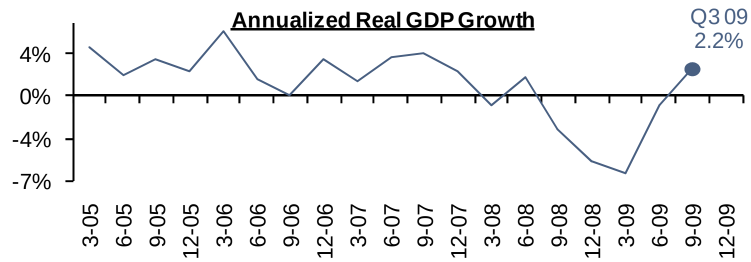
Your Quarterly Update on the Financial Markets
December 31 2009

4th Quarter

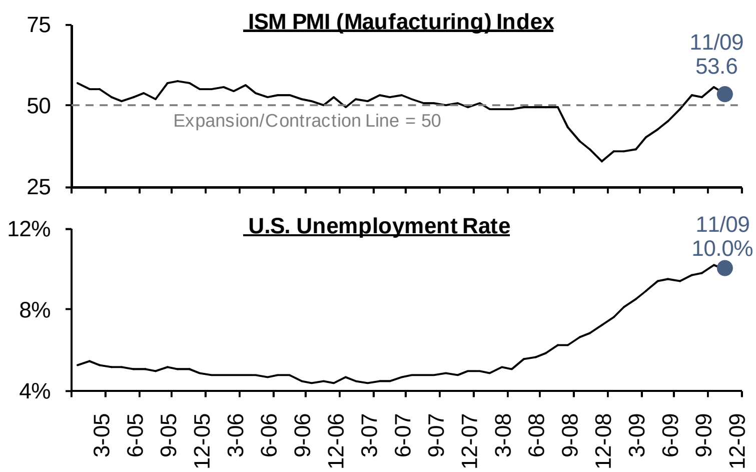
MARKET Recap

The Economy: *"Interest-ing Times Ahead"*

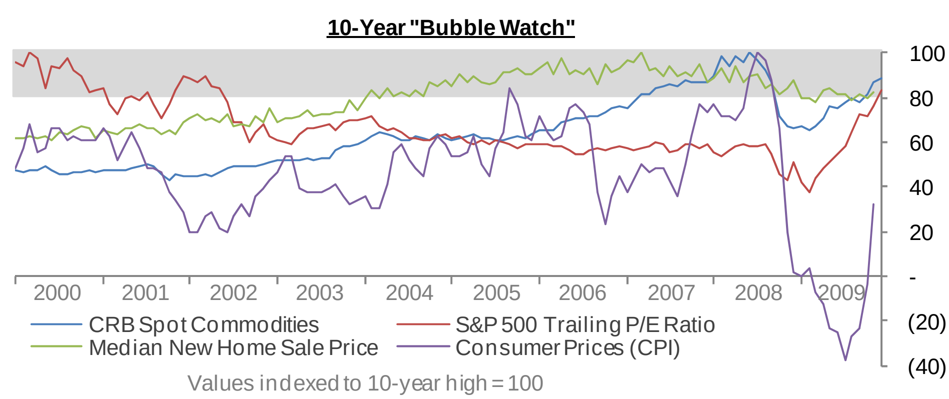
Positive real growth resumed in the third quarter for the US economy, at a pace that was modestly lower than consensus estimates. Motor vehicle output added 1.45% to growth as the Cash-for-Clunkers program concluded. Residential fixed investment increased 18.9%, in contrast to a decrease of 23.3% in the second quarter. Exports increased on a declining US dollar, and federal spending continued to increase at a slightly lower (8.0%) pace. Personal consumption expenditures were up modestly.



With the significant exception of the consumer sector, signals abound that this contractive phase of the cycle has concluded. US manufacturing activity continued to increase through the fourth quarter, pushing the manufacturing PMI index into expansive territory. Auto manufacturing remained weak as demand for increased sales were met with inventory, but broader activity was strong on defense-related spending, export demand, and depletion of inventory. The Census Bureau's October inventories and sales data release showed that the ratio of total business inventories to sales stood at 1.30, roughly in line with the experience for the inter-recessionary period of 2004-2007, after peaking at 1.46 in January of 2009. Resumption of manufacturing bodes well for the troublesome US unemployment rate, although this statistic tends to lag significantly during recovery periods.



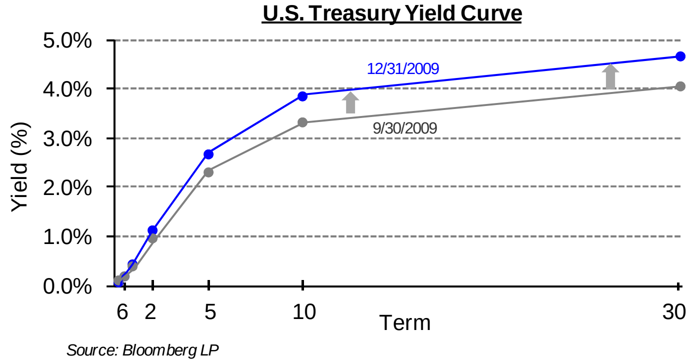
Inflationary signs continue to emerge in asset markets, which have moved back to historically rich price levels. Commodities gained steadily through the fourth quarter, particularly base metals and oil, and even new home prices moved slightly upward (on very low volume compared to the inter-recession peak). The weak state of the household balance sheet continues to dampen consumer spending and prices, but with nearly every indicator except the CPI giving off inflationary signals, a widespread bias toward rising interest rates has emerged. Chairman Bernanke continues to speak of an extended period of low interest rates to support the US consumer. The bond market seems to doubt the Fed's ability or willingness to maintain loose policy; according to the weighted average of 73 forecasts compiled by Bloomberg, policy makers will increase the benchmark rate to 0.50% in the third quarter and to 0.75% by the end of the year from the current range of zero to 0.25%. In December the treasury yield curve continued to steepen; the spread between yields on 2-year and 10-year treasuries rose to 284 basis points, a level not seen since the end of the previous recession in the second half of 2003. Rising rates may mitigate our concerns over asset inflation, although it does portend a rough year for stock and bond investors.

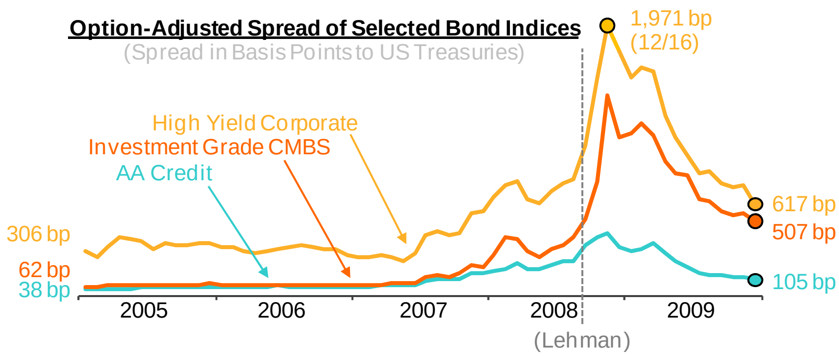


The U.S. Bond Market

Anticipation of rising rates generated losses in intermediate- and long-dated treasuries for the quarter, making US treasury bonds one of the few places investors took losses for the full year. Credit bonds stood in sharp contrast for a third consecutive quarter, although the pace of spread compression slowed. AA-rated bond spreads fell by approximately 20 basis points, and BB-rated high yield spreads fell by about 100 basis points (more or less, depending on which section of the yield curve you choose). For all of the hype about rallying stock markets, the best US investment sector for 2009 was high yield corporate bonds, up nearly 60% for the full year.

Bond Indices - Total Return	4Q09	2009
BarCap Aggregate	0.20%	5.93%
BarCap Interm. Gov't	-0.42%	-0.32%
BarCap Long Gov't	-5.07%	-12.19%
BarCap Interm. Credit	1.61%	15.93%
BarCap Long Credit	-0.73%	16.80%
BarCap High Yield	6.19%	58.21%





Which begs the question, can the rally in US credit continue? Since peaking at record levels late in 2008, spreads have collapsed 50-75%. Spreads still look wide compared to pre-crisis levels, but risk was broadly mispriced prior to 2007. One would expect a higher "normal" spread level in recognition of the market's new appreciation of default risk, and current spreads should be elevated because of higher default risk in the tail end of a recession. Therefore we're lead to believe that this run of spread compression is largely over for US corporate debt. That said, fundamentals for US corporations are stabilizing, and our view is that the downside for corporate debt is both well understood and reasonable. With risk-free yields at such low levels, shorter-duration corporates may be attractive even without further spread tightening.

Not so for commercial MBS in our view. CMBS remains quite prevalent in many liability-sensitive fixed income portfolios, including defined benefit pension plans, bank & insurance portfolios, and stable value funds used by 401(k) plans. The fundamentals for commercial real estate have yet to stabilize, leaving this sector largely on government support through programs like TALF and PPIP. Through the crisis CMBS spreads detached from investment grade corporates and now trade like high yield; absent government support, investment-grade CMBS would likely trade through corporate high yield. Doubtless there are many specific issues at bargain prices even at today's price levels, but one must wonder as the dust settles how much exposure to this sector is appropriate for portfolios that would avoid or significantly limit corporate high yield.

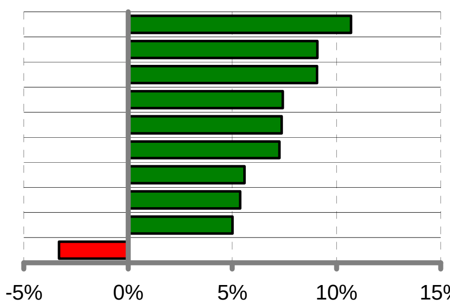
The U.S. Stock Market

The fourth quarter closed with all major indices posting positive returns for a third consecutive quarter. The Dow closed the year at 10,428, up 59% from its 12-year closing low (in March 2009) of 6,547, but still 26% below its record closing high of 14,164 (in October 2007). The NASDAQ Composite closed the year at 2,269, which was its biggest annual point gain since 1999 and the second-biggest annual point gain in its history. On a percentage basis, the NASDAQ had its best year since 2003. The S&P 500 ended the year at 1,115, turning in its best year since 2003 as well. However, taking a step back we get a less rosy picture. As mentioned last quarter, the Dow's return to 10,000 was only the completion of a roundtrip started in 1999. The S&P 500 fared even worse. At the close of 2009, its 10-year annualized total return was -1%. Talk about a lost decade!

Stock Indices - Total Return	4Q09	2009		4Q2009	2009
Largecap Stocks			**Midcap Stocks**		
S&P 500	6.04%	26.46%	S&P Midcap 400	5.56%	37.38%
Russell 1000	6.07%	28.43%	Russell Midcap	5.92%	40.48%
Growth	7.94%	37.21%	Growth	6.69%	46.29%
Value	4.22%	19.69%	Value	5.21%	34.21%
Broad Markets			**Smallcap Stocks**		
NASDAQ Comp.	7.17%	45.32%	S&P Smallcap 600	5.12%	25.57%
Wilshire 5000	5.79%	28.30%	Russell 2000	3.87%	27.17%
			Growth	4.14%	34.47%
			Value	3.63%	20.58%

As with the last quarter, returns were spread fairly evenly across the capitalization sectors. However, the fourth quarter saw a style rotation as growth stocks edged out their value counterparts for the quarter and for the year as a whole, driven by the top-performing Tech sector and poorly performing Financials sector. The Consumer Discretionary sector, led by Auto Manufacturers and Internet Retailers, and Materials sector, led by Diversified Metals & Mining firms which benefitted by the 2009 run-up in gold prices, also had particularly strong years. The Telecommunications and Utilities sectors, meanwhile, were laggards. Utilities generally fell out of favor for most of 2009 as investors sought out higher growth, more cyclical, less regulated sectors. Telecom stocks were challenged by unemployment and the associated decrease in demand for services as well as an anticipated rise in taxes and regulatory fees.

S&P 500 Economic Group Components - Total Return



Sector	4Q2009	2009
Info Tech	10.70%	61.72%
Healthcare	9.09%	19.70%
Consumer Disc.	9.08%	41.30%
Telecom	7.43%	8.93%
Materials	7.36%	48.59%
Utilities	7.26%	11.91%
Energy	5.58%	13.82%
Industrials	5.38%	20.93%
Consumer Staples	5.02%	14.89%
Financials	-3.32%	17.22%

Source: Standard & Poor's

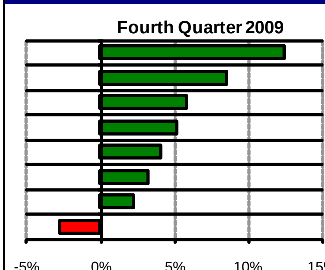
The traditional high-growth Technology sector was the place to invest in 2009 where internet stocks were more resilient during the downturn than expected. Gains were spread relatively evenly among all three industry groups, with Software & Services and Semiconductors & Semiconductor Equipment each returning 55% for the year and Technology Hardware & Equipment returning 65%. Analyst attributed the chart-topping performance to several factors including e-commerce taking more market share from retail businesses, heavy exposure to overseas growth markets, and cost-cutting, both within many of the firms themselves as well as for clients through the products and services offered.

According to Thomson Reuters, the blended earnings growth rate for the S&P 500 for Q4 2009 has been hovering around 184% on a year-over-year basis, as of the first week of January 2010. Back in October, estimates put it at 145%. S&P 500 companies are expected to show earnings growth of just over 37% in the first quarter, according to Thomson Reuters, an increase from the 23% growth analysts were expecting last April.

Overseas Markets

Global markets ended what could only be characterized as a chaotic year on a note of moderation. Performance for the year was strong across much of the globe, but fourth quarter performance was somewhat "lackluster" with many sectors achieving "only" mid-single-digit positive performance. Global economic indicators continue to be mixed and segments of both developed and frontier markets remain under duress (Greece & Dubai). As the quarter drew to a close, more talk and evidence of the end of the recession was being discussed. For the quarter and the year, Latin American emerging markets took the prize followed by Pacific markets. Developed markets continued to struggle to keep pace with other sectors.

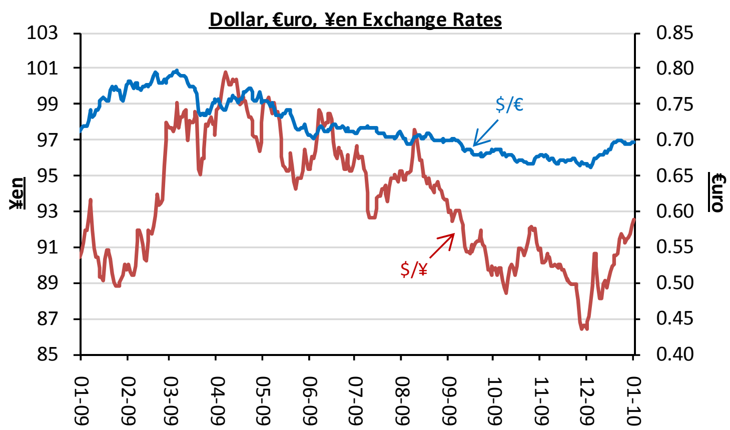
Net Total Return of Selected MSCI Regional Indices



Region	4Q09	2009
Latin America	12.43%	103.77%
Emerging Markets	8.55%	78.51%
North America	5.79%	28.44%
Pacific ex Japan	5.16%	72.81%
World Index	4.07%	29.99%
Europe	3.24%	35.83%
EAFE	2.18%	31.78%
Japan	-2.76%	6.25%

At the start of the quarter the ECB kept its interest rates at a record-low 1% as ECB President Trichet downplayed the likelihood a speedy economic recovery. Consensus expectations were that rates would remain unchanged, but that subsequent moves by the ECB would be with a tightening bias. Although most economists polled expect no change until late in 2010, tighter liquidity conditions may push up market rates before then. Consumer inflation across the euro zone remained in negative territory in October as prices fell 0.1% compared to a year earlier, following a 0.3% annual decline in September. In addition, September unemployment edged up to 9.7% from 9.6% in August, pushing the rate to its highest level since January 1999, but in line with forecasts. The ECB, which has an annual inflation target of around 2%, has repeatedly indicated it expects inflation to return to positive territory in coming months. German investors grew less optimistic about the country's economic outlook, although sentiment remains positive. The ZEW economic expectations index declined to 51.1 in November from a reading of 56 in October. Economists had forecast a more modest slip to 54. In France, accelerating headline inflation has been linked to rising energy prices. However, core inflation appears to actually be decreasing and overall business confidence in France remained positive. Elsewhere in the Eurozone, Greece's economic woes came to the fore in December as soaring budget deficits led to a downgrade of the country's ratings by the major ratings agencies. 2010 will see the Greek government undertake massive spending cuts and other measures to prevent bankruptcy and attempt to regain the trust of investors and other EU member nations. The MSCI Greece Index fell -22.4% for the quarter.

Japan continues to struggle. Minutes from the BoJ meeting in September showed members still uncertain over a global economic recovery and concern that the effects of stimulus measures appear to be fading. The minutes also reflected some disagreement over the central bank's special stimulus measures, such as purchases of commercial paper and corporate bonds. Members urged caution due to the yen's recent rise and its impact on the Japanese economy. The nation's economy is expected to shrink by 3% - 3.5% in 2009, then grow again by about 1% in 2010, and expand by about 2% in 2011, according to the BoJ. Around mid-quarter the central bank began its gradual pullback from credit markets, announcing it will end that part of its special liquidity-boosting measures. However, late in the quarter Japan's government unveiled a new economic stimulus package which includes a 7.2 trillion yen ($80.6 billion) in spending to provide additional public assistance. It is new Prime Minister Yuko Hatoyama's first stimulus plan and it includes 3.5 trillion yen to help specific regions, 600 billion yen for employment and 800 billion yen on environmental initiatives.



Data from China showed that the economy expanded at an accelerated rate in the third quarter, raising the prospect that Beijing may begin to unwind its expansionary policies by year's end. GDP expanded 8.9% in the third quarter compared to the same period a year earlier. The increase was greater than the 7.9% expansion in the second quarter, and in line with consensus expectations. Industrial production rose 13.9% in September, higher than the expected 13.3% increase and a 12.3% gain in August. For the first nine months of the year industrial production rose 8.7%. To date growth appears to have been domestically driven, but economists worry the economy could begin to overheat when the world starts buying more Chinese-made goods. According to J.P. Morgan, exports strengthened in September and are on track to stop contracting, in year-over-year terms, during the fourth quarter. China said it has no plans to back away from its current expansionary lending policy and large fiscal stimulus. However, the evident pick-up economic growth could lead to inflation, which would add to pressure on Beijing for a tightening of policy. CPI is expected to turn positive in the fourth quarter, raising the prospect of higher interest rates or a measured appreciation of the yuan against the dollar. The MSCI China Index was up 9.5% for the quarter and 62.3% for the year. Elsewhere in the emerging markets, Dubai, a small country within the United Arab Emirates (UAE), made news as it spawned its own debt crisis as the result of a real estate bubble. International markets panicked briefly as Dubai asked for a delay in repaying $60 billion it owed to creditors. The impact appeared to reach into developed markets, most notably in the UK, as commercial banks with exposure to the region took hits. Emerging markets have calmed as Abu Dhabi stands ready to inject capital into Dubai to backstop any immediate liquidity issues. The MSCI UAE Index was down -16.7% for the quarter.

Latin American Emerging Markets led all global sectors for the quarter and the year. Argentina's GDP contracted slightly during the third quarter, contracting 0.3% for the year. The government predicts GDP growth of 0.5% this year and 2.5% in 2010. In November an increase in industrial production indicated that the economy is taking fledgling steps towards recovery. The big story in the sector was Argentine debt. Argentina's bonds returned 133% in 2009 on speculation that the government would gain better access to financing after completing a restructuring. President de Kirchner proposed the use of foreign reserves to service debt - a sign to the markets that the government would take steps to prevent another default. Brazil's current account deficit widened in November to $3.29 billion, according to the Brazilian Central Bank, and it revised its forecasts for 2010 to show a wider current account deficit than previously expected. However, Brazil's economy is showing consistent signs of recovery. Idle capacity is helping maintain low inflation pressure, according to Brazil's central bank from minutes of its December monetary policy meeting. The bank said that while inflation expectations remained in line with official targets it would continue to maintain a cautious stance to assure that past rate easing, improving credit conditions and domestic demand would not bring undue price pressure. The MSCI Brazil index was up 128% for the year on fundamentals and appreciation of the real.

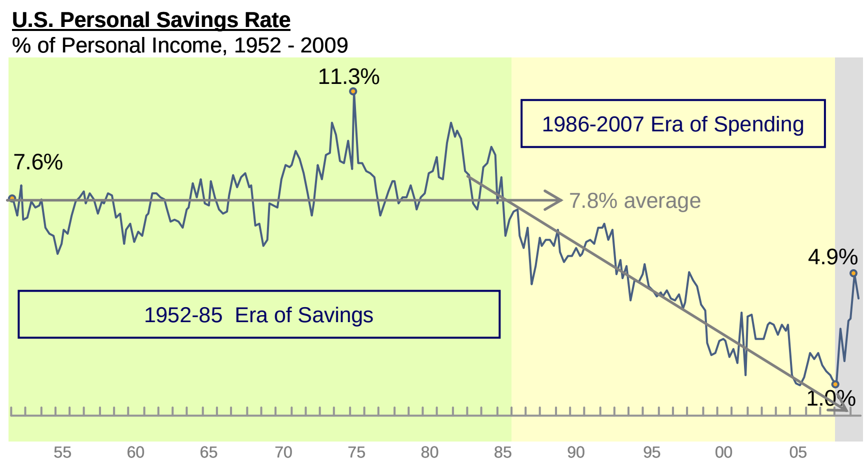
Focus On: *Behavioral Economics – Why Are We Saving?*

Economics is fundamentally a social science, close kin to sociology and psychology. Before releasing *The Wealth of Nations*, Adam Smith wrote *The Theory of Moral Sentiments* in which he used psychological principles to explain individual behavior. Many have viewed this as the foundation of his later work. By the late 1960's, cognitive psychology and its focus on how we process information and make decisions had crept into economic study. Today behavioral economics is an advancing field of study that can provide perspective on the current economic climate. Simplified, behavioral economics is the study of human behaviors and psychology and their driving effects on economic and financial decisions. A common field application for research is investor decision making, including decisions about budgeting and spending.

In Jason Zweig's *Your Money & Your Brain*, studies of an investor's brain activity during stock selection decisions are shown to have very similar patterns to those of gamblers during betting situations or to those of a drug user before a fix. In fact, "neural activity of someone whose investments are making money is indistinguishable from that of someone who is high on cocaine or morphine." And since our behavior, rational or otherwise, can create sharp changes in the economy, understanding how closely our emotions are linked to our financial decisions becomes increasingly important when trying to forecast recovery from an economic recession. In the case of our current credit-driven downturn, behavioral economics can explain our disinclination to save despite our knowledge (or memory) of severe past recessions as well our disinclination to resume spending.

Behavior and the Recession Today

The credit crisis and collapse of major banking corporations can be attributed to a systemic behavioral fault; in aggregate we purchased more than our incomes could support, financing our spending with inflated assets and debt. However, a closer examination of our collective spending habits reveals a trend that began almost thirty years ago. In the early 1980's we began to save less and less, eventually spending beyond our means. As a society, we decided that it was acceptable to spend to extreme; that "greed... is good" to quote the character Gordon Gekko in the 1987 film *Wall Street*, a portrayal of 1980s excess. The cause of this trend can be debated (and most likely it is attributable to a number of factors). But more importantly, it continued through a variety of social, political, and economic environments, including a number of economic expansions and contractions as well as two wars. More recently the trend was supported by the easy availability of credit, but it began long before what was to become the credit crisis. Somewhere along the line, as a society, we changed our attitudes toward spending, and lower savings levels became normal.



Time Scale: Calendar Years
Source: Department of Commerce, Bureau of Economic Analysis, NIPA Series, published 12/22/09
Quarterly data seasonally adjusted at annual rates.

Social psychology categorizes social norms in two ways: injunctive and descriptive. The 2005 text book *Social Psychology* defines injunctive norms as "people's perceptions of what behaviors are approved or disapproved by others" and descriptive norms as "people's perceptions of how people actually behave in given situations." Said another way, social norms can be divided into things we do because we think they are "right" (by society's definition) and things we do because we think everyone else is doing them. While most of us are aware of the social approval given to saving and other financially responsible behavior, the belief that everyone else is (or was) spending above their means has been significantly more influential on our behavior over the past two decades. Whether it was a neighbor or colleague buying a car or home they could ill-afford or our government blowing out the national debt, over-spending became our national solution to any financial problem. In fact, our behavior suggests that until recently the social approval given to saving and financial responsibility had decreased markedly to the point that it was seen more as sign of being overly-cautious, too conservative, or needlessly frugal – in short, of being a chump. (For more discussion on the low national savings rate, see our Market Recap from June 30, 2006.)

However, things may have changed recently. The overall savings rate has increased over the past eight quarters, with a fifteen year high of 4.9% posted in May of 2009. This has been mirrored in myriad reports of decreased consumer spending. With an unemployment rate flirting with 10%, plummeting home values that only recently have started to stabilize, and much tighter credit, it is easy to assume that fear is finally pushing us collectively to better behavior. But in fact, over the past two decades increased savings during or immediately following most recessions has been temporary. The First Gulf War and the associated recession only suspended the declining savings rate for a year or two. The bursting of the dot com bubble had even less effect. Even the tragedy of September 11th was not enough to shock us into saving. Within a matter of months, we resumed our downward savings trend. Have the events of the past eighteen months finally changed our behavior and reversed our declining savings trend or will recent experience turn out to be just a blip?

A New Era of Savings?

The Great Depression of the 1930's marked the most significant financial meltdown that this country has seen to date, and it provides an interesting period for examining the change in attitudes towards saving and spending. Following another era of legendary excess (the Roaring 20's), the economic depression lasted for a decade, brought on by monetary contraction and a severe banking and stock market collapse. It ended in the late 1930's when the country managed to return to economic stability through a combination of Roosevelt's New Deal, economic cyclicality, and the booming war manufacturing industry. In our romanticized view of the period, we tend to see a nation saved by hard work and frugality, a lesson that stuck for generations. The post-Depression period brought many changes to the American lifestyle. In its October 12, 2009 article "Inconspicuous Consumption," *The New Yorker* pointed out that in the five years after World War II purchases of household furnishings and appliances rose by 240%. Between 1940 and 1960, homeownership rose by almost 50%. Yet during this time, Americans still had a significant savings rate, around 8% of personal income.

Vegetables make economical gifts during the Great Depression.

To determine if our recent return to savings will become the same kind of lasting trend, we can examine the attitudes of the affluent towards spending and savings. While this group makes up a small percentage of the population, they present a clear picture on the issue because their savings decisions are "free." That is, they do not *have* to save and they *can* spend, so a choice to do either must reflect an attitude towards the behavior rather than a necessity for it. In addition, we look to the wealthy as trend leaders and role models. (Just look at the amount of coverage the media gives "celebutantes.") Right or wrong, we aspire to their behaviors and lifestyle and often adopt their attitudes.

Fortunately, because this group is important to us, they are regularly surveyed and tracked. A 2009 American Express Publishing and Harrison Group study, *The Survey of Affluence and Wealth in America*, noted respondents moving away from "unexamined consumption" and deriving "pride – self-esteem – from their ability to make careful, reasoned purchase decisions." Authors of the study point to resourcefulness as a new "moral norm," stating that "being 'in the black' is the 'new black." *The Fall 2009 Affluent Market Tracking Study #16* by The American Affluence Research Center (AARC) noted that the affluent see themselves as "careful spenders and aggressive savers who live within their means." These studies seem to be evidence of a new era – a return to savings as both the right thing to do and as what is actually done.

Unfortunately, there is also evidence that the increased savings rate is temporary. The AARC study also shows respondents intend to return to pre-recession levels of spending when the economy and their net worth have recovered. However, the disparate attitudes indicated in these surveys may ultimately be an accurate reflection of the causes of the current increasing savings rate. Perhaps the magnitude of it is due to the fact that the trend has two causes – a fear response brought on by the current crisis as well as a change in attitudes towards spending and saving.

Time Will Tell

We have seen broad trends over the past century that mark changes in our saving and spending behaviors. Certainly the severity of the Great Depression deeply impacted the American psyche. Even after spending resumed, it firmly cemented the social acceptability of savings as evidenced by a 7.8% average savings rate from 1952 through 1985. What remains to be seen is whether the current recession will restore savings as an accepted norm. If our increased savings has been a direct response only to current economic and financial conditions, with a market recovery will come a return to a downward-sloping saving rate. However, if there truly has been a shift in our attitude toward savings (and spending), we can expect the savings rate to continue to rise, although perhaps at a lower rate. Likely the answer will depend on how quickly we move through to recovery. The Great Depression lasted the better part of a decade with unemployment reaching 25% through multiple waves of contraction. We are only two years into our current downturn and unemployment still has quite a way to go to reach Great Depression levels. Trends from recessions since the Great Depression seem to indicate that our attitudes are influenced by the length of the contraction that elicited them, so a recovery in the next year or so could just change our minds about saving.

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