Economic & Market Outlook

- The Commerce Department recently reported U.S. GDP grew at an annual rate of 2.8% in the third quarter of 2009. The issue going forward is how sustainable the recovery will be once fiscal and monetary stimulus are no longer in place.
- The U.S unemployment rate remains high at 10%. Despite some promising trends, we expect recovery in the labor markets will be a slow process, with unemployment levels to remain high throughout 2010 and beyond.
- Despite positive trends in housing prices and home sales in recent months, pending home sales dropped dramatically in November. We believe the housing market still faces challenges of high inventories and rising foreclosures and will act as a drag on economic growth in the coming year.
- We expect consumer spending will remain subdued over the coming year as consumers continue to save. Longer-term, we believe we are in the early stages of a secular trend of reduced consumption, private sector debt reduction and increasing personal savings.
- We believe inflation vigilance always makes sense, but it is difficult to see inflation in the data for the U.S. and other developed nations. Excess capacity remains near 50-year lows, and high unemployment makes a wage-price spiral unlikely. The $1 trillion in excess reserves banks have parked at the Fed indicates private borrowing is not accelerating, reducing inflationary potential.
- After the worse-than-expected December employment report, the Fed Funds futures market pushed back its forecasts for the first Fed rate increase to September 2010. The next Fed meeting is January 23. We believe short term rates will eventually rise, but the cost of waiting is high, and we can implement better bond strategies than waiting in cash at near 0%.
- Treasury Secretary Geithner announced on Christmas Eve that Fannie Mae’s and Freddie Mac’s $200 billion government guarantee was increased to an unlimited amount through 2011. With the Fed’s mortgage-backed securities buying program likely to end in Mar. 2010, Fannie and Freddie may be able to become the primary buyers and keep mortgage rates low for longer.
- For investors in individual taxable bonds, we favor taxable municipals, which have higher yields than lower-quality corporates of the same maturity. We also are buying industrial and utility bonds with stable or improving credit profiles. We remain extremely selective on financial bonds, and are avoiding banks where it is difficult to separate their standalone credit risk from to possible (but not guaranteed) additional government support.

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- For buyers of tax-exempt municipals, the likelihood of higher tax rates in 2010 or 2011 and constrained supply should support the muni market somewhat, but Fed rate increases are a concern. 1-5 year munis are expensive compared to historical averages. We favor the 11-25 year range of maturities, but note that most munis have call features that may make their interest rate risk significantly less than the final maturity date implies.
- U.S. stocks (measured by the S&P 500) were up 1.93% in December. Stocks were up 26.46% in 2009, the best annual performance since 2003. International stocks were up even more with the emerging market stocks being the best performers in 2009, up over 70%. Growth stocks outperformed value stocks and large stocks outperformed small for the year. Cyclical stocks outperformed defensive stocks in 2009.
- The equity markets continued to climb higher in December, defying many who were forecasting a pause to digest the recent spike in equity prices from the prior months. It does appear that most of the recent positive news in the economy and earnings results has been factored into stock prices. However, further positive economic data and renewed interest in stocks may continue this rally.
- Within the equity markets, we remain fully diversified but continue to prefer large cap over small cap stocks and growth over value on a relative basis. Developing markets stocks have been relative outperformers on the international side, which we have stressed in our allocations.
- We believe stocks of high quality companies with more access to the credit markets should do relatively well in a slowing/weak and even growing economy. Companies with significant international sales should benefit if the dollar weakens.
- Cyclical and lower quality companies have outperformed defensive names in this rally but we remain wary of their continued strength and believe the market will revert to more consistent, stable revenue and earnings generators given our thesis the economy will not be as robust as the equity market has already predicted in it’s current valuation.
- We encourage investors to stay focused on their long-term goals in the midst of this current market volatility. It is especially important to stay diversified and to reaffirm that our clients' current asset allocation is consistent with their long-term goals. We advise clients with time horizons less than 3 years to remain cautious toward risky assets.

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