

October 15, 2009

#### COMMENTARY

Economic data began improving in the second quarter and continued improving throughout much of the third quarter. In the second quarter economic data was categorized as “less worse” and in the third quarter the phrase “better than expected” gained traction. After falling 5.5 percent in the first quarter, second quarter GDP declined only 0.7 percent. As recently as June, second-quarter GDP was projected to decline between 2.5 to 3.0 percent. The improved GDP figure boosted sentiment and had many thinking that the recession that started in December 2007 likely ended in July 2009. To put this recession in context, assuming it ends in July, it will be the longest since the Great Depression.

Both the manufacturing and services indices improved over the quarter and ended the period indicating that growth had returned. The Institute for Supply Management (ISM) Purchasing Managers Index (a proxy for manufacturing activity) improved from 44.8 in June to 52.6 for September. September’s reading was the second consecutive month of growth. The ISM’s Service Index increased from 47.0 in June to 50.9 in September. The Service Index showed growth in the non-manufacturing sector after 11 months of contraction. In general, ISM survey respondents indicated that business activity and new orders were improving, but employment remained weak and credit remained tight.

The Conference Board’s Consumer Confidence Index improved slightly over the quarter, primarily from higher expectations for the future rather than the present situation. The Index ended June at 49.6 and ended the quarter at 53.1. However, consumers remain concerned about rising unemployment and a tight lending market. Consumers have been saving at the highest level in more than two decades and are not likely to resume normal spending activities until the employment outlook improves or at least stabilizes.

According to the Case Schiller Composite 20 Home Index, home prices began falling in May 2006 and continued falling every month through May 2009. After three years of falling prices the index registered rising home prices in June and July. Although the July 2008 to July 2009 period reflected home prices fell about 13 percent, the month-to-month increase was identified as the first step toward home price stability. In August, existing home sales posted their first annual increase in nearly three years. Several factors, including low interest rates, near-record affordability, and an \$8,000 first time home buyer’s credit helped stabilize the housing market and support the belief that a bottom is forming.

Despite a recovery in many areas of the economy, employment has yet to show signs of turning positive. The latest employment situation summary showed job losses of 263,000 in September, which was higher than expected. Since the start of the recession 7.6 million people have become unemployed and the unemployment rate reached the highest level since 1983. Monthly job losses have declined significantly since the high of 741,000 in January of this year and remains in the category of “less worse”. Nonetheless, the weak job market remains a substantial drag on the overall economy and specifically consumers, whose spending accounts for about two-thirds of GDP.

#### EQUITIES

Following their best performance in 10 years in the second quarter, U.S. equities staged another impressive quarter and logged the highest third quarter returns in 30 years. Stock prices jumped in July as second quarter earnings reports beat analyst estimates. According to Zacks Research,

almost 73 percent of S&P 500 companies beat their earnings estimates in the second quarter. Only 24 percent of companies increased revenues. The vast majority aggressively cut costs, which contributed to the stronger earnings. As earnings season ended, stock price increases were fueled by “better than expected” economic data in the final two months of the quarter. Improvements in housing, manufacturing and the services industry gave investors hope that the recession was finally losing steam and that growth was returning.

Similar to what occurred in the second quarter, investors exhibited a preference for beaten down stocks, as well as more economically sensitive stocks. The top three sectors in the S&P 500 were among the worst performers in 2008. Financials, Industrials, and Materials were the leaders in the third quarter as each posted gains of more than 21 percent. The defensive sectors, such as Consumer Staples, Healthcare, and Utilities were the poorest performers, despite strong absolute returns. Investors’ preference for economically sensitive stocks supported outperformance of value stocks relative to growth stocks. Regardless of size (large, mid or small cap), value stock indices outperformed growth indices by about 5 percent in the quarter.

International stocks outperformed U.S. stocks in the third quarter as signs of a global recovery increased and the U.S. dollar declined versus most major currencies. Among developed nations, Germany and France announced that they had positive growth in the second quarter. The news was well received and Germany’s equity index increased 23.2 percent and France’s equity index was up 26.6 percent. The weaker dollar accounted for about one-quarter of the MSCI EAFE’s 19.5 percent quarterly return. Again the MSCI EAFE index was boosted by strong returns among Financials, which account for about one quarter of the index.

After a surge in September, emerging market equities maintained the top spot for the third quarter in a row. The emerging market countries have clearly been the leaders with respect to economic growth over the last few quarters. China is expected to experience GDP growth of over 8 percent for 2009 and India isn’t too far behind at 6.5 percent. These growth rates are projected to subsequently move higher in 2010. Investors looking for growth have shifted funds away from slower growing developed countries in favor of emerging markets. A growing domestic consumer market has helped maintain growth among countries that historically were huge exporters to the developed markets. Trade between emerging countries has also increased dramatically, and this has helped support growth while the developed markets struggled.

#### FIXED INCOME

Safety was not the flavor of the day within the fixed income market, and the clear winners were the riskier securities. However, some concern regarding whether stock prices had moved too high, too quickly kept yields on safer securities from rising. The 10-yr. Treasury started the quarter with a yield of 3.53 percent and finished the quarter yielding 3.31 percent. Unlike most periods when stock prices rise strongly, bond yields among even the safest securities did not increase. Investors did not sell out of safe fixed income securities and make a wholesale move into equities. This fact indicates that there is still a lot of disagreement regarding the recovery. There seems to be a divide between whether the economy will continue to improve or may slide backward next year. This divide is what contributed to uncharacteristically high bond returns coupled with strong stock returns.

Spread products, specifically high yield, convertible, bank loan, and investment-grade corporate bonds posted equity-like returns. Investors snatched up high yield and convertible bonds, generating quarterly returns of 14.1 and 15.5 percent, respectively. Bank loan and investment grade bonds provided returns in the 7 to 8 percent range. International bonds also posted solid returns as the weakening dollar boosted performance. Abnormally large spreads proved to be attractive, especially to investors looking to take on more risk, but not purchase stocks. As the quarter ended, most bond spreads had dropped to levels prior to last September.

## 2009 MARKET OUTLOOK

We were bullish at the beginning of the second quarter, and fortunately we were correct. Both stocks and non government-guaranteed bonds posted strong returns. The downside of such strong performance is it reduces the likelihood of outperformance going forward. The correction in prices has made many asset classes less attractive than they were only a few months ago.

At this stage, we still see reasonably attractive opportunities within equities. However, we believe there may be a shift away from economically sensitive stocks toward larger cap dominant players and companies that have the ability to grow earnings even if economic growth is somewhat weak. We continue to emphasize large cap stocks over small and mid cap stocks as well as growth stocks over value stocks.

We do not believe the threat of inflation is a short term concern. With high unemployment and low capacity utilization, wage pressure will be nonexistent in the near term. However, record levels of U.S. Government borrowing and unprecedented stimulus efforts could result in higher inflation in the future. We monitor expected inflation and if it appears that inflation is likely to increase notably, we will evaluate the use of REITs, TIPS, and/or commodities to hedge against this risk.

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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