

January 15, 2010

COMMENTARY

To say the global economy is better today than it was one year ago is analogous to stating that Bernie Madoff had a down year! As 2009 commenced, virtually every country across the globe was facing declining growth and huge economic uncertainty. In response, global governments implemented aggressive, unconventional, and somewhat controversial stimulus programs aimed at jumpstarting economic activity. The intense pain felt around the globe caused policymakers to act aggressively with an eye on the short-term. The efforts seem to be working as economic growth returned to most regions and according to the International Monetary Fund every major economy is poised for growth in 2010. The long-term implications of the massive stimulus efforts will not be known for many years, but in the short term the governments' efforts have arguably helped put the US economy back on a growth trend.

Third quarter US gross domestic product (GDP) was finalized in late December at 2.2 percent. Although GDP was revised down from its initial estimate of 3.5 percent, it was still well above second quarter's decline of 0.7 percent. The third quarter marked the official end of the recession, which began in the first quarter of 2008. The positive GDP was fueled by growth in personal consumption, exports, federal government expenditures, and higher inventories. To put it in context, the recent recession was the longest in history in terms of both length and severity (measured by GDP from peak to trough) since the Great Depression.

The manufacturing index continued to improve during the quarter. The Institute for Supply Management (ISM) Purchasing Managers Index (a proxy for manufacturing activity) improved from 52.6 in September to 55.9 for December. Economic activity in the manufacturing sector expanded in December for the fifth consecutive month. Both new orders and employment continued to move higher, indicating that the growth will likely continue. The ISM's Service Index didn't fare as well in the quarter as the index went from 50.9 in September to 50.1 in December. While slightly declining over the quarter, the Service Index maintained levels above 50 indicating growth in the non-manufacturing sector in three of the last four months. In general the survey indicated that respondents were slightly more optimistic about business conditions moving forward. Services account for about five times the economic impact of manufacturing and are therefore a better gauge of the health of the overall US economy.

Home prices stabilized and began improving in the spring of 2009. The latest Case Schiller Composite 10 Home Index indicates that home prices continued to rise in October, although the rate of increase slowed. Despite the recent increase in prices, homes are essentially selling for about the same level as fall of 2003. Existing home sales continued to improve in the quarter, fueled by low interest rates and the announced expiration of the first-time homebuyer's credit. November's level surged to 6.54 million units, a 44.1 percent increase from a year earlier. The inventory of unsold homes dropped to 6.5 months in November, which compares favorably to last November's reading of 11.0 months. Although the housing market has improved, it remains fragile as heightened foreclosure activity could ultimately send prices lower. In response, the government extended the first-time homeowners credit and expanded the act to include some existing home owners as well. In addition, the government agreed to cover unlimited losses in

mortgage giants Fannie Mae and Freddie Mac through 2012. Both moves are designed to provide a boost to housing activity and prevent future price declines.

Employment is a lagging indicator! However, that isn't much solace for the 15 million plus unemployed in the US. Despite some improvement in the global and US economies, the unemployment rate in the US remains at the highest level since 1983. Companies aggressively cut payrolls in response to the worst recession in over 80 years. The latest unemployment insurance claims numbers indicate that the number of workers filing is declining fairly quickly. However, the latest employment situation survey indicated companies still shed 85,000 jobs in December. Despite December's job losses, the trend is clearly improving as the job losses exceeded 600,000 in each of the first three months of the year. November offered the first monthly increase during the last two years. Additionally, temporary help services added 47,000 jobs in December. Growth in temporary jobs is often a precursor to companies adding permanent jobs as the economic recovery takes hold.

### EQUITIES

What a difference a year makes! Twelve months ago the S&P 500 index dropped 21.9 percent in the fourth quarter and recorded a breath-taking 37.0 percent decline for 2008. In the fourth quarter and calendar year 2009 the S&P 500 returned 6.0 percent and 26.5 percent, respectively. All sectors of the S&P 500 ended with positive returns for the year with particular strength from growth sectors, Technology (61.7 percent) and Consumer Discretionary (41.3 percent). Growth stocks outperformed value stocks by 12 percent or more across the entire cap range from small company to large company stocks. Leadership from Technology companies became clear as the sector ranked among the highest for positive earnings and sales growth surprises during the final earnings season of the year. Healthcare, a large component of the growth indices, reported similar strength in earnings and sales growth and bounced back in the fourth quarter with returns of 9.1 percent. After dramatically cutting costs, companies are running lean and mean, which has fueled solid earnings growth. For the third quarter S&P 500 companies' reported about five positive earnings surprises for every negative surprise - approximately double the normal pattern.

International developed market stocks outperformed U.S. stocks by just over 5 percent for the year despite underperforming in the fourth quarter. A sharp increase in commodity prices provided strong support for resource rich countries, such as Australia and Canada. During the fourth quarter Australia became the first developed country to raise interest rates since the global recession began. Export dependent countries, including Japan and Germany, lagged the broader index as global growth remained weak by historical standards. International stocks did not fare as well as domestic stocks in the last month of the quarter, primarily attributable to a strengthening dollar and its negative affects on returns in foreign currencies. Despite signs of strengthening in France and Germany, fourth quarter downgrades in the credit quality of Greece and Spain government debt and troubled Austrian banks helped push the Euro lower.

The International Monetary Fund (IMF) continues to project emerging market countries, especially China and India, to be the front runners in 2010 global GDP growth. China's growth in 2010 was revised upward to 9 percent versus 2.7 percent projected for the U.S. Emerging markets ended the year with returns of 78.5 percent after declining 53.3 percent in 2008. While American consumers are spending more modestly, China's Ministry of Commerce officials expect their domestic retail sales to grow around 16 percent in 2010. For the first time, Chinese consumers are expected to buy more cars than Americans with long waiting lists for popular models. Surprisingly, annual returns from emerging markets in Europe and Latin America were higher than those in Asia.

## FIXED INCOME

Treasury yields rose during the quarter, especially at the longer end of the curve. 10-year Treasury yields rose from 3.31 percent on September 30<sup>th</sup> to 3.85 percent on December 31<sup>st</sup>. Higher interest rates and a steeper yield curve indicate increasing inflation expectations in the intermediate to long term. However, short term rates were unchanged, indicating little inflation risk in the immediate future. As rates rose, Treasury prices dropped and the 10-year Treasury bond declined 3.6 percent for the quarter and 9.9 percent for the year. A stark contrast to the 20.3 percent gain in 2008.

Flows into bond funds have been stronger than flows into equity funds every month this year. While there were attractive opportunities in the bond and equity markets, investor fund flows clearly show a preference for bond funds. The Barclays Aggregate Bond index returned 5.9 percent in 2009, roughly equal to 2008's returns of 5.2 percent. However, the various bond sectors reversed roles with the winners of 2008 becoming the losers of 2009. At the beginning of the year, Treasury prices were arguably inflated after investors flocked to safety in 2008. In contrast, spread products, such as municipals, corporate bonds, and convertible bonds, began the year trading at an historically large spread. As risk appetite returned, spreads narrowed dramatically and provided equity-like returns for the year, despite more modest gains in the fourth quarter.

At the end of November, international bonds were up 9.6 percent for the year (2 percent above Barclays Aggregate Bond index). However, widening credit spreads and a sudden strengthening of the US dollar caused international bonds to decline by 5.8 percent in December. The European Commission announced that half of the Euro-zone's 16 countries are considered "high risk". Consequently, international bonds ended the year with a modest return of 4.4 percent.

## 2010 MARKET OUTLOOK

We have identified several themes for 2010: (1) High quality stocks are attractive compared to lower quality stocks; (2) Large cap stocks are trading at a discount relative to mid and small cap stocks; (3) Stock valuations are attractive relative to bonds; (4) Growth stock valuations and growth prospects compare favorably to those of value stocks; (5) Emerging market stocks appear attractive based on growth expectations and valuations; (6) Interest rates on the safest fixed income instruments will likely rise; and (7) Alternative investments should provide competitive risk-adjusted returns as the markets continue to stabilize.

Although we would be surprised to experience another year of 25 percent plus returns for stocks, we see opportunities in many asset classes and sectors and believe a properly positioned portfolio could provide above-average returns in 2010.

We continue to work diligently to help you achieve your investment goals. Please call us if you have any questions.

Very truly yours,

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