JANUARY 2010 MARKET COMMENTARY

This year has certainly been an interesting one. After starting horribly and rapidly deteriorating, the stock market bottomed in March kicking off a tremendous recovery that has continued for 9 months. As usual, the stock market recovered long before the economy and acted as a leading indicator. Fortunately, the economy did recover as the stock market expected. The severe and relatively short market collapse lent more credibility to claims that the past couple years were really more the Great Panic than the horrible economic Armageddon many projected. In fact, for 2009, the economy will experience overall growth while the stock market will be up around 25%. Of course, for both of these measures, this was coming off of a terrible 2008, but still, the growth is impressive. Once again, it reaffirms the adage, "Don't bet against the U.S. Economy", at least in the longer run.

As we stand now, we expect a strong fourth quarter for the U.S. economy, with a robust gain of about 4.0% vs. 2.8% in the third quarter. Not only is the expected growth rate for fourth quarter larger than the third quarter, the sources of the numbers are also much more encouraging. In the third quarter, much of the growth resulted from artificial government stimulus which likely shifted spending forward from future quarters. By contrast, fourth quarter numbers are more the result of normal and sustainable economic activity rather than manipulated and temporary stimulus.

Various factors are contributing to the improving economy. Exports are surging and holiday spending improved. The consumer is finally waking up again, although very slowly. Housing, the major factor that kicked off the economic turmoil appears to be gaining more strength. Sales of previously owned U.S. homes jumped last month to their highest level in nearly three years, the latest sign that the economic recovery is gaining steam. The National Association of Realtors said on Tuesday that existing home sales increased 7.4 percent, the fastest pace since February 2007. The rise was above market expectations.

These positive trends as well as others are kicking off a recovery within businesses and the broader economy as companies are building confidence needed to finally start increasing depleted inventories. In addition, manufacturers are extending workers' hours, and more companies are offering year-end bonuses both of which spur consumers to spend more. The same way that the panic started a spiral downward, we seem to be now spiraling in a more positive direction as various parts of the whole economic system find more solid ground and contribute to on-going recovery.

Multiple positive developments will help 2010 start off well, but growth is still likely to be slow while unemployment remains high. Overall, consensus GDP projections hover around 3% which should add at least 1 million new jobs, many of those coming in the second half of the year. Unfortunately, slow job creation as the economy recovers from a recession is very typical. Job growth simply takes time. Given that approx. 8 million jobs were lost during the last recession, there are a lot of jobs that need to be created for employment to get back to even.

However, as painful as it sounds, there's actually a benefit to adding jobs back more slowly – at least to the general economy, if not to the unemployed. If jobs are added back too quickly, it triggers inflation. In this case, central banks must pull back their monetary support which was added to prop up the economy over the last couple years, but without causing withdrawal shocks.

Given the weak jobs market and still very tame economic recovery, **inflation is very likely to stay under control in 2010** and remain at levels around 2% for the year. Surprisingly, this would be a half point less than the rate of 2009. As always, there's one major caveat. Oil prices can always surge without warning. It recently hit $79 a barrel, its highest levels since November, because of the recent cold snap.

In addition, given the still slow economy, **it appears unlikely that interest rates will move for the next several months.** The Federal Reserve is content with the current inflation rate, and it has no incentive to slow the economy.

Focusing more specifically on the stock market, Barron's December 21, 2009 edition published its annual survey of consolidated forecasts for stocks in 2010. **Gains were estimated at 12% while cash is projected to continue to earn near 0%.** However, as expected, there are many caveats to these predictions. The big risks were clearly identified as monetary, tax and trade policy – all government controlled decisions. An administration hostile to private enterprise makes the business community nervous. And, the uncertainty resulting from many new and usually punitive initiatives coming from Washington will also slow economic recovery. However, in spite of these hurdles, the U.S. economy continues to strengthen, and a double dip recession appears less and less likely with few believing it's likely.

Heading into 2010, we expect a good year punctuated by inevitable bad news. As bad news outsells good news by a 5 to 1 margin, even a great economy will generate negative press. 2010 will generate its share of problems. Bank failures and home foreclosures will continue. Commercial real estate also continues to face problems, although the market is betting that the worst is nearly over in this sector. Real estate trusts that trade on the stock market have done much better than the general stock market for the past several months.

The good news should continue on many fronts. Some good news we will hear about such as the housing recovery, employment and retail spending. Other issues should also contribute, but are likely to be less widely reported. The globe is also recovering which will help pull the U.S. forward. Emerging markets are actually growing rapidly. In the U.S. we still have 90% employment which is very high by global standards. It's also high enough to power the nation forward. And, as we pull out of every recession, productivity gains are very high. Recent gains have been tremendous.

I believe we're even seeing encouraging news from Washington, although it's more in the form of less bad news. While health care reform in some form will pass, this version will likely be somewhat less damaging to the economy than what could have been enacted. More significantly, Washington's inertia to expand without consequence appears to be slowing considerably. Future policy will be less economically hostile. For example, Cap and Trade is most likely dead, and the deficit is now actually becoming a political issue. While anything is possible, the lack of popularity of current and announced initiatives is becoming quite apparent through numerous polls. The onslaught against business and the economy will either change through behavior modification or voter actions, or both.

Finally, as this year draws to a close and we launch into a new decade, I believe we do so with many reasons for optimism even if we undoubtedly face many challenges. We wish you the best for 2010.

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