent of small business owners cited "financing" as their number one business problem.¹²

The broader issue affecting business spending appears to be the unwillingness of business leaders to borrow and invest for future growth. During their second quarter earnings calls, we continued to hear many CEO's beating the drum of fiscal responsibility with the now familiar phrase: "managing for cash" as they worked to reduce inventories and cut discretionary spending. Their sentiment has also been felt by loan officers, many of whom have suggested that demand for C&I loans remains weak.¹³

⁶ The Federal Reserve Board, Household Debt Service and Financial Obligations Ratios, Q2 2009

⁷ The Federal Reserve Board, July 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices

⁸ U.S. Bureau of Labor Statistics, Employment Situation Report, October 2, 2009

⁹ Thomson Baseline, Source: Moody's, Federal Reserve

¹⁰ The Federal Reserve Board, July 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices

¹¹ U.S. Bureau of Economic Analysis

¹² National Federation of Independent Business (NFIB), Small Business Economic Trends

¹³ The Federal Reserve Board, July 2009 Senior Loan Officer Opinion Survey on Bank Lending Practices

In the aftermath of the recent credit crisis we believe that the majority of business leaders will be slow to authorize significant increases in capital spending. However, some leading indicators, including reduced inventory levels and a less negative outlook by small business leaders, support a premise that capital spending is near bottom.

Although the U.S. economy has endured significant pain over the past twelve months, we believe that the economy should continue to stabilize over time. Consumer activity appears to be improving and we expect business activity to eventually follow suit. There are many encouraging signs of progress that, if sustained, could trigger a self reinforcing loop with positive implications for the economy. The timing and force of a U.S. economic recovery are important variables when assessing the magnitude of the country's longer-term challenges. We continue to be mindful of the longer-term picture and recognize that unforeseen shocks to consumers would negatively impact the nascent recovery.

Our investment strategy entails identifying companies our analysis shows to be industry leaders with sustainable competitive advantage and sufficient financial flexibility to weather troughs in economic activity. We believe that competitively advantaged companies will emerge stronger from the economic decline and that this period continues to represent opportunity to purchase great enterprises at attractive prices. We will continue to invest according to this precept for the long-term interests of our clients.

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