

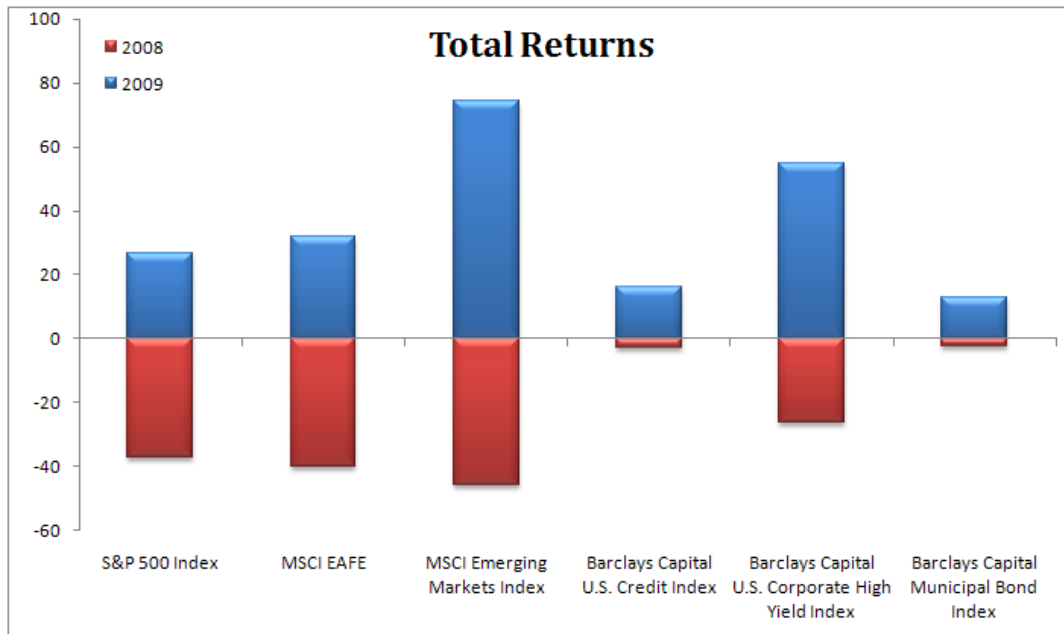
## Quarterly Market Commentary – Q409

*Presented by Sean Gross*

### **By all measures, a great year**

History will show that 2009 was a good year for market participants, helping them regain some of 2008's painful losses.

- U.S. and overseas equity markets posted strong gains for the year.
  - The S&P 500 Index advanced 26.46 percent.
  - The MSCI EAFE Index was up 31.78 percent.
- Stocks that were historically more volatile performed very well, as lower-quality names led the early stages of the rally and gained momentum throughout the year.
  - High-yield bonds (Barclays Capital U.S. Corporate High Yield Index) gained 54.78 percent.
  - Emerging markets (MSCI Emerging Markets Index) gained 74.50 percent.
- Most major bond indices also posted strong gains in 2009.
  - Corporate bonds returned 16.04 percent, measured by the Barclays Capital U.S. Credit Index, as spreads narrowed closer to levels seen prior to the credit crisis.
  - Municipal bond spreads narrowed, as prices for underlying bonds moved higher, and the Barclays Capital Municipal Bond Index gained 12.91 percent.
- Markets showed remarkable resilience, given the rocky start.
  - By March 9, 2009, equity markets had fallen more than 25 percent for the year, as measured by the S&P 500.
  - Federal Reserve Chairman Ben Bernanke coined the phrase “green shoots,” describing the climate of an emerging economic recovery; a sharp rally ensued.
  - Equity markets ended 2009 on highs.



Source: Commonwealth/FactSet

### The case for a strong market in 2010

- Recent data shows there's no doubt the economy has rebounded from its lows.
  - The rate of decline has slowed.
  - The economy lost 11,000 jobs in December—a sharp decrease from more than 650,000 jobs lost in March 2009.
    - 100,000 new jobs are needed to maintain existing employment levels, but steady decline in job loss through the second half of 2009 was well received by markets.
  - Consumer confidence showed modest gains in the latter half of the year.
    - Though low by historical comparisons, December's 52.9 level is sharply up from the March 2009 low of 25.3.
- Some improvement resulted from government stimulus and government involvement in many areas of the economy.
  - \$249.8 billion of the \$787 billion spending package was paid in tax benefits (\$92.8 billion), contracts, grants and loans (\$65.8 billion), and entitlements (\$91.2 billion).
  - The impact has been seen in gross domestic product (GDP).
    - Third-quarter GDP showed an annual growth rate of 2.20 percent, up from the 6.40-percent decline in first-quarter 2009, per the Bureau of Economic Analysis.
    - Though encouraging, the third-quarter number was revised down from initial estimates.
- A small portion of government stimulus was used for auto and housing incentive programs.

- “Cash for Clunkers” provided an immediate and significant boost to auto sales.
- Housing experienced a robust second half of 2009, as unit sales rose and existing inventories fell sharply.
  - New home sales rose to 355,000 in November, from a low of 329,000 in January, while inventories fell to 7.9 months at the current sales rate.
  - This was critical, as housing and related financing activities are at the heart of the current economic woes. Continued strength in housing will be an important component of an economic rebound.

### **A case for a weak market in 2010**

- Unemployment continues as a concern; a 10-percent unemployment rate is a challenge.
  - A significant number of new jobs are needed to replace the 7.82 million jobs lost since January 2008.
  - It could take five years for job creation to return to more normal levels.
  - Income loss in the aggregate could dampen future spending and economic growth and could pressure top-line revenue growth for many companies, presenting a headwind for earnings growth to drive equity returns.
- The consumer is still challenged by mortgage delinquencies and shrinking personal credit.
  - 25 percent of U.S. homeowners have an upside-down mortgage, meaning they owe more than the house is worth.
  - One of seven mortgages is in arrears or in foreclosure.
  - Although improving, consumer confidence is at levels that do not bode well for renewed consumer optimism and increased spending in the near term.
    - The savings rate continues to hold at higher levels—4.70 percent in November, up from a low of under 1 percent in the early stages of the recession.
    - This may translate into future spending but will likely put negative pressure on the consumer’s ability to add significantly to GDP growth in the short term.

### **Can the government make a graceful exit?**

- Governments around the globe have been critical to this recovery.
  - China committed \$586 billion to support its economy, predominantly through infrastructure spending.
  - European countries have enacted stimulus plans to support their economies and prevent further deterioration.
  - U.S. government intervention is more widespread and includes the TARP program, the TALF program, the stimulative short-term interest rate policy, and other initiatives to actively support mortgage markets through a direct buying program.

- The U.S. government must use extreme caution in curtailing stimulus, as we believe it is unlikely that economic recovery is strong enough to continue in the absence of government intervention.
  - When tax incentives for first-time home buyers expired, home sales slipped, prompting the government to extend the duration and breadth of the program.
  - Markets have no doubt reacted positively to government stimulus but could face a headwind as stimulus programs wind down.

### **Perhaps more of a mixed bag**

- Key factors for 2010, similar to 2009, will be to watch the U.S. government closely and to monitor policy decisions on interest rates and spending.
  - The government will likely remain accommodative throughout 2010 to allow for recovery to gain strength.
  - Unemployment will continue to drag on growth, as companies remain cautious about hiring.
  - Markets will scrutinize economic data more closely, given the strength of the rally in 2009 and the potential for skepticism over sustained recovery.

Investors should continue to be cautious, knowing that markets and market sentiment can shift as dynamics change. Markets are still sharply below the highs of several years ago, so long-term investors could potentially use market fluctuations to reposition portfolios for what will likely be a slow and ever-changing recovery.

***Disclosure:** Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. All indices are unmanaged and investors cannot invest directly into an index. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The Barclays Capital U.S. Corporate High Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The MSCI Emerging Markets Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. The Barclays Capital U.S. Credit Index is comprised of the U.S. Corporate Index and the non-native currency sub-component of the U.S. Government-Related Index. It includes publicly issued U.S. corporate, specified foreign debenture, and secured notes denominated in USD. The Barclays Capital Municipal Bond Index includes investment-grade, tax-exempt, and fixed-rate bonds with long-term maturities (greater than two years) selected from issues larger than \$50 million.*

###

Authored by Simon Heslop, CFA<sup>®</sup>, director of asset management, at Commonwealth Financial Network.

© 2010 Commonwealth Financial Network<sup>®</sup>