



## The Economy

As the third quarter drew to a close, we received a final revision to the second quarter gross domestic product (GDP) number. The number came in at  $-0.7\%$ , better than the original estimate of  $-1.0\%$ . Although still negative, it is considerably better than the  $-5.4\%$  for the fourth quarter of 2008 and  $-6.4\%$  for the first quarter of 2009. The four consecutive quarters of GDP decline ( $-3.8\%$  on a year-over-year basis) marks the deepest recession since the 1930s.

What lies ahead? Federal Reserve chairman Ben Bernanke is on record declaring that the recession ended in the third quarter. Most economists agree. A recent polling of U.S. economists shows that the median estimate calls for  $2.6\%$  GDP growth in the second half of 2009. They point to the five consecutive months of positive results for the Leading Economic Indicators index, a survey of 10 different indicators that has been very good at predicting the future movement of the overall economy. Other good news comes from home prices (up three months in a row) and the manufacturing surveys. Another positive: inflation remains mild.

All the economic news, however, is not positive. The employment outlook remains grim. We have experienced 20 straight months of job losses, although the pace of losses has slowed greatly. Unemployment is at  $9.7\%$ , and appears to be heading above  $10\%$ . Capacity utilization is at a historically low level of  $69.6\%$ .

## Fixed-Income Markets

Interest rates eased modestly in the second quarter as the Federal Reserve maintained its commitment to keeping the federal funds rate at 0 to  $0.25\%$ . Credit spreads (the difference in interest rates between bonds of different quality) continue to contract, indicating a further healing of fixed-income markets after the near meltdown of last fall. Access to reasonably priced credit is essential to any economic recovery, and this positive news from the bond market is encouraging.

One concern that has been voiced recently relates to the massive amounts of government debt we are creating. The fear is that this may be inflationary, causing interest rates to rise and bond prices to fall. There is definitely a correlation between high budget deficits and inflation. However, in the near term we expect inflation to be moderate due to all the economic slack caused by high unemployment and low capacity utilization.

### Changes to Your Statement

In response to requests from clients for additional information, we've changed the "Activity Summary" section of your statement to provide more detail. The new section—now titled "Cash Activity Summary"—provides a concise summary of cash activity in your account, including dividends and interest.

We hope you'll find this change helpful. If you have any questions, please contact your relationship manager.

### Cash Activity Summary

SECURITIES PURCHASED  
SECURITIES SOLD/REDEEMED  
CASH DEPOSITS  
DIVIDENDS  
INTEREST  
CASH DISBURSEMENTS  
OTHER ACTIVITY

**INCOME**

## Equity Markets

The third quarter witnessed a continuation of the strong rebound in stocks from the lows reached in early March. As shown in the accompanying table, year-to-date returns are very impressive. From the intraday low of 666, the S&P 500 has advanced 59%. However, the S&P is still 9.4% below the September 30, 2008 close and 32.5% below the October 2007 high of 1,565. The advance has been widespread with most foreign markets doing even better than the US markets.

A look at sector performance shows that financials (+25.1%) and industrials (+21.2%) led the way. Year-to-date, technology (+44.8%) built on its earlier lead. The only negative sector year-to-date is telecommunications (-3.1%).

Another notable development for stocks has been the makeup of the market leadership from a quality standpoint. The post-March advance has been led by the poorest quality stocks with the weakest balance sheets. Of course, these are the stocks that suffered the most in the market decline. Further advances from this group of stocks may require validation in the form of better operating results.

Index	3rd Quarter 2009	Year-to-date 2009
S&P 500	+15.0%	+17.0%
DJIA	+15.0%	+10.7%
Nasdaq	+15.7%	+34.6%
Russell 2000	+18.9%	+21.0%

Reflects price changes only

## Outlook

Economic prediction is never easy. An added variable in the current environment is the recently completed "Cash for Clunkers" program. We know the program borrowed demand from future car purchases, we just don't know how much. The program will continue to affect indicators such as retail sales, durable goods orders, and industrial production for several months.

From a fundamentals standpoint, equities are no longer extremely undervalued, as they were in recent months. The soon-to-be-released third quarter earnings reports take on added importance in light of the rapid market advance. Further market appreciation may require much better earnings.

The current level of interest rates suggests that a cautious strategy is the most prudent when contemplating fixed-income investments. The low-quality end of the sector has not seen the last of bond defaults. And inflation, while not of immediate concern, still poses a threat to long-term bonds.

