

January 2010: Fourth Quarter

PRICE CHANGES FOR LAST 3 MONTHS AND YTD

VALUE	BLEND	GROWTH	
3.6%	5.5%	7.5%	LARGE
16.3%	25.5%	34.8%	
4.6%	5.4%	6.4%	MEDIUM
30.5%	37.7%	44.5%	
3.1%	3.5%	4.0%	SMALL
17.7%	25.2%	33.5%	

The stock market ended 2009 on such a high note, some investors worry about what's in store for 2010. Early in the year the Dow lost over 2,200 points, or 25%, when investors feared for the viability of the banking system. It recovered them in quick fashion once this Armageddon scenario was taken off the table. By early June the market was back to where it had started. The next stage of 2009's market advance was grounded in news that, at least according to the textbooks, the recession was receding. Personal consumption expenditures bottomed in May. Industrial production bottomed in June. And in August, the ISM Purchasing Managers' Index signaled an expansion in the manufacturing sector. U.S. Corporate Profits after Taxes (USCPAT) had plunged in the fourth quarter of 2008, but the gains in 2009 have consistently exceeded analyst expectations. Through the third quarter of 2009, USCPAT were up 40% from Q408's recession-low. News that the economy was not as bad as feared fueled the second stage of the stock market's recovery. The Dow ended the year at 10,428, 19% higher than where it began and 60% higher than its March 9, 2009 low.

As is usually the case, the public's worst fears did not come to pass. The market selloff would have been justified had the banking system collapsed. But, it didn't. And, instead of the recession morphing into a depression, it was unofficially termed "over" in July. All-in-all, the economic news has been better than expected. We attribute the positive surprises to an accommodative Federal Reserve, a need to replenish depleted inventories by consumers and businesses and a still expanding global economy. In fact, some economists are calling for a "V" shaped economic recovery. So, the near-4,000 point rally in the Dow from its low doesn't keep us up at night. Based on what transpired in 2009, we deserved it. In the near-term, we expect stock prices to add to last year's gains and are continuing to emphasize a global-growth theme.

How we transition from a government-funded economic turnaround to a privately-funded expansion is what keeps us up at night. In the past, we weren't too concerned about the size of our budget deficits or the level of our government debt. But, our position has changed since they are now measured in the trillions. Adding to our budget woes is the about-to-be-passed healthcare bill where the "tax" (increased insurance policy mandates and reduced Medicare reimbursement rates) will be levied immediately and the benefits of greater access will be implemented later. Personal consumption expenditures account for over 60% of our gross domestic product (GDP). Growth in personal consumption expenditures needs to supplant the growth in federal government expenditures. For this to occur consumers must see rising wages, increased wealth, including the investment they have in their homes, and a bright future. Of course, employment is integral to all three drivers. While we've seen some improvement in the pace of job cuts, we've not seen much job creation. Again, Washington D.C.'s activism is not helping. Much of the current administration's policy agenda - initiatives like adopting a card check system for instituting a union, lowering greenhouse gas emissions and eliminating President Bush's tax cuts - will raise the cost of doing business in America and crowd out dollars that could be allocated to adding employees. Therefore, we are managing the longer-term risk of a disappointing recovery by tempering our allocation to equities. We've taken some gains as the Dow cleared 10,000 and will look to take some more as the recovery extends into spring.

Bond investors were also invited to the rally in the financial markets in 2009. At the start of the year, yields on intermediate-term, BBB-rated industrial bonds, a proxy for an average credit yield, were near double-digit levels. The yield for a 10-year BBB-rated bond dropped nearly 300 basis points (3%) over the course of the year. As a result, the bond's price rose by over 20 percent. In fact, yields are back to levels last seen in late 2007 before the credit crunch gripped our economy. With bond prices returning to pre-bear market levels, investors wonder where to go to find some income. It's hard to conjure up a scenario in the long-term that doesn't include rising interest rates. We are looking to hold onto our credit investments, as rates are not expected to rise in the near-term and most of them were purchased with enough of a cushion to withstand an eventual rise in rates. For new purchases, we are employing a price preservation theme - looking at some global opportunities, accessed through mutual funds, where the yields are higher than the U.S. and evaluating opportunities where the coupon either steps up over time or floats with a measure of inflation.