

Hillman Capital Management
4th Quarter 2009
Market Commentary

We continue to believe that the U.S. economy is trending toward a condition of near-term stability. Consumer activity, unemployment trends and the direction of credit standards have been improving, and signs of increased demand for manufactured goods are evident. In the context of recent events, it is important to draw a distinction between the near-term stabilization of activity and the long-term soundness of the economy. In order to achieve long-term economic stability, we believe that significant reductions in the rate of unemployment and the scale of federal deficits must be achieved. If recent economic trends persist, many segments of the economy could return to growth, the strength of which will have bearing on our longer-term economic outlook.

Preliminary estimates for personal consumption expenditures (PCE) and disposable personal income (DPI) in October and November support the premise that consumers are returning to more rational purchasing behavior. In each of the two months, both PCE and DPI increased while consumers maintained a steady savings rate of 4.7%.¹ Though it appears that declines in consumer spending have subsided and that modest increases have begun, we believe that appetite for credit remains weak. The Federal Reserve's October Loan Officer Survey indicated that an increased number of loan officers reported weaker demand for consumer loans² and we believe that 2009 is likely to have been the first year since 1991 in which aggregate consumer credit declined. Consumer credit balances have historically risen in the years following a recession when factors such as increased DPI, a positive wealth effect, and favorable labor trends supported consumer confidence. Though consumer debt aversion remains high, many of the aforementioned factors are evolving to support the return of consumers' appetite for spending and debt.

Firmer consumer spending has helped to stabilize the economy and appears to be supporting the labor market. Through most of 2009, employment statistics exhibited a positive trend of smaller month over month decreases in non-farm payroll employment. Estimates showed an average monthly decline of 691,000 jobs in the first quarter versus an average decline of 69,000 in the fourth quarter of 2009.³ Our expectation is that monthly employment statistics will continue to be lumpy going forward. However if current trends persist, the U.S. economy could achieve a significant psychological milestone in 2010 in the form of positive job creation.

The current stage in the U.S. economy's inventory cycle suggests that a potential catalyst for improved economic activity exists. In the manufacturing sector, stable end market demand is likely to support economic growth. Throughout the end of 2008 and into 2009, many customers of manufacturers cut purchases, relying instead on existing inventories to satisfy end demand. The sharp contraction in orders led manufacturing firms to justify operations by cutting production levels and headcount to levels reflective of the reduced sales environment. The sharp

¹ Bureau of Economic Analysis, "Personal Income and Outlays: November 2009"

² U.S. Federal Reserve, "October 2009 Senior Loan Officer Opinion Survey on Lending Practices"

³ BLS, "The Employment Situation – December 2009"

contraction of inventories was so profound that Carey Leahey of Decision Economics commented that “the sharp drop in the level of inventories and implied liquidation of inventories is unprecedented in the last 50 years”.⁴ The effects on GDP were notable as greater inventory reduction caused significant headwinds during the first two quarters of 2009. We believe that stabilizing end market demand is a likely precursor to stability in inventory balances. During the third quarter, declines in inventory balances were less severe, resulting in a positive contribution to GDP, accounting for 31% of the 2.2% increase in the benchmark of U.S. economic activity. Over the near-term, a stabilization of end market demand should bode well for growth in the manufacturing sector, as businesses rely more heavily on newly manufactured goods than existing inventory stocks to meet end demand.

We believe that the financial sector has begun to respond to positive market psychology and less dire labor market conditions. In the midst of declining production, employment, home values, and equity values in late 2008, many banks were quick to tighten lending standards, further exacerbating the issues that affected asset values and purchasing activity. However, trends in lending standards indicate that fewer banks are tightening further. The Federal Reserve’s October Loan Officer Survey indicated that fewer than 20% of domestic respondents were further tightening standards on consumer loans, down from a peak of more than 60% in 2008.⁵ While we expect banks to be hesitant, continued economic stabilization and resurgence of competition for loans among banks could result in an eventual easing of lending standards from current levels. Although lending standards are unlikely to return to levels witnessed in 2007, a modest loosening paired with an increased appetite for consumer loans would present a tailwind to the economy.

We believe that economic activity has begun to exhibit signs of near-term stabilization. The vicious circle of decreased asset values, lending activity, purchasing activity and employment appears to have subsided. The apparent end of the vicious circle is a positive for the economy and if present momentum is maintained, employment, credit availability and personal consumption could improve. However, the economy is complex, and there are many potential inputs that could throw off the balance of the nascent recovery. Examples of such variables include but are not limited to: PCE growth could be hampered by a continued unwillingness of consumers to augment personal income by borrowing, bank lending could be hindered by further declines in asset values, and federal budget deficits could be impacted by a number of factors including adverse interest rates and poor fiscal discipline.

We continue to focus on the current direction of economic activity and factor conclusions into our assessments of the companies we track. Our investment strategy entails identifying companies 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 opportunity exists to purchase great enterprises at attractive prices. We will continue to invest according to this precept for the long term interests of our clients.

⁴ Decision Economics, “The Inventory Cycle: Is it different this time?”

⁵ U.S. Federal Reserve, “October 2009 Senior Loan Officer Opinion Survey on Lending Practices”



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HCM-10-22