



## 2009 Year in Review

December 31, 2009

### *SUMMARY & HIGHLIGHTS*

- The economy gradually improved throughout the year. GDP contracted 6.4% in the first quarter of 2009 and expanded 2.2% in the third quarter as government stimulus programs began to bear fruit. Many economists believe fourth quarter GDP will increase over 4%.
- Job losses slowed as seen in the November Payroll Report which showed only 11,000 jobs lost compared to 741,000 lost in January. It is anticipated that actual job growth will be seen in the next several months and unemployment will trend back below 10%.
- Equity market performance in 2009 was nothing short of spectacular. After declining 11% in the first quarter, stocks rallied throughout the remainder of the year giving the S&P 500 a return of 26.5% in 2009. Unfortunately, it was not good enough to make up for the dismal 2008 performance. The S&P 500 is still well off the peak highs of 2007 when it reached over 1550, roughly the same level it was in 2000!
- All ten S&P 500 sectors had a positive return in 2009, a drastic improvement over 2008's dreadful performance. There was quite a large spread between the top and bottom performers during the year. The technology and materials sectors were the top performers in 2009 returning 59.9% and 45.2%, respectively, while telecom and utilities gained 2.6% and 6.8%, respectively. Investors shifted away from more defensive areas in favor of higher risk assets.
- Long-term rates moved up over the last year signaling investors' growing concern about the future prospects of inflation and at-record issuance. However, the Treasury and the Fed are trying to keep short-term rates down as many see low interest rates as the engine for keeping the economy out of another recession.
- With the exception of high yield bonds, fixed-income securities underperformed equities in 2009 as investors unwound the flight to quality trade given increased stability in the credit markets and signs the economy bottomed. High yield bonds gained 66.6% in 2009 outpacing all other categories as the risk premium for those bonds decreased.
- After examining the current environment and applying some experience, perspective and reason to the equation, we feel the "new normal" is the general theme that will emerge in the next several years. Namely, economic activity will be subdued, producing modest 2% GDP growth for 2010 and 2011. We remain cautious about the prospects for the equity and bond markets in 2010. We do not anticipate another blockbuster year like 2009 and expect only modest equity market returns in 2010.

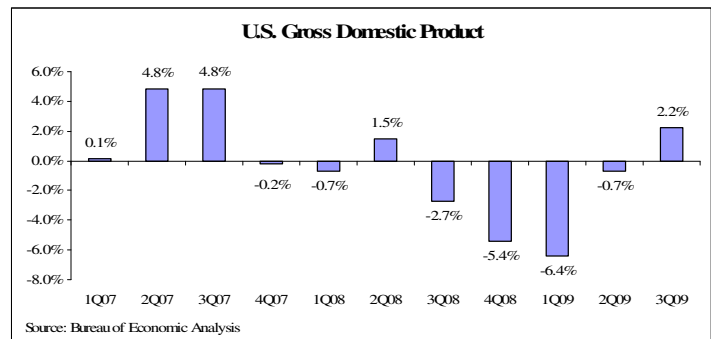
# 2009 Year in Review

## GENERAL OVERVIEW

### U.S. Economy

During 2009, the U.S. economy was described as a hospital patient in the intensive care ward or a ship sailing through a terrific storm in uncharted seas. Whatever the appropriate metaphor you choose, at this time last year the U.S. economy was in big trouble. However, over the last year, the U.S. and global economies are now beginning the long, painful and uneven process of setting a new course to emerge from the storm. The economic meltdown was avoided and a fragile economic recovery is underway.

In March of 2009, the stock market anticipated the bottoming of the economic downturn and equity markets rebounded aggressively as investors snapped up bargain basement stock prices even though the earnings outlook at the time was awful. So far, the bulls have been proven right as the U.S. and other economies expanded during the later part of 2009. GDP for the U.S. rose 2.2% in the third quarter of 2009 and some economists expect over 4.0% growth in the fourth quarter.

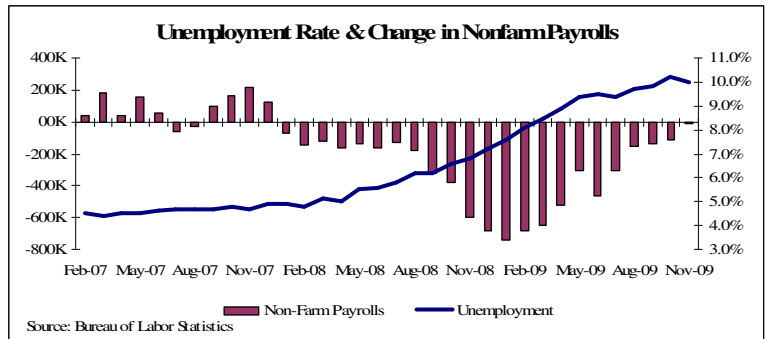


The debate is now raging as to who was responsible for the financial meltdown as Chairman Bernanke faces tough confirmation hearings for his re-appointment for a second term as the head of the Federal Reserve. Many members of Congress are concerned that the Federal Reserve was asleep at the switch at a time when the housing bubble could have been deflated in an orderly manner. Others defend Bernanke's (and Treasury Secretary Paulson's) quick and decisive action to head-off a depression as banks were not functioning and credit dried up with prospects abounding for massive defaults. The TARP, the \$800 billion stimulus program approved by Congress at the end of the Bush Administration and large amounts of liquidity pumped into the economy by the Federal Reserve are credited as the major reasons a total disaster was averted. Regardless of who was responsible for the financial calamity of 2008-2009, it was more important to first avoid the disaster and then learn from the mistakes to ensure such an event does not occur again.

Now the challenge becomes how to rebuild a sustainable economy that is durable enough to continue once the tremendous amounts (about \$2.0 trillion) of government subsidies, bailouts and stimulus programs are curtailed down the road. The bulls and bears continue to argue if the stock market has gotten ahead of itself in recent months and whether or not a pullback is just around the corner. A growing number of economists and strategists say the economic recovery is stronger than anticipated and will surprise on the upside in months ahead. There is a general view proposed by Bill Gross and Mohamed El-Erian at PIMCO that a "new normal" condition will emerge from the financial crisis that will provide economic growth of 2% going forward, much reduced from the 3% to 4% economic growth experienced over the last decade. The rationale being that a great deal of the economic growth of the last 10+ years was developed through excessive amounts of risk and leverage. In the aftermath of the financial crisis, new regulations are on the horizon, toxic assets still remain on balance sheets and low capital and reserve positions at large banks will make it difficult for credit expansion. Given this picture, it is difficult to see how the economy can grow at anything but modest rates of about 2%. Not only is it challenging for banks to stimulate economic growth through credit expansion, there are a number of other headwinds (see 2010 Outlook section) that exist to make it increasingly difficult for consumers, businesses and the government to provide the stimulation needed for 3-4% economic growth over the next several years.

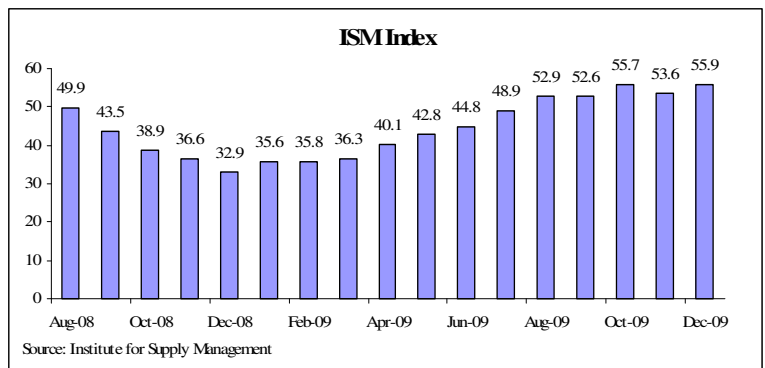
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While headwinds and challenges abound, historically after past recessions, the U.S. has found a way to overcome adversity and get back on a growth track. Even now, there are several bright spots in the economic picture. For instance, job losses slowed as seen in the November Payroll Report which showed only 11,000 jobs lost compared to 741,000 lost in January. It is anticipated that actual job growth will resume in the next several months and unemployment will fall below 10% very soon.



It should be remembered that the economy has lost over 7 million jobs since the downturn began. Other areas of improvement include factory orders and industrial production. Inventories have been worked down and production is gearing up to replenish inventory stock. Exports also improved with the help of the falling dollar. Housing has seen some improvement as the drop in home prices seems to be slowing as reflected in the monthly S&P/Case-Shiller Report.

The ISM Index of Manufacturing trended higher throughout the year and most recently showed a reading of 55.9 for December, indicating solid expansion. The Index of Leading Indicators (LEI) also showed nice increases indicating that further economic expansion is achievable. For December, the LEI showed a 0.9% increase, so the outlook is not all gloom and doom. However, the issue remains whether or not the economy can grow enough to support meaningful job creation to put the over 7 million people who lost their jobs in the crisis back to work.



One of the benefits of the financial crisis is the positive impact low economic activity has on inflation. In 2008 the Federal Reserve raised short rates in an attempt to temper what they perceived as growing inflation. At the present time only modest inflation is showing up in the numbers, but is mostly discounted by experts due to the large gap between current output versus potential output of the economy. Inflation appears when resources are constrained and prices rise as a result. However, raw material costs represent only 20% of GDP. Labor costs are a much greater ingredient (about 60%) and with the high level of current unemployment it will be some time until this component is constrained causing wages to increase.

If inflation does creep into the system interest rates will begin to rise, especially on the long end of the yield curve. At the end of 2009, the 30 year Treasury bond traded at 4.68% up from 2.55% a year ago. The Federal Reserve is being forced to walk a tightrope due to the heavy debt levels being assumed by the government needed to rescue the economy from disaster. If you combine heavy government debt with incipient inflation the "bond vigilantes" will force rates higher. This will produce a heavier headwind for the economic recovery and must be avoided. Even strong GDP performance in the fourth quarter will produce pressure on interest rates, thus creating a conundrum for the Fed.

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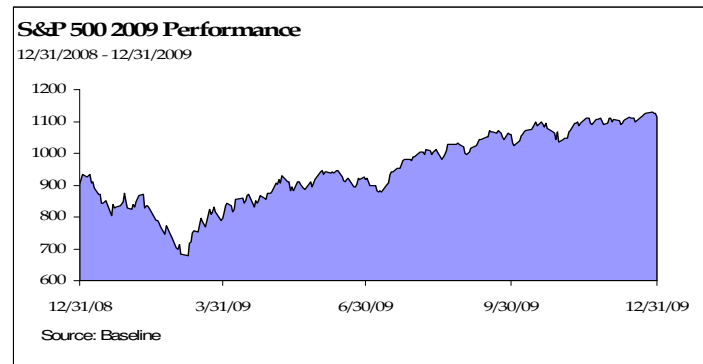
Even if inflation is held in check due to the excess economic capacity, a strong level of productivity currently exists in the economy to help keep prices in check. High productivity is one of the byproducts of a shrinking labor force. Productivity in the third quarter rose 8.1%. Therefore, the Federal Reserve and the Obama Administration relegated inflation to a lesser priority status. However, while investors seem complacent now about inflation, the weakness of the dollar and the increase in the price of gold from \$850 a year ago to the current level of over \$1,100 are troubling. The weakness in the dollar shows a loss of investor confidence in the policies of the government and reflects the slow pace of economic activity. The high price of gold is also a NO CONFIDENCE vote for the dollar and government policies.

There is no doubt that Congress and the Obama Administration have their work cut out for them in the next two years. Some would argue that the agenda is too ambitious and more focus on important issues such as bringing down spending and the budget deficit would produce better results. However, if we can continue to make incremental progress toward re-building the economy, a big part of the problem will be addressed. Looking back over the decade there has been great progress and advancement made on many fronts. But make no mistake; a tectonic shift in the global economic landscape has taken place. The failure of the global financial system and the complicity of the U.S. in manufacturing and distributing toxic loans will leave lasting scars.

## ***EQUITY MARKET OVERVIEW***

### **Equity Market Performance**

Equity market performance in 2009 was nothing short of spectacular. With the S&P 500 down 11% in the first quarter, 2009 looked as if it might be another painful year for equity investors. The indiscriminate selling at the end of 2008 trickled into the early part of 2009 as fear over the financial crisis caused investors to shun stocks and seek government securities as a safe haven. Eventually the panic subsided and stocks began an incredible rally beginning in early March as government programs were put in place to shore up the financial system and stimulate economic growth. From the March lows the S&P 500 rallied 65% to end the year with a return of 26.5%.



Virtually overnight, investors shifted from the “defensive trade” to the “risk trade.” Fear turned to optimism as government programs to re-inflate the economy and stabilize the financial system began to materialize. Stock prices tend to anticipate changes 6-12 months out. Investors sold defensive investments and piled into riskier assets in hope these government programs would pay off by the second half of the year. Thus far it appears these government programs have achieved their goals as the economy expanded 2.2% in the third quarter after contracting 6.4% in the first quarter.

Company earnings over the past few quarters were also generally better than expected helping propel stock prices higher. Management teams were extremely aggressive in cutting costs to minimize the impact of sluggish revenue growth on earnings. These lean corporate structures should allow for favorable earnings growth in 2010 as the economy heals and demand accelerates.

# 2009 Year in Review

All the major U.S. indices performed exceptionally well in 2009. Unfortunately, it was not good enough to make up for the dismal 2008 performance. The S&P 500 is well off the peak highs of 2007 when it reached over 1550, roughly the same level it was at in 2000! In essence, long-term investors who held an S&P 500 index fund over the past 10 years have lost a significant amount of wealth with the index ending 2009 at 1115. The Nasdaq was the clear winner of the U.S. indices returning 43.9% in 2009 given its heavy weighting in the technology sector, the best performing sector for the year.

Equity Performance	2006	2007	2008	2009
Dow Jones Industrials	19.0%	8.8%	-31.8%	22.6%
S&P 500 Total Return	15.8%	5.5%	-37.0%	26.5%
Nasdaq	9.5%	9.8%	-40.5%	43.9%
Russell 2000	17.0%	-2.8%	-34.8%	25.2%
Wilshire 5000	13.9%	3.9%	-38.7%	26.5%
MSCI-EAFE	26.3%	11.2%	-43.4%	31.8%
MSCI-Emerging Markets	NA	36.5%	-54.5%	74.5%

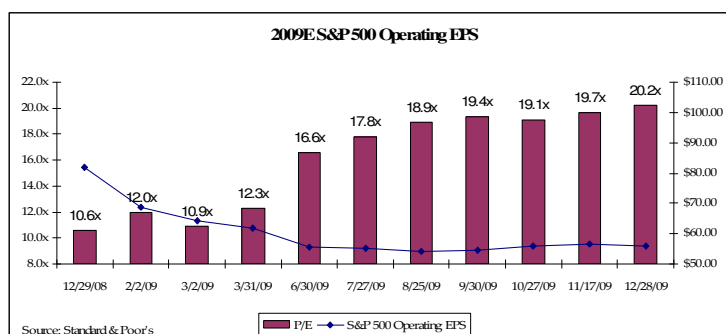
International equities outperformed domestic equities in 2009 as measured by the MSCI-EAFE and MSCI-Emerging Markets Indices after underperforming during the market meltdown in 2008. Emerging market stocks were the big winners for the year returning 74.5% after a -54.5% performance in 2008. Investors focused on emerging market stocks in countries such as China, India and Brazil given better economic growth prospects in those markets relative to the more developed countries.

All ten S&P 500 sectors had a positive return in 2009, a drastic improvement over 2008's dreadful performance. There was quite a large spread between the top and bottom performers during the year. The technology and materials sectors were the top performers in 2009 returning 59.9% and 45.2%, respectively. Technology stocks Apple and Google were up over 100% while material companies such as Packaging Corp. and Dow Chemical both gained over 70% for the year. As mentioned earlier, investors sold defensive securities in favor of more risky assets. Telecom services and utilities, two of the more defensive sectors, significantly underperformed returning 2.6% and 6.8%, respectively.

S&P 500 Sector Performance	2006	2007	2008	2009
Consumer Discretionary	17.2%	-14.3%	-34.7%	38.8%
Consumer Staples	11.8%	11.6%	-17.7%	11.2%
Energy	22.2%	32.4%	-35.9%	11.3%
Financials	16.2%	-20.8%	-57.0%	14.8%
Health Care	5.8%	5.4%	-24.5%	17.1%
Industrials	11.0%	9.8%	-41.5%	17.3%
Information Technology	7.7%	15.5%	-43.7%	59.9%
Materials	15.7%	20.0%	-47.1%	45.2%
Telecom Services	32.1%	8.5%	-33.6%	2.6%
Utilities	16.9%	15.8%	-31.6%	6.8%

## S&P 500 Earnings

2009 estimates for S&P 500 earnings trended downward throughout the first half of 2009 before stabilizing in June. The year began with analysts expecting earnings of \$82. However, estimates trended lower as the economic slow down driven by the financial crisis weighed on company earnings. Eventually they bottomed around \$55 which is in-line with current expectations. Looking to 2010, the future appears much brighter as analysts expect S&P 500 earnings to grow 36% to \$76. While the economy showed drastic improvement over the past few quarters, the question remains as to whether or not it has the ability to sustain such growth once government support is eased.



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## Mutual Fund Performance

Mutual funds posted solid performance in 2009 with stock funds outperforming bond funds with the exception of high yield bond funds. Large-cap core funds gained 27.1%, slightly better than the S&P 500's 26.5% return. Intermediate U.S Government funds lagged in 2009 as investors shifted money out of defensive funds and into high risk funds. The longer term view tells another story. Stock funds underperformed bond funds over the last five years. Large-cap core funds produced a meager 0.5% average annual return over the past five years while intermediate bond funds returned 3.9%. In essence, the dreadful performance of 2008 virtually wiped out any gains stock fund investors had accumulated over the past few years.

Mutual Fund Performance	2009	5-yr*
<b>Stock &amp; Stock/ Bond Funds</b>		
Large-Cap Core	27.1%	0.5%
Mid-Cap Core	36.6%	1.6%
Small-Cap Core	31.9%	0.7%
Equity Income	22.9%	1.1%
Global Equity	33.9%	2.4%
<b>Bond Funds</b>		
Intermediate Bond	12.9%	3.9%
Intermediated U.S. Gov't	7.8%	3.8%
High Yield Taxable	46.4%	4.4%
Intermediate Municipals	9.9%	3.2%
*Average annual return		
Source: Lipper		

## BOND MARKET OVERVIEW

### Bond Market Performance

The bond market limped out of 2009 to sit near the worst levels since June on 10-year Treasuries, taking the yield up to 3.9%, briefly. Bond prices and bond yields move inversely to each other. The recent run-up in rates was reflected in the latest mortgage rate data, with Freddie reporting the 30-year fixed rate averaging 5.14% over the past week, up from 5.05% and the highest since August, after hitting a record low at the start of December.

With the possibility of economic growth stalling in the face of higher rates, the Fed will likely be more inclined to use their words to hint at the timing of tightening. They will also continue to remove, or let expire the many tools they have employed in keeping things afloat the past year. Those moves are seen as small steps toward lessened accommodation and the market should respond to further chatter on those measures by pressing rates higher.

Economists at New York-based JPMorgan Chase & Co. and Goldman Sachs Group Inc., the second- and fifth-largest U.S. banks by assets, say there's so much deflationary pressure coming from excess labor and plant capacity in the economy that the Fed won't raise interest rates until at least 2011.

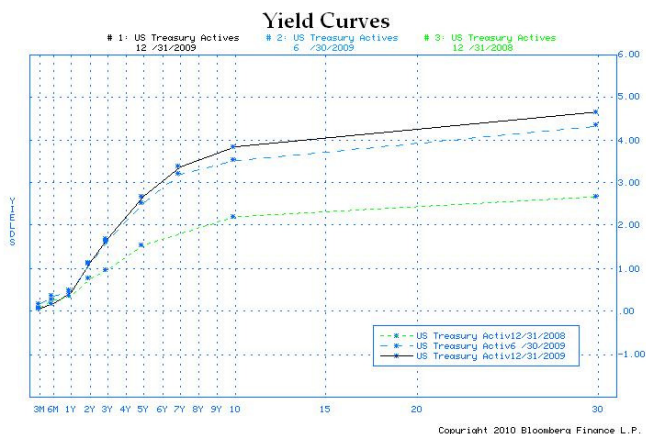
With the exception of high yield bonds, fixed-income securities underperformed equities in 2009 as investors unwound the flight to quality trade given increased stability in the credit markets and signs the economy has bottomed. High yield bonds gained 66.6% in 2009 outpacing all other categories as the risk premium for those bonds decreased. As prices increase, the yield, or risk premium, decreases.

Bond Market Performance	2006	2007	2008	2009
90 day T-bills	4.7%	4.9%	2.1%	0.2%
10 year T-notes	1.4%	9.8%	20.3%	-9.9%
Corporates	4.6%	5.4%	-3.3%	17.1%
Agencies	8.2%	14.7%	14.8%	4.1%
GNMA Bonds	5.0%	7.6%	8.5%	5.8%
TIPS	NA	25.2%	-4.5%	22.5%
High Yield Bonds	13.3%	2.3%	-29.1%	66.6%
Municipal Bonds	5.7%	3.9%	-2.9%	14.9%

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## Yield Curve

The yield curve as seen in the graph to the right could retest the June highs in both short and long term interest rates. Long rates have moved up over the last year signaling investors' growing concern about the future prospects of inflation and at-record issuance. However, the Treasury and the Fed are trying to keep short rates down as many see low interest rates as the engine for keeping the economy out of another recession.



## Spreads

Credit spreads tightened over the past year as more money flowed into Treasuries from continued at-record auctions. The Twos/Tens Spread (Two-Year Treasuries vs. Ten-Year Treasuries), a measure of the steepness of the yield curve, widened to 283 bps at the end of the year after being as tight as 140 bps at the beginning. A normal spread of about 250 bps indicates healthier margins at financial institutions that normally borrow at short term rates and lend at long term rates.

The Credit Spread (U.S. Treasuries vs. Corporates), a good measure of fear, reached a twelve month low in December 2009 at 107 basis points having contracted during the fourth quarter. Spreads had moved to as wide as 361 basis points during the market lows.

The Junk Spread (U.S. Treasuries vs. High Yield Corporates), a good measure of risk premium or the amount of additional return necessary to accept significant default risk, reached a twelve month low of 361 basis points near the end of the fourth quarter. Since the peak in spreads at 1116 basis points in December of 2008 spreads have moved passed historical norms and into low risk premium territory.

The TIPS Spread (U.S. Treasuries vs. TIPS), a good indication of inflation expectations ended the year at a 12 month high of 257 basis points as inflation expectations have risen. Over the past twelve months we have seen it steadily widen from a low of 21 basis points in January during the market downturn.

## 2010 OUTLOOK

After examining the current environment and applying some experience, perspective and reason to the equation, we feel the "new normal" is the general theme that will emerge in the next several years. Namely, economic activity will be subdued, producing modest 2% GDP growth for 2010 and 2011.

Some of the concerns we have for the economy and markets are as follows:

- The Federal Reserve has committed to keeping interest rates at current levels of 0 to 0.25% for the foreseeable future. This means that banks can borrow at low rates and simply invest in market securities to make a profit, rather than making new loans to grow the economy. Also it is uncertain how the economy will fare once this period of "easy money" has passed and a more normal interest rate environment prevails.

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- The Federal budget deficit for fiscal 2009 was about \$1.5 trillion and is expected to be in the area of \$1.3 trillion for the next several years, at best.
- Congress does not seem interested in reducing spending while the deficits as a percentage of GDP could reach an unprecedented 10%! Just prior to the Christmas holiday, Congress quietly passed an authorization to again increase the size of the budget deficit.
- New bills are circulating through Congress on financial reform, regulation of climate change and CO2 emissions, health care reform and others that will either require more spending or act to curtail economic output.
- Unemployment remains above 10% and is feared that even with better GDP employers are not hiring back those laid-off during the downturn. GDP growth of 2% will NOT allow for enough job creation to make a meaningful dent in unemployment.
- State and municipal governments are struggling with their debts and anticipate much less tax revenue. Budgets across the country are being slashed, programs are being cut and further layoffs are expected, even for essential services.
- The excessive rescue measures enacted by the Federal government to avoid a financial crisis have caused investors to shun the dollar in foreign exchange trading. While the weaker dollar does stimulate exports, it does not strengthen the economy at home and provides incentives for other countries to devalue as well. A strong dollar equals a strong U.S. in the eyes of the world. The U.S. cannot devalue its way to prosperity! It must reduce the trade and budget deficits to rebuild faith in the dollar.
- Consumers are reluctant to spend and an economic recovery will not be fueled by the traditional consumption patterns in the U.S. Until employment improves and consumers feel secure about their future, spending will be modest and the savings rate (currently in the 5.0% range) will continue to rise. Consumer spending drives 70% of the U.S. economy.
- Debts and excess leverage are being cut wherever possible. Americans have lived above their means for years and now the bill is coming due. Home mortgages are being defaulted, credit card delinquencies are high and consumers and businesses alike are attempting to pay down debts as fast as possible. Without banks lending and without consumers and businesses borrowing, it is difficult to see how economic growth will be generated domestically. Deleveraging is not an ingredient in the recipe for growth.
- Aging "baby boomers" will become more burdensome to the economy in the years to come as health care, retirement and social security costs will increase on a smaller population base in the work force. This silent and creeping phenomenon has yet to be dealt with by the Obama Administration and could offer additional challenges for the fragile recovery.

Given these headwinds, we remain cautious about the prospects for the equity and bond markets in 2010. We do not anticipate another blockbuster year like 2009 and expect only modest equity market returns in 2010.

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Written 1/7/2010 Dow: 10,606.86 S&P: 1,141.69  
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