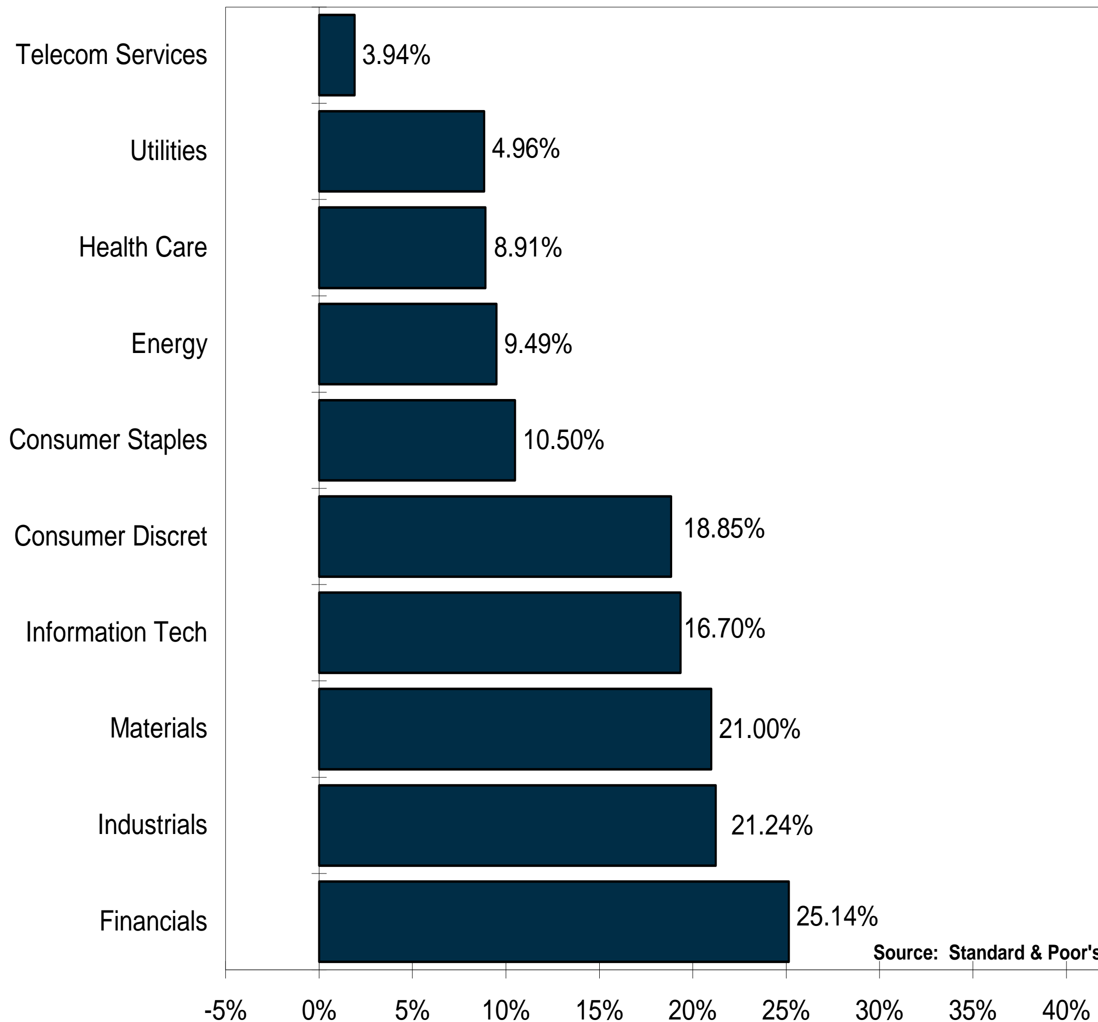
Third Quarter 2009 Market Summary

The Economy

Signals of stabilization in the economy and financial markets were well received by investors during the third quarter of 2009. There were indications of a beginning to the end to the global recession while equity markets continued to trend higher. Investors were happy to hear positive news such as improvement in financial market conditions, increasing activity in the housing sector, and an increase in household spending.

However, there were also clear reminders that an economic recovery will be a slow, drawn-out process. Painfully visible on the economic landscape were the issues of ongoing job losses, slow income growth, lower home prices, and tight credit conditions.

A little over a year ago, Lehman Brother's bankruptcy reverberated throughout the global financial system. Generally considered to be the tipping point of the economic problems that ensued, the Lehman bankruptcy caused a series of previously unforeseen events resulting in a worsening recession that included a government bailout of the world's largest insurer, AIG, and near collapse of the global financial system.



As we enter the fourth quarter, it is remarkable to consider everything that has transpired in only a year. The first three quarters of 2009 have witnessed unprecedented policy initiatives coming in the form of fiscal and monetary stimulus on a global scale. Financial conditions and economic activity could be described as "playing off" of one another as they have both provided reinforcement for each other. The state of the economy is better now than it has been over the course of the last year. Nevertheless, the sustainability of the recovery, given the "less negative" reports within the context of a global recovery, remains at the forefront of investor concerns.

The final revision to second quarter GDP came on the last day of the third quarter. The quarter ended with positive news as the report was better than expected at a -0.7% change. GDP is one of the most widely used indicators of a country's economic health as it measures the value of all goods and services produced within the United States. This report helped corroborate claims that the next report for third quarter GDP would be reported in positive territory, thus indicating the U.S. had resumed economic growth. This follows dire reports of -6.4% in the first quarter of 2009, the worst in almost three decades, and a -5.4% contraction in the final quarter of 2008.

A painful reminder of economic reality could be found in the unemployment numbers released throughout the quarter. The July unemployment report indicated a loss of 247,000 jobs and caused the unemployment rate to fall from 9.5% to 9.4%. Interpreted as a signal of improvement for the economy, equity markets and consumer sentiment reacted favorably.

Unfortunately, the September report showed a loss of 263,000 jobs were shed versus a projected 175,000, bringing the unemployment rate to 9.8%, a 26-year high. The job loss numbers served as a clear reminder of the long road to recovery in store for a battered labor market as jobs continued to remain scarce.

The news was somewhat more upbeat regarding the housing sector. A report released in late July showed home prices to be stabilizing as the Case-Schiller index increased for the first time since July of 2006. Foreclosure activity has been a critical factor in supplying for the housing sector. The National Association of Homebuilders (NAHB) Housing Market Index, an index measuring confidence by U.S. homebuilders, improved to 19 in September, the highest level since October of last year. Nevertheless, economists have noted that a rebound in housing alone is not enough to propel a full-on economic recovery.

Consumer behavior was closely monitored by economists and market participants alike and indicated a sharp downshift in borrowing. The July Consumer Credit report measures the debt incurred through a consumer's purchase of a good or service. This figure dropped much more than expected, contracting to $21.6 billion, instead of the $4.0 billion estimate. This indicates caution on behalf of the consumer and the continued desire of banks wishing to limit their lending exposures.

In the previous quarter, consumers cut spending at a rate of 0.9%. However, the Commerce Department's August consumer spending report surged by the largest amount in nearly 8 years, increasing 1.3% while income edged up 0.2%. Analysts are predicting that third quarter consumer spending will once again be in positive territory. These will be important numbers to watch as a reluctance to spend on the consumer's behalf, coupled with rising unemployment and hard-to-obtain credit, has the potential to significantly impede an economic recovery.

Though consumer behavior and housing tended to receive many of the headlines, the PMI (Purchasing Managers Index) was also a scrutinized figure. An increase in demand caused U.S. manufacturers to increase their production once again. During the second quarter, business spending had been slashed at a record pace of $160.2 billion. As inventories have reached extreme lows, businesses have started to boost production in order to meet customer demand, another factor that should be reflected in a recovering GDP

number. The September manufacturing index came in at 52.6, well below analysts' expectations of 54. Nevertheless, it was still the second consecutive time the report registered above 50, indicating manufacturing growth, after contracting for 18 months.

Generally, improving economic reports have led to an upgrade in consumer confidence to begin the quarter. The confidence index rose from 47.4 in July to 54.5 in August. Analysts were predicting an increase to 57.0 for September, though that fell short at 53.1. Despite the recent rally and upbeat economic news, it is clear the U.S. consumer remains cautious heading into the fourth quarter and beyond.

The Fed has continued its ardent efforts to provide support to mortgage lending and housing markets while seeking to improve overall conditions in the credit markets. Continuing a daring tightrope act, the FOMC announced it was "cautiously optimistic" about prospects for the economy going forward. In a July speech, Fed Chairman Ben Bernanke stated that he believed positive job creation would return by year-end. He let it be known that the economy would stabilize going forward and inflation will remain subdued in the near-term.

September's Fed Beige Book report showed signs of stabilization during July and August. The Fed indicated optimism for business prospects and the economy going forward. In their last meeting before quarter end, the Fed voted unanimously to leave the Fed funds rate at a range of 0-0.25%. It was also noted that the overnight lending rate would remain "exceptionally low" for an extended period of time. Chairman Bernanke commented that the recession was "very likely over," though he warned economic hardship would persist for sometime.

Recently, the Fed has started to set deadlines for the expiration of various asset purchase programs. Going forward, the Fed has pledged to purchase a total of $1.25 trillion of agency mortgage-backed securities and up to $200 billion of agency debt. It seeks to eventually phase out these purchase plans by the end of the first quarter of 2010. The Fed's purchases of $300 billion of Treasury securities will be completed by the end of October 2009, signifying their continuing commitment to provide support to the lending, housing, and credit markets.

Despite all the progress thus far in the global financial markets, there are still strong headwinds including a strained consumer and high unemployment. Investors will be curious to see just how sustainable the current rally will be. During the last week of the third quarter, the International Monetary Fund (IMF) released results from its report in which it calculated that the global financial crisis

will produce $3.4 trillion in losses for financial institutions, thus leaving banks with an additional $1.5 trillion in write-downs still to come. On the other hand, the IMF also reported that the global economy is recovering faster than expected despite the imminence of a sluggish rebound.

Though the global financial system has not been given the "all clear" signal, it is evident that the journey on the road to recovery is in its early stages. Many economists expect the recovery will be slow and difficult. Despite the headwinds of a challenged labor market, tight credit conditions, and a heavily pressured consumer, investors will anxiously monitor whether the current rally in the markets can be extended even in this secularly difficult period for the economy. Despite the severity of the downturn investors have experienced, a look back at U.S. history in the 1930s and Japan in the 1990s provides evidence that a continuation of a rally in some form is quite possible.

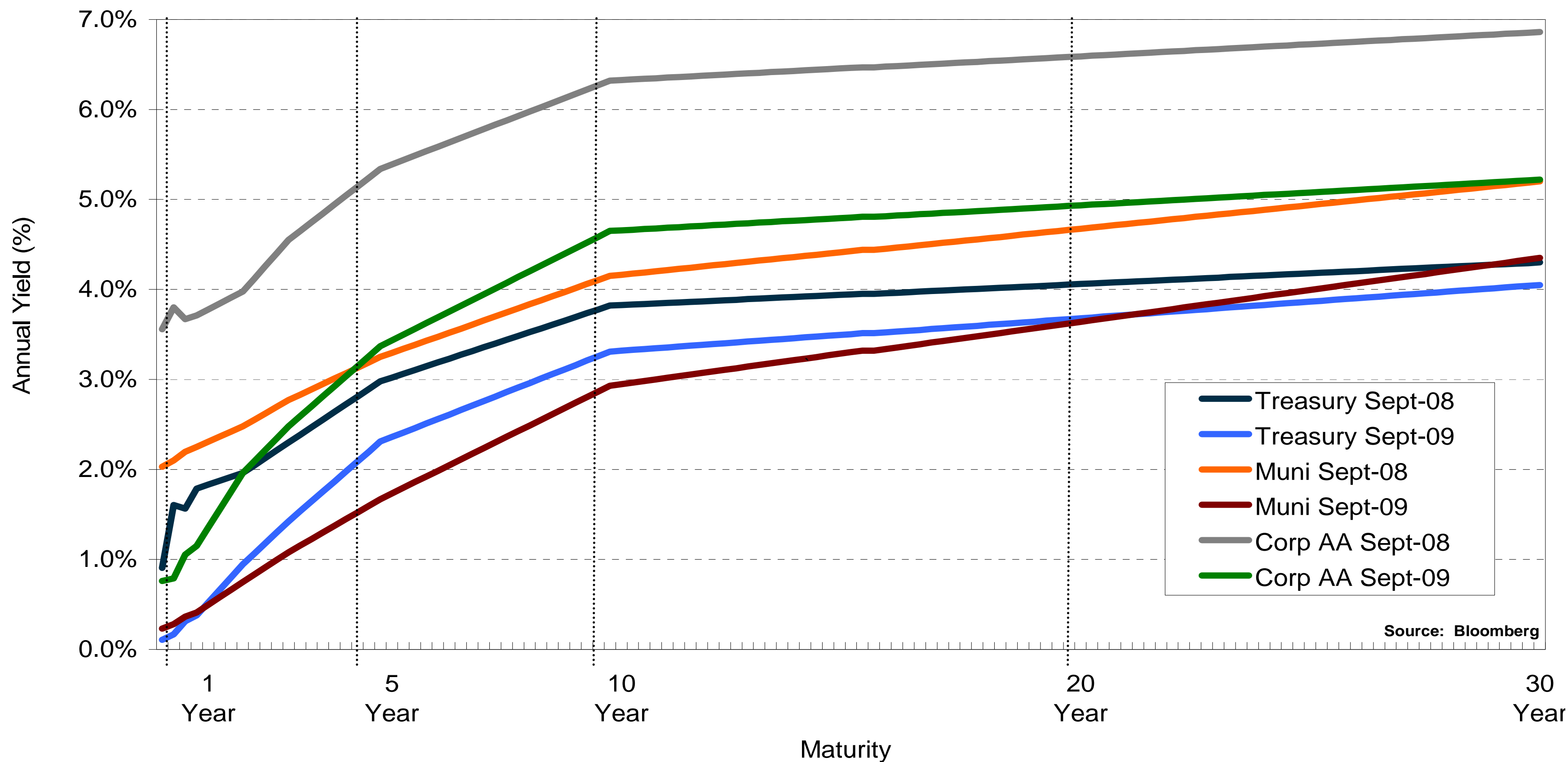
Interest Rates

Against a backdrop of ongoing proactive support by the Federal Reserve, the fixed income markets continued to recover in the third quarter. Yields in all segments of the market fell, with the biggest price gains and yield declines coming in the high-yield category.

The Federal Reserve maintained its fed funds target rate of 0-0.25%, and continued its program of purchasing mortgage-backed and agency debt, effectively ensuring the financial system has ample liquidity. Undergirding the Fed's accommodative stance is the fact that it understands that the economy is on the mend, but that the recovery will be fragile over the next several quarters.

At both its August 12th and September 23rd policy meetings, the Federal Open Market Committee (FOMC) stated that its fed funds target rate would remain "exceptionally low…for an extended period." It is evident from FOMC meeting minutes and speeches by individual Fed governors that the committee believes the recession is over, but that growth is likely to be muted as a result of substantial resource slack and heightened unemployment rates. With inflation expectations under control, continued output slack and consumption likely to be dampened because of elevated unemployment and stagnant incomes, the Fed can be expected to maintain its current course of action and fed funds target rate well into 2010. Going forward, market participants will begin to focus to a greater extent on how the Fed exits the current policy regime.

Yields on U.S. Treasury securities declined during the quarter, with the yield on the 10-year Note falling from 3.53% on June 30 to



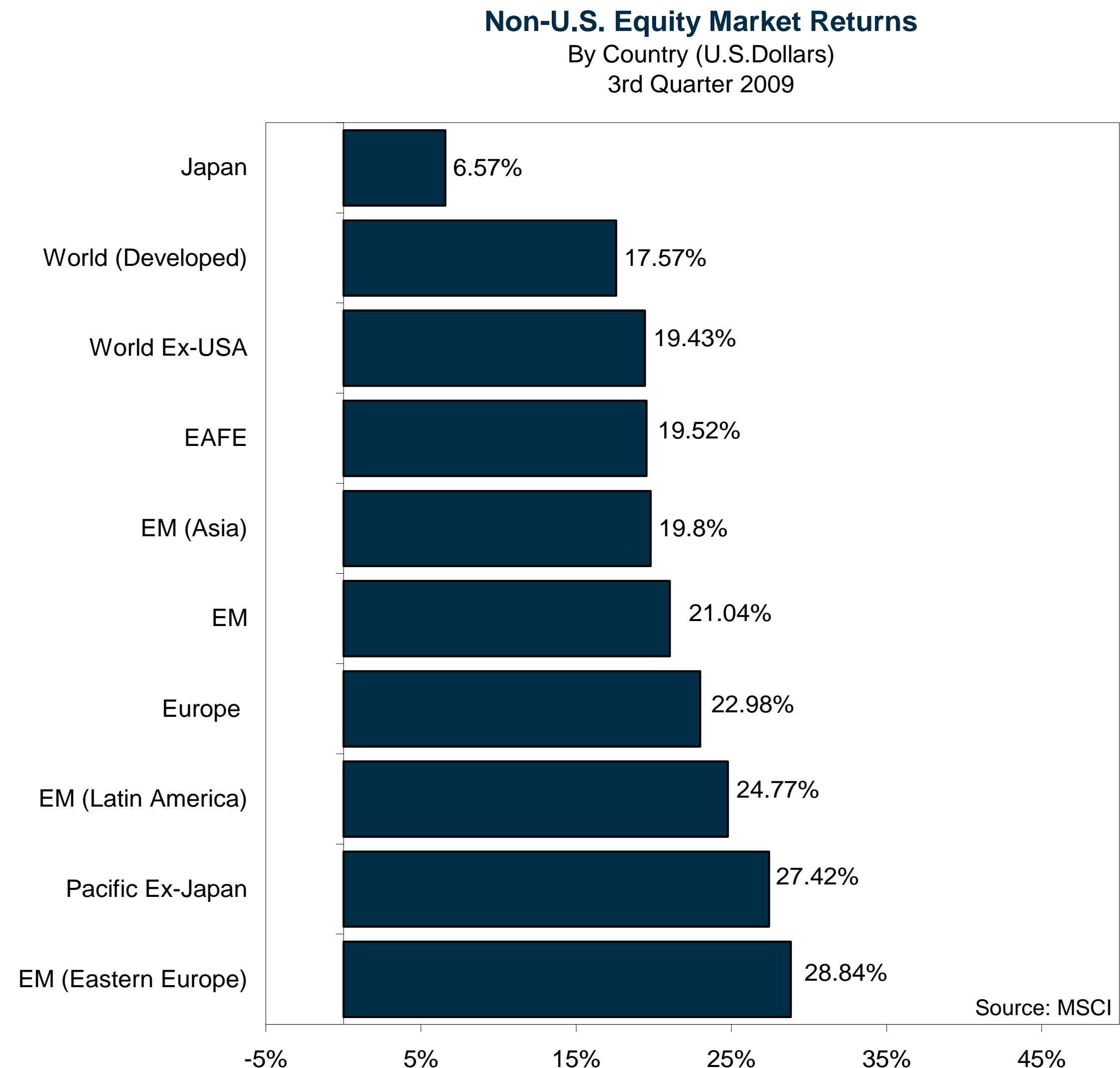
3.31% on September 30. Shorter-maturity Treasurys also fared well, with the yield on the 2-year Note declining from 1.11% on June 30 to 0.95% on September 30.

Investment grade corporate bonds also fared very well in the quarter as it became evident the economy is on the road to recovery. The yield on the FINRA/Bloomberg Investment Grade Bond Index witnessed a steep drop, from 5.80% on June 30 to 5.06% on September 30. Similarly, investors bid up the prices of high-yield securities so that their yields fell sharply during the quarter. The FINRA/Bloomberg High Yield Bond Index yield fell from 11.95% on June 30 to 10.17% on September 30. Strikingly, the yield on the index was 17.43% on December 31, when a depression scenario was still being priced into the market.

Equity Markets

Despite ending on a shaky tone in September, stocks registered an impressive third quarter. The robust equity rally continued as the S&P 500 finished the quarter up 15.61%, bringing the index to a 19.26% year-to-date (YTD) return. Technology and growth companies fared well also as the NASDAQ finished the quarter up 15.66%, following a 20.32% gain in the previous quarter.

Emerging markets once again posted double-digit returns as the MSCI Emerging Markets Index posted a gain of 21.04%, bringing the YTD number to 64.88%. Emerging markets in Asia and Eastern Europe posted



gains of 19.8% and 28.84% respectively, and have both reached the 60% mark for 2009. The Latin America Emerging Markets Index is up 81.74% YTD.

Developed markets also posted strong returns as the MSCI EAFE, a major benchmark for international equity, registered a 19.52% gain for the quarter, bringing the index's year-to-date (YTD) return to +29.58%. The MSCI Europe Index was up 22.98% for the quarter while Japan lagged noticeably with a 6.57% quarterly return. Japan's Ministry of Finance said declines in automobiles and steel exports were particularly pronounced within recent months as exports have fallen for 11 straight months. Large-cap, mid-cap, and small-cap equity indices all posted double-digit returns as the Russell 1000, Russell Mid-Cap, and Russell 2000 posted gains of 16.07%, 20.62%, and 19.28%, respectively.

Domestically, the Financials sector led the way for the second quarter in a row in posting a gain of 25.14% for the quarter and 19.19% YTD. This coincided with strong earnings announcements from larger financial firms such as JPMorgan Chase and Goldman Sachs. There was also strong quarterly performance in the Industrials (+21.24%) and Materials (+21.00%) sectors. The Materials sector, highly sensitive to changes in supply and demand which is reflected in the price of raw materials, has posted the largest YTD gain within the S&P at 35.86%. The only sector to remain in negative territory YTD is the Telecommunications Services.

Whether the market's breathtaking gains from the March lows can be sustained going forward, it will be a focus of market participants. Many strategists believe that the improving economic environment; accommodative Fed policy; still-reasonable valuations; contained inflation expectations; and ample uninvested cash translate into a favorable environment for the equity markets.

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