Quarterly Market Commentary – Q409
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By all measures, a great year
Looking back at 2009, history will show that it was a good year for market participants, helping them gain back some of the painful losses of 2008. The U.S. and overseas equity markets posted strong gains, with the S&P 500 Index advancing 26.46 percent and the MSCI EAFE Index up 31.78 percent for the year. Lower-quality stocks, which have historically been more volatile, performed very well for the year, as lower-quality names led the early stages of the rally and gained momentum throughout the year. Both high-yield bonds (Barclays Capital U.S. Corporate High Yield Index) and emerging markets (MSCI Emerging Markets Index) reinforced this notion, gaining 54.78 percent and 74.50 percent, respectively, for the year.

The story for fixed income investors was similar to that of equities, and most of the major bond indices posted strong gains in 2009. Corporate bonds returned 16.04 percent, as measured by the Barclays Capital U.S. Credit Index, as spreads narrowed closer to levels seen prior to the credit crisis. Municipal bond spreads also narrowed as prices for the underlying bonds moved higher, and the Barclays Capital Municipal Bond Index gained 12.91 percent for the year.

The markets showed remarkable resilience in 2009, given the rocky start in the first quarter. Equity markets sank in early 2009 and, on March 9, had fallen more than 25 percent for the year, as measured by the S&P 500. It was at this time that Federal Reserve Chairman Ben Bernanke coined his now famous phrase "green shoots," describing the climate of an emerging economic recovery. A sharp rally ensued, and, despite cries from skeptics, equity markets pushed higher through much of 2009, ending the year on highs.

The case for a strong market in 2010
Economic data shows there is no doubt that the economy has rebounded from its lows. While it appears difficult to make the case for a strong economic recovery, we have seen the rate of decline in recent data slow and in many cases improve, at least somewhat. Case in point: employment data indicates that the economy lost only 11,000 jobs in November—a sharp decrease from more than 650,000 monthly job losses in March 2009. Although economists suggest we need at least 100,000 new jobs just to maintain existing employment levels, the steady decline in job losses through the second half of 2009 was well received by the markets. Consumer confidence is a similar story, showing modest gains in the latter half of the year. Although December's consumer confidence level of 52.9 is low by historical comparisons, it is sharply off the March 2009 low of 25.3.

Some of the improvements in the economy have no doubt been the result of government stimulus and the government's subsequent involvement in many areas of the economy. So far, $249.8 billion of the massive $787 billion government spending package has been paid out in the form of tax benefits ($92.8 billion), contracts, grants and loans ($65.8 billion), and entitlements ($91.2 billion). The impact of this stimulus spending has been seen in the output of the economy, as measured by gross domestic product (GDP). The third-quarter GDP report showed the economy growing at an annual rate of 2.20 percent, up from the 6.40-percent decline seen in the first quarter of the year, according to the Bureau of Economic Analysis. This improvement is encouraging; however, the third-quarter number has been revised lower from the initial estimates, suggesting that further stimulus may be needed to sustain future economic growth.

A small portion of the government stimulus has been used for incentive programs for both autos and housing. The "Cash for Clunkers" program provided an immediate and significant boost to auto sales. Housing experienced a robust second half of 2009, as unit sales rose and existing inventories fell sharply. New home sales rose to 355,000 in November, from a low of 329,000 in January, while inventories fell to 7.9 months at the current sales rate. This has been critical, given that housing and housing-related financing activities are at the heart of the current economic woes. Continued strength in the housing market will be an important component of an economic rebound moving forward.

A case for a weak market in 2010

The employment situation continues to be a concern, and a 10-percent unemployment rate is a challenge for the economy. Although job losses have slowed substantially and nonfarm payroll employment was essentially unchanged (–11,000) in November, it will take a significant number of new jobs to replace the 7.82 million jobs lost since January 2008. Economists project that it could take five years to see jobs return to more normalized levels. The loss in income across the economy in the aggregate will no doubt put a damper on future spending and economic growth. It could also put pressure on top-line revenue growth for many companies and consequently present a headwind for earnings growth to drive equity returns.

The consumer is still challenged in the current environment, with the pressures of mortgage delinquencies and the shrinking of personal credit. Currently, 25 percent of U.S. homeowners have a mortgage that is upside-down, meaning they owe more than the house is worth. Furthermore, one out of seven mortgages is currently in arrears or in foreclosure. So despite the fact that consumer confidence has moved off its lows toward the end of 2009, it is still at levels that do not bode well for renewed consumer optimism and increased spending in the near term. In fact, it could be quite the contrary, as the savings rate continues to hold at higher levels—currently 4.70 percent in November, up from a low of under 1 percent in the early stages of the recession. While the higher savings rate may translate into future spending, it will likely put negative pressure on the consumer's ability to add significantly to GDP growth in the near term.

Can the government make a graceful exit?

The U.S. government and other governments across the globe have been a critical component to this recovery. China alone committed to spend $586 billion to support its economy, predominantly through infrastructure spending. Many European countries have also enacted stimulus plans to help support their economies and prevent further economic deterioration. In the U.S., the government intervention is more widespread and includes the TARP program, the TALF program, the stimulative short-term interest rate policy, and other initiatives to actively support the mortgage markets through a direct buying program. It will be critical for the government to use extreme caution in curtailing the stimulus, given that it is unlikely that the economic recovery is strong enough to continue in the absence of government intervention. Recent evidence of this was seen in the housing market when the tax incentives for first-time home buyers expired and home sales slipped, prompting the government to extend the duration and breadth of the program. Markets have no doubt reacted positively to government stimulus, but they could face a headwind as stimulus programs wind down.

Perhaps more of a mixed bag

The reality of the markets is that there is an ever-changing dynamic, and the likely scenario, quite frankly, is a mixed bag. The key factors for 2010, similar to 2009, will be to watch the government closely and to monitor its key policy decisions on interest rates and spending. We believe it is likely that the government will remain accommodative throughout 2010 to allow for the economic recovery to gain some strength. Unemployment will continue to be a drag on future economic growth, as companies remain cautious on their hiring decisions. Markets will likely scrutinize the economic data more closely, given the strength of the market rally in 2009 and the potential for skepticism over a sustained recovery. No doubt investors should continue to be cautious of risk, knowing that markets and market sentiment can indeed shift as the dynamic changes. Markets are still sharply below the highs of several years ago, so long-term investors could use market fluctuations to reposition portfolios for what will likely be a slow and ever-changing recovery.

Disclosure: *Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. All indices are unmanaged and investors cannot invest directly into an index. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The Barclays Capital U.S. Corporate High Yield Index covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The MSCI Emerging Markets Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin. The Barclays Capital U.S. Credit Index is comprised of the U.S. Corporate Index and the non-native currency sub-component of the U.S. Government-Related Index. It includes publicly issued U.S. corporate, specified foreign debenture, and secured notes denominated in USD. The Barclays Capital Municipal Bond Index includes investment-grade, tax-exempt, and fixed-rate bonds with long-term maturities (greater than two years) selected from issues larger than $50 million.*

Authored by Simon Heslop, CFA®, director of asset management, at Commonwealth Financial Network.

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