

# Outlook

# 2010



From Tailwinds to Headwinds

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# 2010

from **tailwinds** to **headwinds**



As 2010 gets underway the markets are likely to continue to perform as well as they have through the latter part of 2009. However, following a solid start, we expect a challenging second half of 2010. We anticipate the extraordinary global policy efforts that created a tailwind for markets in 2009 will fade, or even transition, to headwinds that may contribute to a renewed slowdown in the economy and a potentially challenging latter half of 2010 for investors.

2010 is likely to have two distinct periods. Initially, the macroeconomic backdrop during the early part of 2010 is likely to remain favorable for investors' portfolios. But as the year goes on, a renewed slowdown in the economy may cause markets to reverse course. Here we offer our perspective on how 2010 will unfold so you may best position your investment opportunities to work with the tail, head or crosswinds impacting the markets.



During 2009, the economy began its recovery. Economists often talk about different letters to describe the shape of the recovery: is it a “V”-shaped or very rapid recovery, or a slower-paced “U”; or an “L”, meaning no recovery. We see the potential for a lopsided “W”-shaped pattern. The economy has experienced the sharp decline and rapid recovery of the first half of the “W,” but there is the risk of another smaller decline in growth in 2010 as the stimulus fades and the tailwinds turn to headwinds.

Based on the path we believe the economy and markets will follow in 2010, several key metrics should be hit.

- We see economic growth in the 3–4% range for the full year 2010, with stronger 3–5% growth in the first half and slower 2–3% growth in the second half.
- Job losses end in the first half of 2010. The transition from recovery to sustainable growth allows the Federal Reserve (the Fed) to begin to raise rates in the second half of the year, slowing the pace of economic growth.
- The Fed is expected to begin to hike interest rates in the second half of 2010 and end their purchase program totaling \$1.25 trillion in Mortgage-Backed Securities (MBS) debt that has been lending support to the credit markets throughout 2009. The spending fueled by the \$787 billion economic stimulus package that was passed in February 2009 will begin to fade by the middle of the year.
- We see stocks posting gains early in the year that are later cut in half to end the year with only modest single-digit gains. With stocks up 60% from the March 9, 2009 low (as measured by the S&P 500), the big market gains are likely behind us as the economy and markets face some new challenges in 2010.
- Earnings growth is projected to rise 25% in 2010 (about \$76 vs. \$60 in 2009). Profit growth will begin to slow in the second half of 2010, one year after it began to rebound, as the economy faces the prospects of tougher comparables and an unwinding of the stimulus-inspired growth.
- The bond market posts flat to mid-single-digit gains in 2010. Credit conditions may begin to worsen late in the year as the outlook for profit and economic growth begins to weaken and the Fed’s MBS purchases (which contributed to narrower spreads across the bond market) fade.

Entering 2010, we recommend overweighting stocks particularly Cyclical sectors, U.S. multinational companies, and Emerging Markets. We also favor the economically sensitive Commodities asset class. In the bond market, we prefer High-Yield Corporate and Emerging Market Bonds.

As the year continues, becoming defensive will likely again become appropriate, resulting in a portfolio strategy that underweights stock and cyclical investments and a transition to investments, such as Covered Calls, Global Macro, and Balanced strategies. Again in 2010, a tactical approach to investing will be important to maintaining the path to long-term investment success.



#### Highlights: 2010 Outlook

GDP	Projecting 3–4% growth for the full year
Stocks	Modest single-digit return
Bonds	Flat to mid-single-digit return

# Outlook At A Glance

## 2010 Recommendations

	TAILWINDS (FIRST HALF OF 2010)	HEADWINDS (SECOND HALF OF 2010)
<b>EQUITIES</b>		
<b>SCENARIO AND RATIONALE</b>	<p>For the first half of 2010, the tailwinds of growth continue to drive positive market results. The combination of continued and unprecedented economic and market stimulus, a strong earnings rebound, and a solid economic foundation lead to solid market gains early in the year. In that environment, investors should favor higher-beta, economically sensitive investments.</p> <p>As global economic stimulus fades or even reverses in the latter part of 2010, similar to past rising rate environments, markets experience greater volatility and may shed some gains. As these signs emerge, investors should take profits in relatively riskier investments and, where possible, shift to more defensive, less risky opportunities to protect first half gains.</p>	
<b>MARKET CAP</b>	<p>Slightly Favor Small Caps</p> <ul style="list-style-type: none"> <li>Typically outperform during post-recessionary periods</li> <li>Possess greater beta and, therefore, more potential upside</li> <li>More sensitive to credit market improvement</li> <li>Strong performance has pushed up valuations and requires close monitoring for opportunities to take profits</li> </ul>	<p>Slightly Favor Large Caps</p> <ul style="list-style-type: none"> <li>Tend to be more defensive than Small Caps</li> <li>Underweight Cyclical sectors</li> <li>More predictable and stable earnings growth benefiting from exposure to emerging market demand</li> </ul>
<b>STYLE</b>	<p>Slight Overweight to Growth Relative to Value</p> <ul style="list-style-type: none"> <li>True Growth sectors tend to have more exposure to emerging market demand, stronger balance sheets, and better earnings growth prospects</li> <li>Rising merger and acquisition activity tends to benefit growth stocks</li> </ul>	<p>Significant Overweight to Growth Relative to Value</p> <ul style="list-style-type: none"> <li>Defensive Growth stocks hold up better in volatile market and economic environments</li> <li>In low growth environments, investors focus on companies offering a solid history of earnings growth</li> </ul>
<b>SECTOR</b>	<p>Favor Cyclical Sectors</p> <ul style="list-style-type: none"> <li>Include Consumer Discretionary, Information Technology, Materials, and Industrials</li> <li>Benefit from improving economic growth</li> <li>Commodity exposure in sectors benefits from continued economic recovery</li> </ul>	<p>Favor Defensive Sectors</p> <ul style="list-style-type: none"> <li>Include Consumer Staples and Health Care</li> <li>Investors favor their earnings stability regardless of economic environment and market volatility</li> <li>Less exposure to commodities, which may suffer from a rising US dollar as the Fed hikes interest rates and a global slowdown in demand</li> </ul>
<b>U.S. VERSUS INTERNATIONAL</b>	<p>Favor Emerging Markets</p> <ul style="list-style-type: none"> <li>Continued economic recovery benefits investing outside the U.S.</li> <li>Emerging market economies, especially in Asia, will continue to benefit from China's growth</li> </ul>	<p>Favor U.S. Relative to International Developed and Emerging Markets</p> <ul style="list-style-type: none"> <li>Removal of global stimulus may crimp economic growth prospects and International Developed and Emerging Markets are less defensive than the U.S.</li> <li>Rising in US dollar may reduce return of foreign investments</li> <li>Foreign indices are overweight Financials, which may suffer in a rising interest rate environment</li> </ul>

Small Cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the Small Cap market may adversely affect the value of these investments. Beta measures a portfolio's volatility relative to its benchmark. A Beta greater than 1 suggests the portfolio has historically been more volatile than its benchmark. A Beta less than 1 suggests the portfolio has historically been less volatile than its benchmark.

High Yield/Junk Bonds are not investment-grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.

International and emerging markets investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

The market value of Corporate Bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

Long positions may decline as short positions rise, thereby accelerating potential losses to the investor.



	TAILWINDS (FIRST HALF OF 2010)	HEADWINDS (SECOND HALF OF 2010)
<b>FIXED INCOME</b>		
<b>SCENARIO AND RATIONALE</b>	<p>As demonstrated by the powerful returns in relatively higher risk bond sectors, tailwinds benefited fixed income as much as stocks in 2009. Greater liquidity, balance sheet repair, and less risk of default resulting in spread contraction are the key drivers that should carry on through the first part of 2010. Fixed income investors should continue to favor more risky bond sectors as they offer higher yields relative to U.S. Treasuries and more spread contraction is possible.</p> <p>Unfortunately, later in 2010, as global economic stimulus fades and the Fed begins to hike interest rates, fixed income markets may suffer. A continued overweight to spread products should offer some cushion to rising interest rates, however, the reduced economic stimulus suggests reducing exposure to more risky bond sectors.</p>	
<b>DURATION</b>	<p>Focus on Intermediate-Term</p> <ul style="list-style-type: none"> <li>The yield curve remains at very steep levels and an incremental move up curve is beneficial</li> </ul>	<p>Favor Intermediate-Term</p> <ul style="list-style-type: none"> <li>Yield curve will likely remain steep</li> <li>Incrementally add to Short-Term Bonds if Fed acts more aggressively than expected or inflation accelerates</li> </ul>
<b>SECTOR</b>	<p>Overweight Spread Product, Especially in More Risky Sectors</p> <ul style="list-style-type: none"> <li>Aggressive fixed income strategies offer capital appreciation opportunities</li> <li>Significant overweight to Emerging Markets Bonds which should benefit from continued worldwide economic growth</li> <li>Overweight Corporate Bonds with particular emphasis on High-Yield Bonds as balance sheet repair and less default risk create opportunity</li> </ul>	<p>Remain Overweight to Spread Product, But Reduce Exposure to More Risky Sectors</p> <ul style="list-style-type: none"> <li>Higher yield and potential spread contraction should cushion the negative effects of higher interest rates</li> <li>Reduce overweight to more aggressive, economically sensitive sectors as higher interest rates may crimp economic growth</li> </ul>
<b>U.S. VS. INTERNATIONAL</b>	<p>Favor Emerging Market Bonds and U.S. Bonds relative to Developed Foreign Bonds</p> <ul style="list-style-type: none"> <li>Economic growth should lead to further spread contraction in Emerging Market Bonds</li> <li>Further decline in US dollar should benefit conversion of foreign returns</li> </ul>	<p>Favor Hedged Foreign Bonds</p> <ul style="list-style-type: none"> <li>Hedged to insulate from rising US dollar</li> </ul>
<b>ALTERNATIVE INVESTMENTS</b>		
<b>SCENARIO AND RATIONALE</b>	<p>As the healing process of the economy continues into 2010, the tailwinds of growth should continue to drive investor optimism. Consequently, strategies that offer potential downside protection or risk management will likely take a backseat to those that offer more upside potential. This somewhat lower volatility environment will likely give way to more elevated volatility levels as market participants anticipate the removal or reduction of economic stimulus. In this more uncertain environment, some investors will increase cash or fixed income exposure. However, the more prudent course of action may be to increase diversification by adding low correlation investments and incorporating strategies that provide downside protection, risk management, and benefit from an environment of increased volatility.</p>	
<b>POSITIONING</b>	<p>Overweight Opportunistic Strategies</p> <ul style="list-style-type: none"> <li>Favor economically sensitive strategies such as Commodity-driven investments</li> <li>Include eclectic, long-only strategies that focus on finding opportunities regardless of market capitalization or region limitations</li> <li>Possibly add Event Driven or Distressed Debt strategies</li> </ul>	<p>Overweight Volatility and Risk Management Strategies</p> <ul style="list-style-type: none"> <li>Include volatility strategies that offer exposure to Covered Calls, Managed Futures, and Global Macro portfolios</li> <li>Incorporate risk management strategies such as Long/Short, Market Neutral, and Absolute Return</li> </ul>

Alternative investments may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

Options are not suitable for all investors and certain options strategies may expose investors to significant potential losses such as losing the entire amount paid for the option.

Global Macro funds use fundamental inputs (focused on broad global economic themes) in their models as well as technical (or price related) inputs. Global Macro funds may also be less systematic than the typical Managed Futures fund. Historically, the benefit of Global Macro has been solid long-term returns with very low correlation to equities and fixed income securities.

Absolute Return funds have the goal of providing a positive return in all market conditions and tend to have low volatility and provide bond-like returns. They also tend to have a very low correlation to bonds and low correlation to stocks. Because of their goal of low to moderate volatility, these securities are more suited for accounts with more moderate risk/return goals.

Distressed Debt strategies focus on securities of companies that are either in default, distress, or bankruptcy, or are heading towards such a condition.

Event driven strategies involve investments in the securities of corporations undergoing a significant change.

Eclectic strategies include go anywhere, long-only strategies that focus on finding opportunities regardless of market capitalization or region limitations.

# Tailwinds

## Sailing Higher Early On

The powerful policy tailwinds in the form of global monetary and fiscal stimulus are likely to keep the major stock and bond indexes sailing higher in early 2010. We forecast sustained economic growth as these tailwinds should continue to foster a favorable environment for investors in early 2010.



Our outlook for a favorable environment for risk taking in the first part of 2010 is supported by our analysis of the global economic environment and business-led nature of the recovery. The rebound in global economic activity that began in the emerging markets tied to China in early 2009, expanded to include the U.S. and the developed world by mid-year. As we approach 2010, the world is experiencing the first synchronized global economic recovery in a generation.

Our views are that:

- Business spending, fueled by robust export opportunities, intense inventory restocking, low financing costs, and solid balance sheets of non-financial companies could drive Gross Domestic Product (GDP) in 2010, while the consumer contributes modest growth.
- The Fed continues to push down hard on the “economic growth” gas pedal by keeping short-term interest rates near zero and remaining on track to purchase \$1.25 trillion in Mortgage Backed Securities—an area of the bond market hard hit by the financial crisis—by the end of the first quarter of 2010.
- The other engine of global growth, China, continues to implement stimulative policies driving domestic and regional economic activity.
- The modest decline in the dollar helps to boost profits and exports.

### How We Got Here

The seeds of the recovery were sown in the fall of 2008, as companies reacted to the global financial crisis precipitated by the collapse of Lehman Brothers in September 2008. Companies around the world cut back sharply. Inventories and industrial production fell by record amounts in the first three quarters of 2009. In effect, companies were bracing for a repeat of the Great Depression—but instead got a Great Recession.

This worldwide company pullback set the stage for a broad-based recovery. Demand turned out to be less weak than anticipated. This greater than expected demand was helped by record fiscal and monetary stimulus undertaken by the U.S. and foreign governments. In many instances, the stimulus has yet to run its full course and may still help demand into the first half of 2010.

Consequently, we recommended a very defensive investment stance shunning the stock market while favoring investment strategies that potentially helped with volatility, such as Covered Call, Global Macro, and Balanced strategies. Markets deteriorated for the first two months of 2009, rewarding our defensive stance. However, we were expecting improvement and awaiting the opportunity to increase risk positioning.



Fortunately, the extraordinary efforts to restore functioning in the credit markets and growth to the economy proved successful. Led by the Fed, these efforts included cutting short-term interest rates to zero, providing credit to troubled institutions, and buying more than a trillion dollars in bonds. In addition, \$787 billion in stimulus was authorized by the American Recovery and Reinvestment Act in February 2009. These actions were mirrored by governments around the world in early 2009 creating powerful tailwinds for growth.

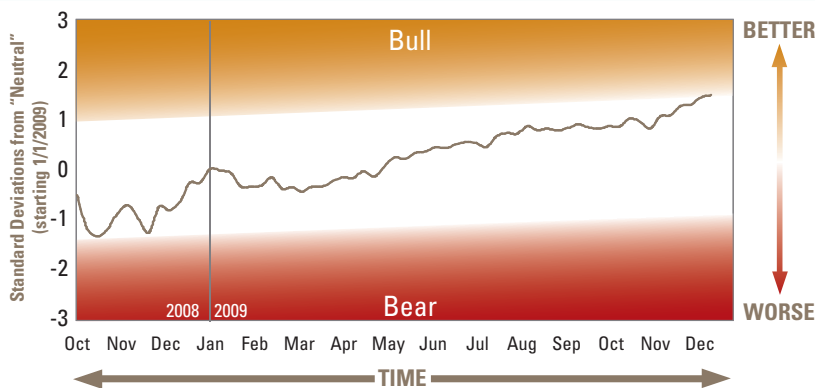
At the start of March, market and economic conditions mounted a comeback. In the months that followed, the rapid improvement continued and we began to incrementally increase the aggressiveness of our recommendations favoring Small Cap, Emerging Markets, Commodities, and High-Yield Bonds.

### Creating the LPL Financial Current Conditions Index

To provide a real-time, objective, and transparent measure of how the economy and financial conditions were changing we created the LPL Financial Current Conditions Index (CCI). The index is composed of 10 indicators\* that provide a weekly, real-time measure of the conditions in the economic and market environment. The CCI bottomed in March and began to steadily move higher over the course of the year.

Currently, the CCI is tracking to the high end of our base case outlook, established at the end of last year, for mid-teen gains in the stock market and mid-single digit gains in the bond market. As of the beginning of December 2009, the markets have already achieved these gains. However, the CCI indicates the economy and markets are on track for an outcome somewhat better than our original base case outlook for 2009. In fact, measures of stress in the corporate bond market (reflected in the Baa-rated bond credit spread\*\*) and volatility in the stock market (indicated by the VIX<sup>^</sup>) moved back to pre-crisis levels. And, as we had forecast, the economy emerged from recession in the second half of the year with third quarter GDP rising by about 3%.

#### LPL Research Current Conditions Index



Source: LPL Financial

We will continue to closely watch the CCI throughout 2010. We will be looking to see when and by how much the CCI shows a pattern of deterioration which may be a leading indicator of pending broad economic weakness.

### 2009 Base Case Outlook

We summarized our base case forecast in the 2009 Outlook publication as: The financial panic that began in September 2008 will subside in early 2009 allowing a normalization of financial markets by mid-year 2009. More precisely we had forecast:

- The economy emerges from recession in the second half of 2009.
- Inflation turns negative early in 2009, but rises by the end of the year.
- The stock market, as measured by the S&P 500, posts a return in the mid-teens, as a volatile first half of the year gives way to more consistent improvement in earnings and sentiment in the second half. We anticipate the year-end S&P 500 close to be around 1000–1050.
- The bond market, as measured by the Barclays Aggregate Bond Index, posts a return in the mid- to high-single digits range.

#### \*Components of CCI Index

Baa Spreads	Retail Sales
VIX	Fed Spread
Initial Jobless Claims	Rail Traffic
Commodity Prices	Money Market Fund Assets
Business Lending	Mortgage Applications

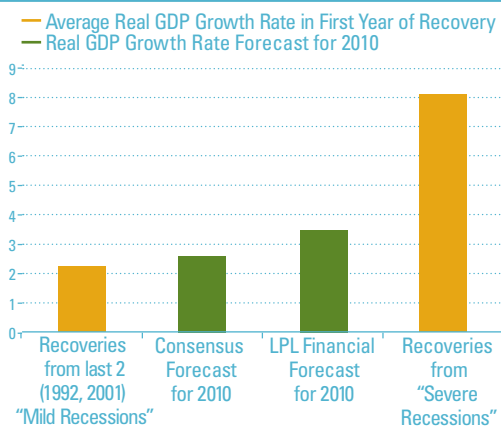
Source: LPL Financial

\*\*The credit spread is the yield on corporate bonds less the yield on comparable maturity Treasury debt. This is a market-based estimate of the amount of fear in the bond market. Baa-rated bonds are the lowest quality bonds that are still considered investment-grade, rather than high-yield. They best reflect the stresses across the quality spectrum.

<sup>^</sup>The VIX is a measure of the volatility implied in the prices of options contracts for the S&P 500. It is a market based estimate of future volatility, which estimates the current degree of fear present in the stock market.



### Consensus GDP Forecast For 2010 Is Still Too Low

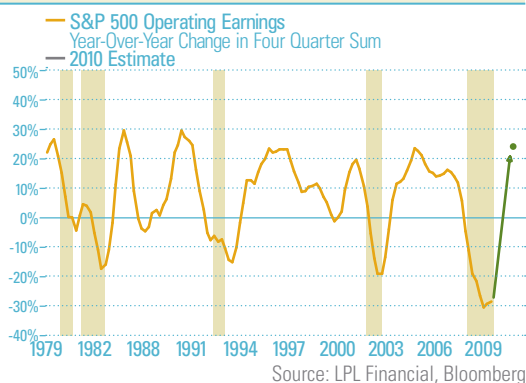


Source: LPL Financial, Haver

## Historic Growth Estimates

- While our forecast for real GDP growth in 2010 is well above the consensus estimate, it remains below the average growth rate for real GDP in the first year of expansions following post-World War II recessions, which is about 6.5%.
- The high forecast among 63 economists surveyed by Bloomberg News is just 5.3%. Excluding the recoveries from the mild 1990-91 and 2001 recessions, the average growth rate in the first year of recovery is 8.1%. The consensus forecast for 2010 of 2.6% is more closely aligned with the average first year growth rate coming out of the "mild" recessions of 1990-91 and 2001.
- In short, given that we just experienced the worst recession since the 1930s, we think that the consensus estimate for real GDP growth for 2010 remains too low, and is likely to continue to rise in the coming months. This further supports our view that the equity markets will continue to move higher in early 2010.

### S&P 500 Operating Earnings Year-Over-Year Change in Four-Quarter Sum



Source: LPL Financial, Bloomberg

## Filling the Sails

In 2010, we expect a modest (by historical standards) recovery in the U.S. economy from what was the most severe recession since the 1930s. Our forecast is for economic growth (as measured by real GDP) in the 3–4% range for the full year 2010, with stronger 3–5% growth in the first half and slower 2–3% growth in the second half.

The question is what will continue to push the recovery forward; the obvious choice is the consumer, which accounts for about 70% of GDP. But history shows that business spending, housing, and more recently exports have led the way out of recession—not the consumer. Our view is that business spending, fueled by robust export opportunities, intense inventory restocking, low financing costs, and solid balance sheets of non-financial companies could drive GDP in 2010, while the consumer contributes modest growth.

While consumers still face a heavy debt burden, businesses generally have good balance sheets. Corporate profits have accelerated at a record-breaking pace since the fourth quarter of 2008. Profits have been boosted by cost cutting on everything including employment, advertising, capital spending, travel, inventories, and more. The impact of aggressive cost cutting is being magnified by the return of revenue growth. An unprecedented globally synchronized rebound is lifting sales for corporations.

## Earnings

As earnings rebound, businesses are looking to reinvest for growth. The rebound in corporate earnings from the early 2009 low has been powerful. Third quarter 2009 earnings results reflected a record-breaking number of companies beating estimates as rising revenue is boosted by wide profit margins. In addition, profits are being lifted by the declining dollar through the translation of foreign-derived profits and increasing U.S. export growth. This combination should allow for businesses to be powerful engines for growth in the coming quarters as spending and hiring returns.

We expect profits for the companies in the S&P 500 index to rise 25% in 2010. While this may seem like an unusually large rebound, by historical standards this would be merely a typical rebound from a recession. In fact, to put the rebound in context, by year-end 2010 we expect S&P 500 earnings to rebound only back to about \$76, where they were in 2005, which is about 20% below the trailing four-quarter earnings peak that took place back in mid-2007. We believe this is reasonable, though possibly conservative, given the mix of drivers in 2010 including very wide profit margins driven by aggressive cost cutting, offset by continued skittish business and consumer spending patterns.

## Valuations

While the rise in valuations has powered the stock market rally thus far, earnings growth—the most important driver of stock market performance—is now on the rise. Yet rising valuations (as measured by the forward price-to-earnings ratio or P/E) may also contribute to gains for stocks in early 2010. During the past 30 years, the average rebound in stock market valuation associated with the end of a recession has been 37% over the 14 months following the low in the stock market. These are the periods that followed the S&P 500 low point in 1982, 1990, and 2002. P/Es are currently tracking the average of the three prior scenarios very tightly which suggests some further room for improvement in valuations.



A continued rise in the P/E from the low of 11.30 at the start of March 2009 to the historical average expansion of 37% would produce a peak P/E of 15.25 at the start of May 2010, 14 months after the market bottom. The S&P 500 is tracking the average very closely since the March 2009 low, with room for improvement. A P/E of 15.25 on earnings estimates at the start of May 2010 suggests double-digit gains on the S&P 500 at the valuation peak in 2010 from current levels, supporting our recommendation to overweight stocks early in the year.

As the confidence of business leaders improves, buoyed by rebounding earnings and stock prices, they are likely to reverse the trend of cost cutting and begin to spend again. In fact, we are starting to see signs of this in merger and acquisition (M&A) activity. A M&A rebound has often been an indicator that the return of business confidence and improvement in the credit markets is contributing to a sustainable recovery. In the past, the revival of M&A deals was a sign that businesses were ready to prepare for growth by hiring workers. Companies often shift their concern from weathering the downturn to taking advantage of opportunities for growth. They do this in part by buying up their competitors at relatively cheap prices once the economic backdrop and credit markets improve sufficiently.

For example, during the last business cycle, job growth finally turned positive around the end of 2003 at the same time M&A activity revived, which came about 9–12 months after the stock and credit markets began to recover in March of 2003. The return of M&A activity in the U.S. bodes well for employment.

### Unemployment

We expect job growth to return in early 2010, about 9–12 months after the market low in March 2009. While a lagging economic indicator, a turnaround in employment is essential to a sustainable recovery. First time filings of claims for unemployment benefits peaked in early 2009 as businesses cut payrolls to the bone in late 2008 and early 2009. As we enter 2010, these claims are only now back to where they were before Lehman Brothers filed for bankruptcy in mid-September 2008. Still, the more than 200,000 drop in the number of claims filed since the peak in late March 2009 suggests that the layoffs are subsiding, and that the economy is no longer tracking toward the “jobless” recoveries of 1991 and 2001. Rather, the claims data, as well as the leading indicators within the monthly labor market report, suggest that the economy is on track to post modest job gains by early 2010 and a return to job growth would help to reinforce the durability of the recovery.

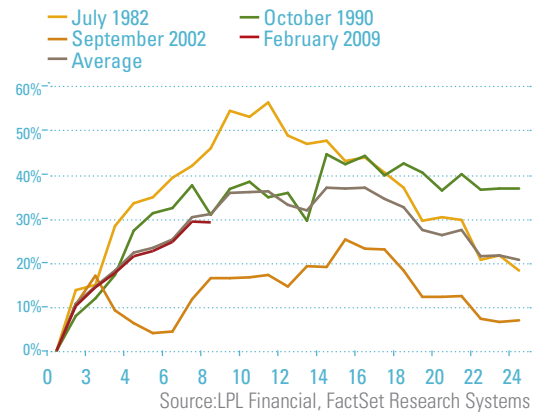
### Fixed Income

The improving backdrop for the economy and profits combined with cheap valuations caused credit spreads to narrow sharply in 2009. Mortgage-Backed Securities\* were the first to improve as Fed purchases led to narrower yield spreads to Treasuries. Corporate bonds soon followed and received an added boost from stronger than expected earnings and corporations cleaning up their balance sheets. Corporate bonds, Investment-Grade and High-Yield, posted record outperformance at the expense of Treasuries.

While Corporate Bonds improved a great deal, yield advantages to Treasuries still remain wide by historical comparison. Once corporations embark on a path of de-leveraging and cleaning up balance sheets, corporate bonds benefit over long periods of time. Corporate credit quality trends tend to be long lasting. Yield spread contraction during 2009 has been sharper than prior

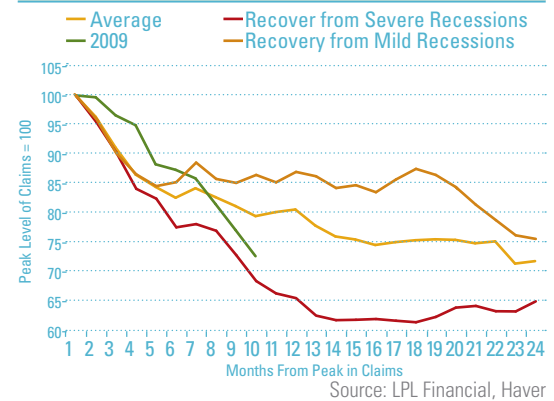
#### S&P 500 Valuation Tracking Path of Prior Post-Recession Recoveries

S&P 500 Forward Price-to-Earnings Ratio Recoveries in Months from the Low in S&P 500 Index



#### Claims Data Suggest Job Growth Is At Hand

Initial Filing for Jobless Claims (Four Weeks Average)

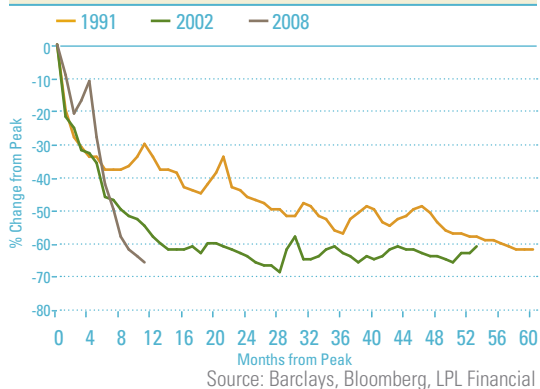


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\*Mortgage-Backed Securities are subject to credit risk, default risk, and prepayment risk that acts much like call risk, where you get your principal back sooner than the stated maturity, as well as extension risk, the opposite of prepayment risk, and interest rate risk.



### Credit Quality Trends Tend to Be Long Lasting Corporate Yield Spread Moves



recoveries, but the magnitude of 2007 damage was certainly greater than what took place during the prior mild recessions in the early 1990s and 2000s. Therefore, as companies' financial health continue to strengthen, the prospect of narrower yield spreads suggests additional room for improvement.

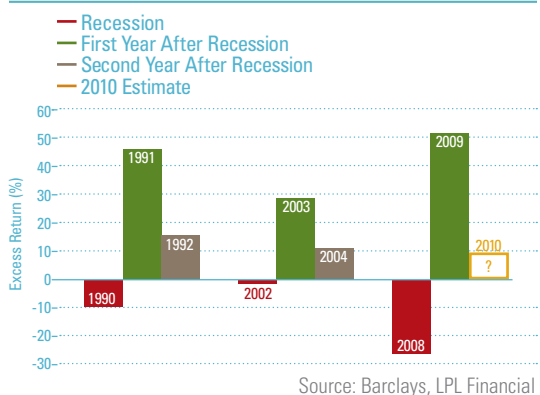
This trend is particularly evident in High-Yield Bond performance. Following the past two recessions in the early 1990s and 2000s, High-Yield Bonds posted impressive outperformance for the subsequent two years following a bottom in the economy and a period of underperformance. High-Yield Bonds will likely benefit from a sharp decline in the default rate, as it falls to 4.5% according to Moody's. Such a sharp decline bodes well for High-Yield Bond spreads to contract further while at the same time collecting a yield that remains very high compared to other bond sectors. Interest income will be an important driver of performance in 2010 given the prospect of weaker bond prices.

### How to Position Portfolios for the Tailwinds

As we look out to the beginning of 2010, we continue to favor the aggressive investment stance we adopted over the course of 2009.

- We recommend overweighting stocks particularly Cyclical sectors, U.S. multinational companies, and Emerging Markets. We also favor the economically sensitive Commodities asset class.
- In the bond market, we prefer higher-yielding Corporate Bonds and Emerging Market Bonds. These preferences are driven by our outlook for continued economic recovery as the tailwinds of 2009 continue into the first half of 2010. We expect further improvement in the bond market and a decline in the value of the dollar.

### Credit Quality Trends Reflect in Performance High Yield Excess Returns During & Following Recessions



### It's The Economy

Historically, when confidence returns to the financial markets, investors tend to target economically sensitive asset classes. As investors increasingly adopt our belief that the recession is over they are likely to seek the traditional beneficiaries of recovery, favoring the sectors and asset classes highly correlated to the economy. We believe cyclical sectors, like Information Technology, Consumer Discretionary, Materials, and Industrials will continue their strong performance.

### Pedal to the Metal

We remain committed to our bullish outlook toward the Commodities asset class, especially those integral to the manufacturing process. The key driver remains demand-driven growth from China. In addition, we expanded upon our optimism toward commodity-driven investments by also looking favorably on precious metals like Gold and Silver. We believe these metals should benefit from increased demand and a declining dollar as well as serve as a partial hedge for inflation.

The fast price swings in commodities may result in significant volatility in an investor's holdings.

### Growth at This Price

Earlier this year, with the U.S. economy firmly entrenched in a recession, we maintained a neutral stance between the Growth and Value styles of investing in our allocations. Historically, Value tends to outperform Growth from the trough to the end of a recession. As the U.S. economy exited the recession, we introduced a relative overweight to Growth. Our favorite sectors include



the traditional growth sectors, such as Information Technology, Consumer Discretionary, and Industrials. Growth sectors tend to have more exposure to strong emerging market demand, and rising merger and acquisition activity, as well as better balance sheets and earnings growth prospects.

### Sometimes Smaller is Better

We favor the stocks of mid- and small-size companies. These companies have outperformed their larger peers since the market bottom in March 2009 as has generally been the case during economic recoveries. Smaller companies are beneficiaries of improving credit markets. Also, the revival of merger and acquisition activity acts as a positive for the small- and mid-sized companies, often the target of larger buyers. The strong returns of these companies throughout 2009 has caused their prices to rise. We expect the relative outperformance of smaller companies to become more muted given their increasing valuations. During the first half of 2010, opportunities should be taken to lock in some gains and trim exposure to these asset classes to prepare for the second half of 2010 where larger cap, multinational companies will likely fare better

Small Cap stocks may be subject to a higher degree of risk than more established companies' securities. The illiquidity of the Small Cap market may adversely affect the value of these investments.

### Emerging Opportunity

We have favored Emerging Market stocks to International Developed markets as the global economy rebounds. These markets are highly leveraged to economic activity and have an abundance of capital to finance growth. China remains a powerful end market for the products of Asian emerging market companies. Our outlook for a steady decline in the value of the dollar also benefits this asset class.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

### Can't Take Enough Risk in Bonds

We believe the fixed income markets continue to provide the best opportunities investors have had in several years. Though some investors view bonds as the safety net that helps limit the potential downside of a portfolio that also contains stock market exposure, at times, aggressive fixed income strategies can offer tremendous capital appreciation opportunities.

We strongly prefer High-Yield Bonds and Emerging Market Bonds to higher quality bonds. We expect these more aggressive bond markets to benefit from contracting yield spreads, declining default rates, and improving financial conditions. The yield advantage is significant enough to provide attractive returns in both up and down interest rate environments. Should the Fed increase interest rates more than anticipated Bank Loans could supplant High-Yield Bonds as a better option. Not only are Bank Loans senior to traditional High-Yield Bonds, but also yields would increase along with Fed rate increases since Bank Loans pay a floating rate. The seniority of Bank Loans would provide greater protection against weaker credit conditions late next year.

These key themes remain reflected in our manager recommendations and asset allocation as we enter 2010.

For a more in-depth view of how these areas will be directly impacted by the tailwinds and headwinds in 2010, please refer to the 2010 recommendations Outlook at a Glance on pages 4 and 5 of this publication.

# Headwinds



## A Renewed Slowdown

Economic and market stimulus is being applied on an unprecedented scale to reverse the effects of the financial crisis. These actions created powerful tailwinds for growth. However, when you borrow from the future, eventually the future comes knocking. The cost of the stimulus will begin to be felt in the second half of 2010. The actions that allowed the healing to take place will be ending, or may even reverse, and that could create a renewed slowdown or, in the worst case, a small contraction in the economy as the tailwinds turn to headwinds.

### We forecast a shift from policy that will slow economic growth.

- The Fed will begin to hike interest rates and end its program supporting the Mortgage-Backed Securities market.
- In the bond market, the Fed presents headwinds on two fronts. First, the Fed will end its purchase program of Mortgage-Backed Securities in early 2010. Secondly, Fed interest rate hikes will pressure bond yields higher and prices lower.
- Outside the U.S., other countries, including China, will increasingly pull back economic stimulus.
- The dollar will begin to rise, weighing on corporate profits and export growth.

As job losses end in the first half of 2010, the transition from recovery to sustainable growth allows the Fed to begin to raise rates in the second half of 2010, slowing the pace of economic growth closer to 2–3% from the 3–5% growth rate we expect in the first half of 2010. This pace is close to the 2.6% growth rate experienced by the U.S. economy over the past 20 years. The consensus is looking for roughly the same growth rate—2.5–3%—in both the first and second halves of 2010.

Additionally, the headwind of a globally synchronized withdrawal of stimulus could result in a global economic slowdown in the second half of 2010 after a strong start. Still, the economic growth in China and other emerging markets is expected to remain in excess of the U.S. As a result, exports and profits of U.S. multinational corporations should be well supported in 2010 even after the Fed raises rates in the U.S.

With the U.S. recovery tied to export-driven business capital spending, the overseas economies—especially in emerging markets and China—are key. Nearly half of all U.S. exports go to emerging markets, up from 30% 10 years ago and 25% in the mid 1980s. In the near-term, the tailwinds of growth are likely to continue to support strong growth in emerging Asia. But the consequences of high inflation on labor costs and consumer spending may require action by Chinese officials by mid-2010. If China begins to rein in stimulus in mid-year 2010 they will likely be in sync with the rest of the world with the U.S. Federal Reserve likely to join Australia, Canada, and other central banks in hiking rates around or after the middle of 2010.

## The Fed's Message to the Markets

An important signal to the markets will be the message from the Fed. Historically after the Fed sends the message to the markets that hikes may be coming, market trends have reversed course. In their public statements, the Fed continues to include the phrase "extended period" as it relates to how long they intend to keep rates this low. The equivalent phrase the Fed used last time, from August 12, 2003 to January 28, 2004, was "considerable period". During that period of time, stocks rallied and the dollar fell. Currently, those same performance trends are in place and have been since the Fed began to use the phrase "extended period" to describe their outlook on rates on March 18, 2009. The Fed removed the phrase "considerable period" from their statements about five months before the first rate hike in the middle of 2004. Removal of the phrase signaled pending rate hikes and stock market performance stalled and the dollar reversed trend to steadily moved higher.

We expect the Fed to begin to hike rates in the second half of 2010. As a result, we expect that the Fed may not remove the "extended period" phrase (or may incorporate language with a similar effect) as a signal of coming rate hikes until sometime during the first half of 2010.

Once the Fed communicates its message about rate hikes to the market, stock prices may decline. We expect stocks to post gains early in the year that may later be cut in half to end the year up only modestly with single-digit gains. A tactical asset allocation shift to underweight stocks, especially cyclical sectors along with the stocks of small- and mid-sized companies, may be appropriate at that time.

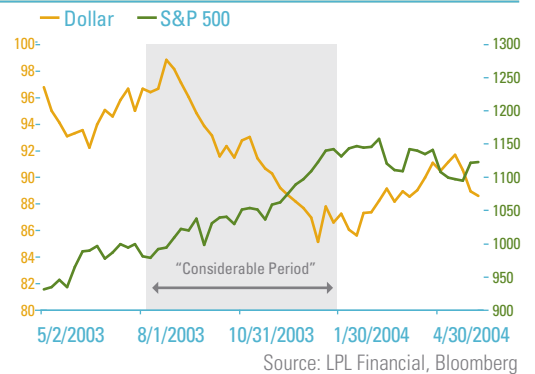
The message from the Fed may also result in a rise in the dollar. The outlook for higher interest rates on dollar deposits would curb the selling of dollars to fund foreign-denominated investments. It is likely that the source of financing for the "carry trade" would shift back to Japan—currency futures reflect far less rate hikes in Japan than in the U.S. resulting in a much lower short-term lending rate.

A reversal in the trend of the dollar would have the effect of weighing on commodity prices and the performance of foreign stocks. These asset classes are also economically sensitive and may suffer as investors favor more defensive investments. It may be difficult to escape the slowdown by investing overseas with the stimulus around the world fading as 2010 unfolds—even in China as loan growth slows. The same synchronized business cycle may result in slowing in all parts of the globe. A tactical asset allocation recommendation to trim Commodity and foreign asset class exposure may be warranted as the intentions of the Fed (and other central banks around the world) are communicated to the markets.

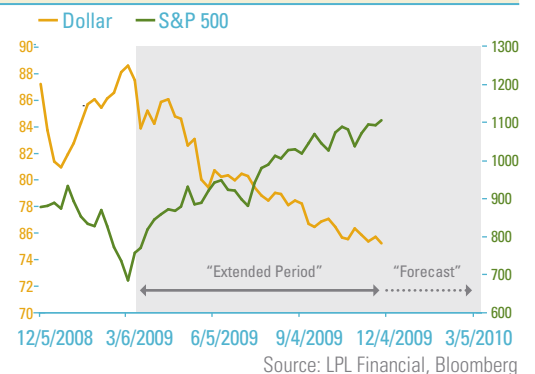
## Spread Thin

In the bond market, the Fed presents headwinds on two fronts. First, the Fed will end its purchase program of Mortgage-Backed Securities in early 2010. The Fed's purchase program helped push MBS yield spreads to Treasuries to historically narrow levels. Removal of this key support will likely result in wider MBS yield spreads. In turn, wider MBS yield spreads may entice investors away from other segments of the high-quality bond market such as corporate bonds. Wider yield spreads could exert downward pressure on bond prices throughout the high-grade bond market.

"Considerable Period" = Good for Stocks, Bad for Dollar  
Performance of Dollar and S&P 500 during period leading up to the first Fed rate hike on 6/30/04



"Extended Period" = Good for Stocks, Bad for Dollar  
Performance of Dollar and S&P 500 during past 12 months



The S&P 500 is an unmanaged index which cannot be invested in directly. Past performance is no guarantee of future results.



## Fed Up

We expect the Fed to hike interest rates in 2010. The Fed pushed down hard on the “economic growth” gas pedal in 2008 and 2009 by lowering short-term interest rates to zero which helped to lower funding costs for banks and provided the economy with much needed credit.

There are three ways the Fed may apply the brakes in 2010.

- **Go Slow:** Given the fragility of the U.S. banks the Fed may slowly apply the brakes with a gradual path back to normal with 25 basis point rate hikes at each meeting starting sometime around middle of 2010. At this pace, it will take a long time to get rates back to a neutral level of about 3%. This slow pace risks leaving the money in the economy too long resulting in too many dollars chasing too few goods and services, potentially creating an inflation problem. Also, hiking rates this early, while the recovery in the economy and banking system are still tentative, may risk taking the stimulus away too soon.
- **Slam on the Brakes:** The Fed could wait to start to hike rates until late in 2010 or early in 2011, when it becomes more confident in the sustainability of the recovery. However, waiting this long may require the Fed to be more aggressive to avoid inflation and may prompt them to hike rates by 150 or 200 basis points all at one time. This risks a destabilizing shock to the financial system.
- **Pump the Brakes:** We believe the more likely path of Fed hikes is one akin to pumping the brakes. They may wait until the second half of 2010 then hike rates by 50 or 75 basis points then pause to assess the impact on the economy and financial system. Then, after several months, repeat the approach with another hike of 50 or 75 basis points and a pause. This course of action has the benefit of timely withdrawal of the unprecedented amount of economic stimulus to avoid inflation, but also allows for a wait-and-see approach to ensure the healing that has taken place is not undone.

Secondly, Fed interest rate hikes will pressure bond yields higher and prices lower. In 2009, MBS and Investment-Grade Corporate Bond yields declined while Treasury yields increased (resulting in a sharp reduction or narrowing in yield spreads). The narrower level of yield spreads means much less capacity to absorb higher interest rates via still narrower yield spreads. In sum, Fed rate hikes may be felt through the entire high-grade bond market without much of a buffer.

Normally, interest income acts as a buffer in rising interest environments, but that capacity will be limited in 2010. With high-grade bond yields at or near historic lows, interest income has a limited ability to offset the price declines associated with rising interest rates.

We expect Treasury yields to increase by roughly 0.50% to 1.00% in 2010. Fed rate hikes will be the primary driver and as we approach the end of 2010, higher inflation expectations for 2011 will pressure intermediate- and long-term bonds. We expect the yield curve to flatten as short-term yields rise more than long-term yields but remain relatively steep by historical standards as the Treasury shifts more issuance to intermediate- and long-term maturities. Low inflation should keep the rise in interest rates relatively modest but should inflation surprise to the upside we would expect yields to rise by more than 0.50-1.00%, a scenario that might lead to negative returns.

The bond market may post flat-to-mid single digit gains in 2010 (as measured by the Barclays Aggregate Bond Index) as higher interest rates and wider spreads in the later part of 2010 pressure bond performance. Within the high-grade market we expect Investment-Grade Corporate Bonds to fare best and post positive returns.



## How to Position Portfolios for the Headwinds

As 2010 unfolds, and we see a renewed slowdown in the economy and a potentially challenging latter half of 2010 for investors, a transition to defense may be the best offense. A prudent plan of action may be trimming exposure to those investments that benefited from the tailwinds to lock in profits, to shifting the proceeds into those investments that may benefit from rising headwinds.

### Going Alt

Going to cash is unlikely to generate positive performance during volatile markets in 2010. Instead trimming the overweight to the stock market and tactically adding those assets to more defensive asset classes, including Alternative Strategies, may help to preserve these gains during the headwinds of the later part of 2010. These strategies, including Global Macro, Covered Call, Long/Short, Market Neutral, Absolute Return, and Opportunistic Balanced, have shown the ability to benefit from the return of volatility and provided an effective hedge for our portfolios during the declines in early 2009.

Alternative investments may not be suitable for all investors and should be considered as an investment for the risk capital portion of the investor's portfolio. The strategies employed in the management of alternative investments may accelerate the velocity of potential losses.

### Defense as the Best Offense

The shift in policy from tailwinds to headwinds may support taking profits by trimming stock market exposure, especially in smaller companies and Emerging Markets. Also, within the stock allocation, this may entail a shift from cyclical to more defensive sectors such as Consumer Staples, Health Care, and Telecommunications.

### From High Yield to High Quality

Prudent investment planning may include a shift from High-Yield and Emerging Market Bonds favored by the tailwinds to the use of Treasury Inflation-Protected Securities (TIPS) and other high-quality bonds to help to preserve these gains during the headwinds of the later part of 2010. TIPS may play a dual role to protect against higher inflation while adding a high-quality element that might benefit from weaker credit conditions. Credit conditions may begin to worsen in late 2010 as the outlook for profit and economic growth begins to weaken adversely affecting Investment-Grade Corporate Bonds. TIPS would benefit from a market shift to higher-quality bonds. Also, to the degree that inflation exceeds expectations or the Fed interest rate hikes surpass expectations, defensive Short-Term Bond positions might become appropriate. If interest rates increase by more than 1.0%, the broad bond market may face negative total returns necessitating a shift to Short-Term Bonds since interest income generation may not be sufficient to offset price declines on Intermediate-Term Bonds.

High Yield/Junk Bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

## Déjà vu?

While some forecasters are reaching back to the 1930s to find comparisons to the environment the markets are likely to encounter in 2010, we find a more recent comparison to be compelling. We believe that 2004 could be a useful guide to what may happen in 2010. After all, 2009 looked a lot like 2003. Consider that in both 2003 and 2009:

- The S&P 500 index started the year at about the 900 level and closed in on 1100 as the year wore on;
- The stock market made its low in March in the aftermath of a recession brought on by a bursting bubble in the financial markets;
- Key economic barometers like the Institute for Supply Managements (ISM) Purchasing Managers Index rose above 50 in the second half of the year signaling the return of expansion in the manufacturing sector; and
- The dollar fell and commodity prices rose.

Just as 2009 echoed 2003, 2010 is likely to be similar to 2004 in a number of areas, including: earnings growth for S&P 500 companies, the actions by the Federal Reserve, the pace of economic growth, the outcome of the congressional elections, and the performance of the stock and bond markets.

- In 2004, earnings growth for S&P 500 companies rebounded 25%. That is the same gain forecast by the analyst consensus for 2010.
- The Federal Reserve began to hike interest rates in mid-2004. Similarly, we expect the Fed will to begin to hike rates around mid-2010.
- We expect the Fed to abandon use of the phrase "extended period" in their statements as it relates to how long the Fed intends to keep rates low in the early part of 2010, just as they abandoned a similar phrase "considerable period" in early 2004, signaling the rate hikes to come.
- GDP growth remained around 3%, similar to our outlook for 2010.
- In 2004, the Republicans picked up seats in both the House and Senate. Based on polling, Republicans appear likely to pick up seats in both chambers in 2010.
- The S&P 500 was up 9% in 2004 and ended the year around 1200, similar to our outlook for a mid-to-high single-digit gain. The bond market, as measured by the Barclays Aggregate Bond index, posted a gain of 4%; similar to our outlook for weak returns in the bond market in 2010.

# Crosswinds

## Risks to Our Forecast



Tailwinds in the form of global monetary and fiscal stimulus are likely to keep the major stock and bond indexes sailing higher in early 2010. But as headwinds arise there may be a renewed slowdown in the economy and a potentially challenging latter half of 2010 for investors. However, throughout 2010 there are crosswinds that may make this transition uneven and introduce risks to our forecasts.

Every good sailor knows how to look out across the water to watch for the wind. Sometimes a single good crosswind or puff will be enough to help you round the mark ahead of your competitor. While your investments are not a race, paying attention to the potential crosswinds in 2010 can help you better navigate potentially choppy conditions.

These crosswinds may take the form of legislation in Washington, the value of the dollar, the budget deficit, higher taxes, the difficult choices facing China in 2010, the health of state and local governments, and commercial real estate markets, among others. We address how these issues will affect the markets in 2010 and how investors may profit from or protect their investments against their impact.

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**GOLD** AT  
NEAR **RECORD** HIGH  
ON GROWTH, NOT FEAR

**Gold is benefiting from three trends: dollar weakness, Chinese consumption, and reflation.**

As the dollar has fallen, the price of gold in dollar terms has risen to an all-time high. We expect the dollar to continue to modestly decline. As institutional investors seek to invest in the markets they often borrow where they find the lowest rates. Some of the lowest short-term rates in the world are currently found in the U.S. After borrowing in dollars, leveraged investors sell the dollars to buy foreign denominated investments. As risk appetite increases, it leads to more selling of the dollar. This carry trade may end when the Fed begins to hike rates in mid-2010.

Gold demand in China and India—historically the largest consumer of gold—has been strong. This helped to fuel the latest surge in gold to well over \$1,000/troy oz. The rise of the middle class in China has boosted the wealth of citizens as the economy grows powerfully creating a lot of demand for jewelry, both as a luxury and as a savings vehicle.

As concern over inflation begins to take hold, gold demand is rising as an effective hedge against unexpected inflation.



Rather than a sign of increasing fear, rising gold prices are the result of the global growth tailwinds and being driven by factors common to many commodities. In addition, while rising inventories of copper and other base metals relative to demand for finished goods may cause investors to fear a decline in base metal prices, unlike these commodities, gold is generally not used as a raw material in the production of other goods. Support for all commodities, including gold, may fade as headwinds arise in the latter part of 2010.

**According to recent polling data, the federal budget deficit is a top issue with voters.** The deficit ranks ahead of other issues such as health care, national security, and other considerations.

One year ago, the forecast for the budget deficit for 2009 was 2% of GDP, now it is expected to be 10%. The government is issuing record amounts of debt. Yet, even though the deficit may appear to be soaring out of control, interest rates have remained at historically low levels and stocks have rebounded about 60% from the lows of March 2009. Foreigners have demonstrated a continued willingness to buy our debt.

The stability in government bond yields and the extended stock market rally may be because market participants view the current surge in borrowing as a temporary boost to the economy and not part of a sustained trend. Whether market participants are right or not will depend in part on a potential second stimulus package, the cost of the health care bill, the tax increases associated with climate change, and the healing in the economy.

Market participants are not pricing in a second stimulus package; however, if conditions take a turn for the worse, stimulus could be back on the table.

In its current form, the Senate Health Care bill involves increasing taxes and cutting benefits a full four years before coverage begins to be extended to the uninsured. This keeps the cost of the bill down over the 10-year cost horizon and means limited budget impact in the next few years.

The cap and trade bill passed by the House at the end of June 2009 represents a tax increase that could reduce the deficit. However, the magnitude of the reduction is relatively small, and there is skepticism that the Senate will pass the bill. Should changes be made to make the bill more palatable to moderate senators, it could end up adding to the deficit rather than reducing it.

A surprise to the assumptions investors have priced into the markets, which could lead to even higher deficits, may cap the rally that has lifted stocks and result in a sell-off in government bonds.

**November 12, 2009 marked the 10th anniversary of the passage of the Gramm-Leach-Bliley act — the financial “reform” act that sowed the seeds of the recent financial crisis by effectively repealing the Great Depression-era Glass-Steagall act of 1933.** With sweeping financial industry reform again on Washington’s agenda we are watching developments closely. Many changes to the financial industry and institutions have already taken place, such as the investment banks converting to commercial banks under the jurisdiction of the Fed, greatly

## ATTENTION ON THE DEFICIT DISORDER

### Funding the Deficit

To fund the deficit, the U.S. Treasury will issue \$2–2.5 trillion in new bonds in 2010, slightly more than the \$1.9 trillion pace of 2009. Furthermore, the Treasury intends to gradually increase the bulk of issuance to longer maturity 10- and 30-year bonds. Heavy issuance and a shift towards longer-term, more interest rate sensitive bonds will be a negative for the bond market. However, Treasury yields declined over the second half of 2009 even though issuance was accelerating. Issuance is just one factor and we believe that the Federal Reserve actions and inflation rates, historically the two primary drivers of the bond market, will remain the pre-dominant drivers of interest rate levels in 2010.

## RISKS POSED BY FINANCIAL REFORM



## Dividends Shift from Elimination to Reinstatement

Most companies in the S&P 500 pay a dividend. Many financial companies (and some non-financial ones) were forced to eliminate their dividend to preserve cash during the recession. In the current recovering environment, an increase or reinstatement of the dividend payment may signal more confidence in a sustained recovery by business leaders than any guidance they are likely to give on their earnings outlook. Investors may increasingly turn to dividends as a gauge of financial health. After all, dividends cannot be restated or written off. The simple clarity of a dividend increase speaks loudly amid the complexities of the current environment surrounding earnings accounting. We expect to see sectors that do not traditionally pay dividends, like Information Technology, to provide some of the best dividend growth rates in 2010.

reducing leverage, and revamped lending practices. The additional reform measures being debated in Congress have the potential to limit future financial crises; however, they also pose the threat of unintended negative consequences over the long-term, as the Gramm-Leach-Bliley act did. Several potential consequences include:

- Institutions designated as “too big to fail” may have cheaper access to capital owing to their implied government-backing. This could result in industry consolidation that would concentrate the industry in the hands of fewer, larger, and more systematically important institutions rather than a larger number of smaller institutions that would pose risk individually to the financial system. If this occurred it would be contrary to the supposed intention of the legislation.
- Stripping the Fed of its regulatory function may limit the dissemination of information necessary to make knowledgeable and effective monetary policy decisions. In addition, any politicizing of the Fed may have negative consequences.
- These reforms fall short of creating a global financial framework for dealing with financial crises. There is little hope of broad reforms in the near future. Europe remains divided with each country regulating its own financial industry. Without a global framework among the G20 to oversee the global financial industry, the patchwork of regulatory oversight will remain with the potential for loopholes and the ability of institutions to seek jurisdictions with the lightest regulation.

There is some pressure to pass reforms ahead of the November 2010 mid-term elections. We will continue to respond to how the legislative and regulatory reforms evolve and impact investment decision making in 2010.

## HIGHER TAXES

Whatever the form of the final health care changes, one outcome of any legislation is likely to be a tax hike for top wage earners. In fact, taxes will be headed higher even in the absence of legislation, since the tax cuts of 2001 and 2003 will expire at the end of 2010 if not extended by Congress. However, it is hard to separate the impact of tax code changes from the economic backdrop for both the stock and bond market to determine what market participants are expecting. Historically, changes in tax rates appear to have had little, if any, direct impact on government bond yields. Yields rose with inflation in the 1970s and fell as inflation fears receded over the vast majority of the last 30 years, regardless of tax code changes or their impact on the deficit. To see why this has also been the case for stocks we can look at earnings and valuation.

### Earnings

Generally, higher taxes mean less of an incentive for individuals to work, invest, take risk to create value, and become entrepreneurs. They can also mean less disposable income to spend on goods and services. However, income tax changes have not had much measurable effect on earnings growth. Earnings growth is very cyclical—it falls sharply during recessions and rebounds early in expansions to average about a 7% growth rate over the full cycle. This pattern has been consistent regardless of the prevailing tax rates. In fact, the growth rate of earnings from the peak of one business cycle to the next has consistently been about 7% over the 6 major earnings



cycles spanning the past 50 years, despite average top marginal income tax rates that ranged from 91% at the beginning of the period to the current 35%. Investors appear to be pricing in the Wall Street analyst consensus for a typical cyclical recovery in earnings growth in 2010 of about 20–25% and a longer term growth rate of about 7%, without any direct impact from the likely tax code changes.

### Valuation

Over the past 30 years, higher effective federal tax rates for the top 20% of earners (who tend to make up the majority of individual investors) have not resulted in lower stock market valuations, measured by the forward price-to-earnings ratio (the current price divided by the next 12-months expected earnings) for the S&P 500 index. Counter-intuitively, periods of higher valuations were during periods of higher effective tax rates, and lower valuations when tax rates were lower. However, much of this market history can be explained by cyclical factors. For example, in the late 1990s, stock market valuations rose to record highs despite relatively high marginal and effective tax rates. With the forward P/E for the S&P 500 near the long-term average, market participants do not appear to be factoring in any impact on valuation from potential tax changes.

**Two important fundamental drivers remain in place that should mute the impact of higher interest rates on the municipal market.** First, new issuance is expected to be light as the Build America Bond (BAB) program continues to siphon away issuance from the traditional tax-exempt market. Second, the Bush tax cuts expire at the end of 2010 and the top tax bracket will revert back to 39.6% from 35%. Furthermore, the current version of the health care bill calls for a substantial increase in the top bracket for high-income earners. The prospect of higher tax rates bodes well for higher municipal bond valuations. Valuations can be measured by comparing municipal yields as a percentage of comparable Treasury yields: the higher the percentage (or ratio) the cheaper, or more attractive, municipals are relative to Treasuries and vice versa. Current Municipal-Treasury yield ratios do fully factor in the prospect of higher tax rates.

However, we expect municipal bond performance to slow in 2010. After an impressive 2009, higher municipal bond valuations and the prospect of higher interest rates will likely lead to lower returns. We expect municipal bonds to outperform Treasuries, but much of it will come in the form of playing “better defense.” As Treasury bond yields rise, municipal yields will likely be more resilient as valuations remain attractive in addition to favorable tax and supply dynamics. As an example, if 30-year Treasury yields rise just over 1% to 5.5%, long-term AAA municipal yields may remain unchanged at 5% and put them in line with their long-term 91% ratio relative to Treasuries.

## HIGHER INTEREST RATES & MUNICIPAL BONDS

### Build America Bonds (BABs)

The \$787 billion American Recovery and Reinvestment Act included the BAB provision to allow municipalities to issue taxable bonds for qualifying infrastructure projects. By expanding the investor base to taxable investors, BAB issuance was intended to facilitate municipalities' ability to obtain funding for important infrastructure projects given still uncertain markets in the wake of the financial crisis. The BAB program has been well received and helped relieve the supply burden facing the traditional tax-exempt municipal bond market. The program may be extended beyond its current expiration at the end of 2010.



## THE UPSIDE OF A DOWN DOLLAR

We expect the dollar to continue to trend modestly lower in the early part of 2010 as investor risk appetite continues to increase. With U.S. overnight lending rates the lowest in the world in 2009, the United States has replaced Japan as the nation funding the so-called “carry trade.”

As markets rally, leveraged investors around the world borrow at very low rates in the United States and then sell those dollars to buy foreign denominated investments; as markets pull back, those borrowers sell their investments and buy dollars to repay the loans. As risk appetite increases, it leads to more selling of the dollar. This carry trade has resulted in an inverse relationship between the dollar and the stock market. This carry trade may end as we approach the beginning of the Fed rate hikes when the lowest rates may once again be found in Japan.

The upside of a down dollar includes boosting the profits of multinational corporations and benefiting exporters by making U.S. produced goods cheaper in foreign markets. The reason that countries do not always try to devalue their currency to gain these advantages is because it typically coincides with higher interest rates, making financing more expensive, and rising inflation which drives up labor costs, so no competitive advantage is obtained. However, in the U.S., interest rates, inflation, and labor costs have remained low effectively giving U.S. companies a competitive advantage. For example, since the recent dollar peak in 2002, the labor cost in dollars per unit of output has risen 76% in Germany and 30% in Japan, while in the U.S. it has only risen by 8%.

A key benefit of a falling dollar for investors is that it boosts commodity prices and the return on foreign investments. We expect the falling dollar in early 2010 to continue to boost the performance of these asset classes.

## MUNICIPAL DEFAULT FEARS OVERDONE

Since state finances lag the broader economy by one to two years, states will struggle with budget deficits in 2010 and likely 2011 as well.

Negative headlines surrounding state budget deficits will therefore persist and state politicians are likely to accentuate the news as they attempt to receive a second round of federal aid. Additionally, media reports have cited impending pension and entitlement costs as another sign of potential doom in the municipal market. While certainly worth watching, pensions are long-term liabilities and what is most important to watch is if or how the pension obligation exceeds the annual debt service costs to finance that future liability. Typically if a municipality falls behind and pension liability expands, revenues are diverted from infrastructure and local services to fund pension liabilities, and not bond obligations.

We view fears of budget issues producing a wave of municipal defaults as greatly exaggerated and not likely representative of what will occur in the municipal market. Through December 2009, roughly \$1.7 billion in municipal bonds have defaulted out of an entire municipal market size of roughly \$1.2 trillion, amounting to a very small default rate of 0.14%. That number will likely increase but it's important to note that the vast majority of defaults have occurred from low-rated or non-rated issuers in the housing sector in a handful of states.

We continue to believe the municipal market will remain resilient to credit challenges. As Moody's highlighted in a long-term study, the cumulative 10-year default rate among investment-grade rated municipal bonds amounted to an average of only 0.10% from 1970 to 2006. Ratings downgrades are to be expected during this difficult period but defaults are likely to be rare for

high-quality issues and manageable for the high-yield segment. States and municipalities have exhibited great flexibility in the past in addressing credit challenges and we expect them to do so again.

**In normal times, the Chinese government uses the banking sector to send masses of low-interest rate loans to companies and sectors targeted for growth.** This maintains growth and employment levels, preserving social and economic stability in a country with a massive population.

In times of stress, this aggressive lending goes into overdrive. The year 2009 witnessed an unprecedented lending surge by Chinese banks, under government direction, to stave off recession in China's domestic economy as exports to the U.S. and the rest of the world plunged. This has been a dramatic success as China's economy rebounded powerfully in 2009.

By the end of 2009, the net new loans fueling this growth are likely to total more than \$1.5 trillion, which would equal over one-third of GDP. This is a massive lending spree, even by China's standards. Much of this lending that was targeted to growth industries has leaked into the stock and real estate markets, which have rallied dramatically and are beginning to form bubbles. With subsidized loans still growing and the global economy now in recovery mode, the threat of double-digit inflation already prevalent in India, another BRIC (Brazil, Russia, India, China) country, is looming.

Attempting to prevent this, authorities have tried several times in 2009 to pull back on lending. Each time sectors of the Chinese economy start to suffer after just a few weeks and the government ramps new loans back up again. The Chinese economy is dependent upon exports. While the decline in China's exports recently narrowed to -9% year-over-year, from more than -20% earlier in 2009, they are still falling. The challenge facing Chinese authorities is how to bring lending down to sustainable levels without sending the economy into a tailspin with global implications. China's authorities can either cutback on lending to curb inflation and risk social unrest and an economic slowdown or wait until exports pick up again at the risk of double-digit inflation. So far, it appears that the Chinese authorities lack the desire to rein in growth and may continue to fuel the rise in asset prices and inflation into early 2010.

**We do not think real estate is the next shoe to drop — it has already dropped with banks failing nearly every week and commercial real estate prices down 15–25% across the country.** This will weigh on the economic recovery but will not prevent it since the magnitude of the commercial real estate problem is much smaller than the residential real estate crisis which is now passing. However, the banks still have tons of commercial real estate debt on their books and it will take a while for it all to unwind. The lenders' stocks seem to have priced in the troubles, but the real estate markets themselves are still in a down cycle. The real estate markets tend to lag the economy by at least a couple of quarters because it takes a while for the economic slowdown to be felt in the form of declining rents and rising vacancies. It has not bottomed yet because companies are still laying people off and stores are still shutting down or reducing space.

However, the real estate companies aren't necessarily in trouble. For those that properly managed debt and used conservative assumptions in their

## CHINA FACES TOUGH CHOICES

## THE COMMERCIAL REAL ESTATE SHOE IS DROPPING



models, there are plenty of opportunities. The only real issue they face is that programs, including non-traded REITs, will take longer to complete. They will need to wait until the markets recover to sell assets. So the REIT companies are attempting to manage these portfolios through a downturn and not lose money on them while they own them, and lowering the dividend is one major lever that they can pull to manage the portfolio. When rents go down with the economy, the yield goes down. Lower yields are a sign of trouble in the commercial real estate markets, but they're not necessarily a sign of trouble for a REIT company, it just means they are paying what they are earning.

The bank stress tests done by the Fed factored in fairly onerous assumptions for future commercial real estate loan losses and still found banks to be well capitalized for the most part. Others raised capital to fill the gap to be well-capitalized even in a bearish (though not unrealistic) scenario. Commercial Mortgage-Backed Securities prices rebounded strongly in the second quarter, suggesting the market became overly pessimistic with commercial real estate forecasts. Stocks of the biggest holders and lenders of commercial real estate—banks, insurers, and REITs—have all rebounded sharply off of their early 2009 lows, suggesting the pessimism was overdone. So while commercial real estate losses ate into profits of other exposed firms (such as banks) during the fourth quarter of 2009, as we get into 2010 the situation becomes much less onerous. Banks are not cheap—they are reasonably valued given the risks.

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## FROM DEFLATION TO INFLATION

As the economy recovers, inflation may become a risk. We are currently seeing deflation, as year-over-year readings on the overall Consumer Price Index (CPI) were negative in each month between December 2008 and October 2009. But by early 2010, deflation will give way to inflation, although only mild inflation. We want some inflation, as the alternative of persistent deflation is what got us into trouble in the 1930s, and what the Federal Reserve has been successfully combating since March 2009 with its programs to pump more money into the economy.

In 2009, intermediate- and long-term Treasury yields rose steadily through the first half of the year as they increased from Depression type levels to reflect a coming recovery. The second half of 2009 witnessed the establishment of a range bound environment anchored by a Fed on hold and low inflation. As we start 2010, low inflation, coupled with a Fed keeping a foot on the gas pedal (by keeping short-term interest rates effectively at zero), should help maintain a trading range in Treasuries.

Inflation expectations, as measured by TIPS, increased at the end of 2009 but still reflect a relatively benign 2.2% inflation rate over the coming 10 years. Inflation, as measured by the CPI index, is expected to remain low for most of 2010. The Fed's favorite measure of inflation excludes the volatile food and energy components of consumer spending. This "core" inflation measure is expected to decelerate well into the second half of 2009. However, as the year progresses, bond yields may rise in anticipation of rising inflation that may arrive late in 2010 and early 2011.



## IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.

Stock investing involves risk including loss of principal.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Small cap stocks may be subject to a higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

High yield/junk bonds are not investment grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.

Municipal bonds are subject to availability and change in price and subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative tax. Federally tax-free but other state and local taxes may apply.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Investing in alternative investments may not be suitable for all investors and involve special risks such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, and potentially illiquidity. There is no assurance that the investment objective will be attained.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

Investing in mutual funds involves risk, including possible loss of principal. Investments in specialized industry sectors have additional risks, which are outlined in the prospectus.

The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield.

Mid capitalization companies are subject to higher volatility than those of larger capitalized companies.

Options are not suitable for all investors and certain options strategies may expose investors to significant potential losses such as losing entire amount paid for the option.

***An investment in a money market fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the Fed seeks to preserve the value of your investments at \$1.00 per share, it is possible to lose money investing in the Fund.***

The Barclays Aggregate Bond Index is composed of securities from the Barclays Government/Credit Bond Index, Mortgage-Backed Securities Index and Asset-Backed Securities Index.

The Standard & Poor's 500 Stock Index (S&P 500) is an unmanaged index generally representative of the U.S. Stock Market, without regard to company size.

Covered Call mutual fund strategies typically hold a long portfolio of stocks and then sell calls. Some covered call strategies then buy puts to further protect against downside risk. The net result is a portfolio that is correlated to the broader markets, but with significantly less volatility and increased risk due to the use of derivatives.

Global Macro funds use fundamental inputs (focused on broad global economic themes) in their models as well as technical (or price related) inputs. Global Macro funds may also be less systematic than the typical Managed Futures fund. Historically, the benefit of global macro has been solid long-term returns with very low correlation to equities and fixed income securities.

Long/short funds focus on managers who go long and hedge against the market through options or shorting equity securities with the goal of outperforming the market while limiting volatility. These funds tend to have a higher correlation to equities than other alternative strategies and, therefore, are most appropriate for more aggressive portfolios.

Consumer Discretionary: Companies that tend to be the most sensitive to economic cycles. Its manufacturing segment includes automotive, household durable goods, textiles and apparel, and leisure equipment. The service segment includes hotels, restaurants and other leisure facilities, media production and services, consumer retailing and services and education services.

Consumer Staples: Companies whose businesses are less sensitive to economic cycles. It includes manufacturers and distributors of food, beverages and tobacco, and producers of non-durable household goods and personal products. It also includes food and drug retailing companies.

Energy: Companies whose businesses are dominated by either of the following activities: The construction or provision of oil rigs, drilling equipment and other energy-related service and equipment, including seismic data collection or the exploration, production, marketing, refining and/or transportation of oil and gas products, coal and consumable fuels.

Financials: Companies involved in activities such as banking, consumer finance, investment banking and brokerage, asset management, insurance and investment, and real estate, including REITs.

Health Care: Companies in two main industry groups: Health Care equipment and supplies or companies that provide health care-related services, including distributors of health care products, providers of basic health care services, and owners and operators of health care facilities and organizations or companies primarily involved in the research, development, production and marketing of pharmaceuticals and biotechnology products.

Industrials: Companies whose businesses: (1) Manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery, (2) Provide commercial services and supplies, including printing, employment, environmental and office services, or (3) Provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

Information Technology: Technology Software & Services, including companies that primarily develop software in various fields such as the Internet, applications, systems and/or database management and companies that provide information technology consulting and services and technology and Hardware & Equipment, including manufacturers and distributors of communications equipment, computers and peripherals, electronic equipment and related instruments, and semiconductor equipment and products.

Materials: Companies that are engaged in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals and mining companies, including producers of steel.

Telecommunications Services: Companies that provide communications services primarily through a fixed line, cellular, wireless, high bandwidth and/or fiber-optic cable network.

Utilities: Companies considered electric, gas or water utilities, or companies that operate as independent producers and/or distributors of power.

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