NOVEMBER 2009 MARKET COMMENTARY

The end of the recession is the major economic theme of the third and fourth quarter. The Commerce Department, in its first estimate of third-quarter gross domestic product, said the economy grew at a 3.5% annual rate which is the fastest pace since the third quarter of 2007. The economy last grew in the second quarter of 2008, and positive growth numbers are a welcome change after a 0.7% contraction in the second quarter of this year.

To add to the good news, GDP growth, which measures total goods and services output within U.S. borders, was above market expectations of 3.3%. Combined with other positive indicators, the strong growth numbers suggest solid GDP growth numbers are likely for the next few quarters.

Strong corporate earnings which have also exceeded estimates add more positive news. Major companies such as Proctor and Gamble, Colgate Palmolive, Aetna, Motorola, Microsoft, and many financial firms have reported stronger than expected earnings for the third quarter. Moreover, the trend of exceeding expected earnings is likely to continue as it appears that most companies have made better than expected progress toward adjusting to altered circumstances.

Housing and increased residential investment also added to GDP which is the first time this sector has contributed to growth since 2005. While housing continues to struggle and a robust recovery doesn't appear imminent, any contribution from housing is a welcome change. New home starts are increasing and continued progress in this sector is likely.

Various other factors will also contribute to the recovery. Inventories need replenishing. Manufacturing is picking up to satisfy demand. While there hasn't been much increase in manufacturing employment, many positive signs signal that it's not far off. Exports are also increasing as the rest of the world also recovers. Furthermore, the dollar is so weak, all of our goods and services are on sale which will further boost exports.

However, all is not positive. Oil companies were the primary sector that released bad news. Exxon, Shell and Eni (Large, European company) all posted large drops in net income. BP was the lone exception reporting better than expected earnings. The overall weakness in the energy sector demonstrates that the economy has yet to recover strongly.

Caution is also warranted as is evident from closer analysis of the components of GDP growth. The cash for clunkers program contributed to the robust GDP growth, but is obviously a temporary event. Furthermore, the program likely borrowed spending from the next couple quarters, so future spending will be adversely affected. Without this giveaway, GDP growth was estimated at closer to 2.0% annualized. While this level of growth is still a welcome change from past quarters, it's not nearly as impressive. In addition, some of the contribution from housing could expire when the $8,000 tax credit for first time home buyers ends next March. While this program could be extended, it's another example of buying current growth through borrowing from the future. The existence or on-going need for these types of programs does not inspire confidence in the economy.

Regardless, before moving on to other issues, it's worth noting that the economy has made tremendous progress toward righting itself and re-establishing normality. While various issues remain, and the affects of this recession will be with us in many forms for years to come, it's notable that we have once again resumed a path of growth which is likely to continue.

Looking toward issues that are likely to affect the economy in the near future, the Federal Reserve rate remains near zero. It's likely the Fed will keep it there for the rest of this year. However, as the economy **continues to strengthen, the Fed will need to increase short term rates to keep the economy from overheating**

and to prevent the dollar from falling even further. But in the near term, low rates will keep home loans rates down and other interest rates fairly low – if someone is qualified or can find a lender willing to lend.

However, the reality for many businesses and individuals is that loans are unavailable. Small business has been hit particularly hard as most creditors have routinely focused on reducing exposure to smaller businesses in particular. For example, many banks have asked that all credit lines by smaller companies be repaid in order to reduce their exposure to this category. This is often in response to FDIC and other government regulators redefinition of the riskiness of particular categories of loans, so it's likely to continue.

Fortunately for individuals and businesses, inflation is not likely to be a factor in the near term. Consensus estimates still appears to be that inflation will range from 0 to 2% over the next couple years. However, at some point, it's also widely expected that inflation will increase, especially if the Fed is unable to accurately dial back the money supply that it pumped up so vigorously during the last year.

Unemployment continues to be an issue that is affecting many parts of the economy. Expectations are that the U.S. unemployment rate rose to 9.9% in October from 9.8% in September. And, it's widely assumed that it will keep rising for the next several months. Not surprising, consumer spending fell 0.5% last month. Lack of confidence in the job market is affecting not only incomes, but how people with incomes manage their money. The savings rate jumped to 3.3% from 2.8% in August. Given that we had a negative savings rate going into the crisis, the double hit of unemployment and markedly increased savings continue to adversely affect the economy, even if increased savings rates are good for longer term financial health.

The combination of weak employment numbers, reduced personal spending and credit contraction will likely create another major round of bankruptcies after this years' Christmas season. The declared bankruptcy of CIT – the leading lender to small businesses, especially retailers – will also create problems for smaller businesses. Retailers struggling to hang on and hoping this year would pull them through are likely to be disappointed.

We appear to be at the beginning of a slow recovery. While there's hope that it will gain momentum, conviction seems to be much stronger that recovery will be relatively anemic. However, it's certainly much better to be arguing about the strength of a recovery versus whether or not one will happen.

Given that stocks have risen substantially from earlier lows while many on-going challenges still exist, I've been asked if stocks are still a good place to invest. Earlier in the year, valuations were very low, and we strongly believed that stocks represented an outstanding long term, and probably excellent short term, buying opportunity. Now, valuations are not nearly as compelling. This doesn't mean that stocks are overvalued, or that there's not great long term potential. However, it does tell us that long-term returns for stocks going forward are likely to be closer to normal levels, rather than offering the incredible potential we saw earlier this year.

Near term, we expect to see continued volatility as various areas of the economy continue to struggle back to health. More banks and retailers will go under, and we're still losing jobs rather than adding them. As always, stock investments should be long term in nature and expectations need to be realistic. We believe we're starting to return to a more normal pattern for stocks – 2 steps forward, one step back.

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