

What's Ahead in 2009

An Investment Perspective

Autumn 2009 Update

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- ▶ A Look Back at the Third Quarter
- ▶ The Economic and Investment Outlook
- ▶ 12 Predictions for 2009: The Scorecard So Far
- ▶ Strategies for Your Investment Portfolio



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The Economic and Market Backdrop

Transition to a Subpar Recovery

At this point, we think it is safe to say the recession has ended and the global economy has entered a recovery phase. Nevertheless, a great deal of uncertainty remains as to what this recovery will look like. Those who are the most bullish are calling for a sharp rebound and a return to boom conditions. At the other extreme there are those who are predicting that the nascent pickup in growth will fizzle and the United States is headed for the type of stagnation that plagued Japan in the 1990s.

► We believe the US recovery is for real, but the economy will grow at a below-normal pace.

Our view lies somewhere in the middle of these two extremes. Ongoing deleveraging and the credit overhang make it unlikely that a rapid expansion could occur. At the same time, continued aggressive support from policymakers should prevent a “lost decade” scenario. On balance, we believe the US recovery is for real, but the economy will grow at a below-normal pace.

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In the United States, we are expecting to see gross domestic product (GDP) growth rates of between 3% and 4% for the second half of 2009 and between 2% and 3% in 2010. We believe US growth will outpace growth in the other developed markets, largely due to quicker and more aggressive policy action, but expect emerging market GDP growth will continue to lead the pack.

What's Next for the Fed?

The economic outlook offered by Federal Reserve officials seems close to one we are offering: a moderate recovery that is occurring against a backdrop of lingering deflationary forces. Given the current environment, we think inflation is likely to remain well contained, and it appears that the Fed shares this view. As always, the Fed is caught between its dual mandates of promoting economic growth and keeping inflation in check, which is why the central bank is simultaneously indicating that interest rates will remain at their historic lows for “an extended period,” while also discussing an exit strategy to remove some policy stimulus.

► Our best guess is that the Fed will reverse course and begin raising rates by the middle of next year at the earliest.

Given that unemployment is approaching 10%, credit is still not flowing normally and inflation levels are hovering around the zero level, it seems unlikely that interest rates will be increased any time soon. At this point, our best guess is that the Fed will reverse course and begin raising rates by the middle of next year at the earliest.

The Declining Dollar

Over the past several months, we have been hearing more noise about the weakness of the US dollar and concerns that the United States may be entering into a “currency crisis,” particularly considering the massive increase in government spending.

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While we do think we may be in the midst of a renewed bear market for the greenback, we do not believe currency trends have gotten to crisis proportions. The weaker dollar has not been driving Treasury yields higher and it has not prevented stocks from appreciating. Additionally, it is important to remember that although the dollar is in a downward trend, the declines have been slow and orderly. On a trade-weighted basis, the dollar’s value is still higher than its 2008 lows, and we think much of the decline can be attributed to a reversal of the “flight to safety” that drove many to the dollar during the heart of the crisis. We would acknowledge, however, that US government spending is on an unsustainable trajectory, which could present more serious long-term risks for the US currency if spending levels do not come back down.

The Third Quarter by the Numbers

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The rebound in equity markets that took hold in the second quarter continued in full force during the third quarter, with stocks posting positive gains in July, August and September. Since their lows in March, US stocks have advanced more than 50%, although markets still remain about 30% below the highs reached in October 2007.

The Dow Jones Industrial Average experienced its best quarter in more than 10 years, advancing 15.8% to close at 9,712 on September 30, which pushed the average to a 13.5% increase for the year. The S&P 500 Index jumped 15.6% in the third quarter, is up 19.3% for the year and now stands at 1,057. The Nasdaq Composite posted a similar 15.7% return for the quarter (ending at 2,122) and is now up an impressive 34.6% on a year-to-date basis, thanks in large part to exceptionally strong performance in the technology sector. Among smaller-cap stocks, the Russell 2000 Index advanced 19.3% for the quarter and is up 22.4% for the year.

International stocks also posted impressive gains for the quarter. European markets were particularly strong, with stocks up 18.0% in Germany, 20.9%

in France and 20.8% in England. In contrast, Japanese stocks were up a modest 1.8% in the third quarter, thanks largely to ongoing strength in the yen. Emerging markets in general continued to fare well, with the MSCI Emerging Markets Index posting a quarterly return of 20.9%. A notable exception was China, which was one of the only markets to post a loss for the quarter at -4.9%. On a year-to-date basis, however, Chinese stocks are still up 67.0%.

In fixed income markets, the yield on the 10-year Treasury bounced around somewhat before ending the quarter at 3.31%, slightly lower than where it began but still significantly higher than where it began the year at 2.25%. In this environment, the Barclays Capital US Aggregate Bond Index posted returns of 3.7% for the quarter and 5.7% for the year.

Finally, cash investments, as represented by the 3-month Treasury bill, have continued to post returns close to zero, with advances of 0.1% for the quarter and 0.2% for the year.

The Outlook

The rapid increase in the value of risk assets that has occurred over the past six months largely came about as part of a realization that the world would not be entering a global economic depression. Sustaining (and building on) those gains will require evidence that the recovery is here to stay.

For stocks in particular, this means we will need to see a transition from a rally driven by undervalued conditions to one based on real improvements in earnings. Almost the entire advance in stocks that has occurred since March has been brought about without much change in forward earnings estimates. The earnings outlook, however, remains uncertain. Companies have successfully managed their costs over the past year, which is certainly a positive, but weak levels of overall economic growth create a difficult corporate environment.

On balance, we believe that a backdrop of low growth, low inflation and still-accommodative monetary policy should help create an equity-friendly environment, but we do not expect the near future to look like the past six months. The rapid advance may have caused the market to have become somewhat overbought, which may require a period of consolidation. This could take the form of some sustained sideways movement, but we cannot rule out the possibility of a correction either. In any case, we do believe that markets will move higher in the intermediate term, but market movement more than likely will resemble a volatile, slow grind rather than a powerful advance.

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The Scorecard So Far

As we are entering into the last part of the year, our predictions made in January appear to be mostly on track. The economy is emerging from a deep hole, but will probably still post a decline for all of 2009. On the financial markets front, stocks and commodities have rebounded impressively, but still face high levels of volatility.

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| 1. The US economy faces its first nominal GDP decline in 50 years. | While we do believe the recession has ended and the economy has moved into a period of recovery, we doubt growth will be strong enough in the second part of the year to make up for the steep declines in the first and second quarters. As such, we expect that nominal (non-inflation-adjusted) growth will be negative for all of 2009. |
| 2. Global growth falls below 2% for the first time since 1991. | As with the United States, many international markets (particularly emerging markets) appear to be moving past, or have already exited, the recession. Overall, however, global growth remains weak, and we anticipate that 2009 global GDP growth will come in at around the 1% level. |
| 3. Inflation falls close to zero in many developed countries, but widespread deflation is avoided. | Thanks in large part to the widespread programs enacted by policymakers around the world, the global economy was able to avoid a plunge into widespread deflation. Many remain concerned that inflation will soon emerge as a threat given increased government spending, but excess capacity and high levels of unemployment should keep inflation in check for some time. |
| 4. The US Treasury curve ends 2009 higher and steeper than where it began. | Treasury yields advanced noticeably earlier in the year as the economy began showing signs of improvement and have since leveled off somewhat. At any rate, the yield curve is both higher and steeper than it was on January 1 and, given current trends, we believe it is unlikely that this will change by year-end. |
| 5. Earnings fall by a double-digit percentage again in 2009, the first back-to-back annual drop since the 1930s. | The earnings picture has improved since the beginning of the year, but remains weak by historical standards. We believe corporate earnings remain on track to post a second consecutive year of declines. |
| 6. High-yield, municipal and investment-grade corporate bond spreads narrow in 2009. | High-yield spreads in particular have narrowed noticeably for all of 2009, and that asset class has posted very strong returns. We have seen similar patterns in the municipal and investment-grade corporate markets as economic data have improved. |
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7. US stocks record a double-digit percentage gain in 2009.
- Six months ago, it appeared there was little chance of getting this one right, but if the year ended today, we would score this one in the “correct” column. While we would not be surprised to see some sort of market correction occur at any point, we remain optimistic that stocks will end 2009 with double-digit percentage gains.
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8. US stocks outperform European stocks while emerging markets outperform developed ones.
- Thanks in large part to a strong third quarter, European stocks are slightly ahead of their US counterparts on a year-to-date basis. In any case, it appears Europe is lagging the United States in terms of economic recovery, and US stocks should outperform over the longer term. Although developed markets made some strides in the most recent quarter, emerging markets are handily ahead for the year as a whole.
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9. Energy, healthcare and information technology outperform utilities, financials and materials.
- Technology has been the best-performing sector so far this year, but returns in healthcare and energy have been more modest. As for our less favored sectors, financials and materials bounced back in the third quarter, but utilities are still lagging. As of now, this prediction is a bit muddled and it looks like it could come down to the wire.
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10. Stock market volatility remains elevated as periodic double-digit percentage rallies and declines occur.
- Volatility levels are lower than they were a year ago, but have obviously remained elevated in 2009 when compared to historic norms.
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11. Oil and other commodities bottom and move higher by year-end as emerging market economies begin to recover.
- Commodity prices jumped sharply in the second quarter of the year, and while oil has remained relatively stable since then, other commodities (such as gold) have continued to post gains. Looking ahead, we expect that increased demand will keep commodity prices relatively high.
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12. The US federal budget deficit soars past \$1 trillion as the government continues to grow.
- Given the sharp increase in federal spending that has occurred this year, it appears to be a foregone conclusion that the deficit will exceed the \$1 trillion mark.

What's an Investor to Do?

The environment remains uncertain, but with an improving economic backdrop, we think it would be appropriate for investors to take on some additional risk. As always, we encourage investors to work with their financial professionals to focus on their long-term objectives and to find tactical investment strategies that work within the context of their long-term plans.

Invest through dollar cost averaging strategies: Many investors are still holding onto cash and are awaiting opportunities to enter the market. In the current environment, we would encourage those investors to move into stocks by gradually dollar cost averaging* over a six-month period.

High quality, but with a balance: We continue to believe investors should overweight higher-quality companies, but from a tactical perspective, we would suggest holding some lower-quality and more cyclical investments given that the economic landscape seems to be improving slowly.

Remain focused on geography: Among developed markets, we continue to favor an overweight position in US stocks. We also believe the long-term case for investments in emerging markets remains intact. In particular, we favor investments in Asia ex-Japan and in Latin America, where signs of economic revitalization are stronger.

Allocate to better-positioned sectors: From a sector perspective, we would suggest above-normal allocations to the energy, healthcare and IT sectors. We have a less favorable view of the financials and consumer sectors.

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* No investment is risk free, and a systematic investment plan does not ensure profits or protect against losses in declining markets. Because dollar cost averaging involves continuous investment in securities regardless of fluctuating price levels, you should carefully consider your ability to continue to purchase during periods of price declines.

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