



January 21, 2010

### **Fourth Quarter 2009 Capital Markets Review**

Equities finished 2009 with a final advance in the fourth quarter of the year. Mixed economic data throughout the quarter along with increasing optimism that the worst of the recent turmoil is largely behind us helped to add confidence in the minds of investors. The improving corporate profit picture helped the performance of both stocks and bonds, for the most part. While it appears economic conditions have improved, there continues to be a level of doubt in the sustainability, particularly as it relates to the weak employment data as well as fears from lack of non-government stimulus.

Stocks added to their gains for the year and finished in positive territory across the board. Technology stocks were the big winners for the year, up almost 60% for 2009. Financial companies performed better during 2009 but a healthy level of concern regarding potential growth across the sector remains. Once again, growth companies significantly outperformed their value peers across the market cap spectrum. However, during the fourth quarter of the year, larger companies significantly outperformed the small cap and micro cap companies. The S&P 500 returned 6.0% for the fourth quarter and finished the year with a return of 26.5%.

With the improving economic conditions, some investors continue to increase their appetite for riskier investments. Investors are keenly aware that corporate profits will likely be a catalyst for equities. In the event the profit picture for the fourth quarter of 2009 is less rosy than expected, we anticipate an increased level of volatility will likely follow. However, for every company that failed to meet earnings expectations for the third quarter of 2009, approximately seven companies exceeded earnings expectations. Investors will demand improving margins and will also expect to see revenue growth in order to be convinced of sustainable economic scenarios.

Economic growth outside of the U.S. continues to look more compelling than domestic growth. Equity and fixed income investors alike continue to favor the faster growth economies. However, the announcement from Dubai in November, regarding the payment of debt, reminded investors that the global economy remains susceptible to bad news. China, as well as the

countries surrounding what is now the second largest economy in the world, continues to report dramatic growth expectations – to the point where investors may begin to question the sustainability and pace of the growth. Markets in Central and South America continue to perform well and parts of Europe also appear to offer compelling opportunities. Emerging markets, as measured by the MSCI-Emerging Markets Index, returned 8.6% during for the fourth quarter and were up an astonishing 79% for the calendar year (in U.S. dollars). International developed markets, as measured by the MSCI-EAFE Index, were up 2.2% for the quarter and up 32.5% for the calendar year (in U.S. dollars).

Improvements in the equity and fixed income markets have not helped instill confidence as it relates to the U.S. dollar, which has experienced declines versus other currencies. The weakening dollar has gone a long way in providing upward pricing pressures on commodities across the board. Precious metals, particularly gold, performed well during 2009, returning over 25% for the year. Performance during 2009 pushed the five-year annualized return to over 20% per year – even beating the performance of Emerging Markets equities in the same time period, which have returned 15% annualized. The weaker dollar has also impacted the price of oil with the price per barrel crossing through \$80 as of the end of the fourth quarter of 2009. Considering the speculation of a continuing weakening dollar in the near-term, it should be expected that commodity prices may continue to increase.

While inflation does not appear to be an issue within the U.S. economy in the short-term, inflationary pressures often come too quickly and unexpectedly for investors to successfully predict. Recent comments by some members of the Federal Reserve involve discussions about how the massive liquidity will eventually be reduced or removed from the economic system. Some of these comments appear to be a gauge to determine the potential reactions from the capital markets. We continue to maintain an allocation to Treasury Inflation Protected Securities (TIPS) as an inflation hedge within bond portfolios. We believe having this inflationary hedge in place, as a part of the bond allocation, remains warranted in the event inflationary pressures occur more abruptly than currently anticipated.

Credit markets continue to show improvement, though the risk of defaults has not completely subsided. The Federal Reserve Board continues to maintain the historically low Fed Funds Target Rate, currently in a range of 0.00% to 0.25%. High yield bonds led the fixed income market returns for the fourth quarter, turning in a return of 6.0%, and up 57.5% for the calendar year, as measured by the Merrill Lynch US High Yield Master II Index. On the other end of the credit scale, U.S. Government Bonds were down -0.4% for the quarter and were down -0.3% for the calendar year.

Within fixed income, there is potential for a collision between public and private debt in the coming quarters. Investors will likely favor higher yielding investments as they become more comfortable with the “riskier” assets while at the same time the U.S. Government will be engaged in reducing liquidity posturing, partly by selling U.S. Treasury bonds to reign in cash from the capital markets. This potential event could put some pressure on the fixed income markets as a whole – for both corporate and government bond issues. Keeping in mind the potential environment for the fixed income markets in the coming quarters, as well as the likely introduction of inflationary pressures within the U.S. economy, interest rates are likely to begin

to edge higher. We have been reallocating bond portfolios by reducing the effective duration of portfolios while also increasing quality. Additionally, we have been working with portfolio managers to reduce exposure to U.S. Treasury investments, where possible, particularly on the long end of the curve.

Moving forward through the next few quarters, we anticipate an increase in the volatility within the equity markets as the possible transition from government-applied stimulus shift toward consumer-supplied activity. Questions about the strength and sustainability of the U.S. economic growth are abundant, especially while investors and consumers are facing less-than-ideal economic data. Unemployment remains high which is putting pressure on the potential for a consumer-led rebound. Interestingly, if additional economic weakness crops up in the U.S., or if growth becomes stagnant, we could possibly see yet another government funded stimulus package. The direction of interest rates will likely be up from here, particularly as the Fed begins to prioritize the reduction of liquidity from the economic system. While potentially beneficial for the U.S. dollar, the magnitude and pace of any potential interest rate increases may have adverse impacts on the capital markets as a whole.

As always, we look forward to discussing your specific investment results with you in the coming weeks.