

The Economy

The U.S. economy, the world's largest, continues to show signs of emerging from the worst financial crisis since the Great Depression. While the National Bureau of Economic Research won't make it official for some time, the recession most likely ended last June or July. After four consecutive quarters of negative GDP growth, the economy finally expanded in the third quarter of 2009 at a 2.2% annual rate. While this is good news, there is some cause for concern, since more than half of that GDP growth came from the federal government's "Cash for Clunkers" program.

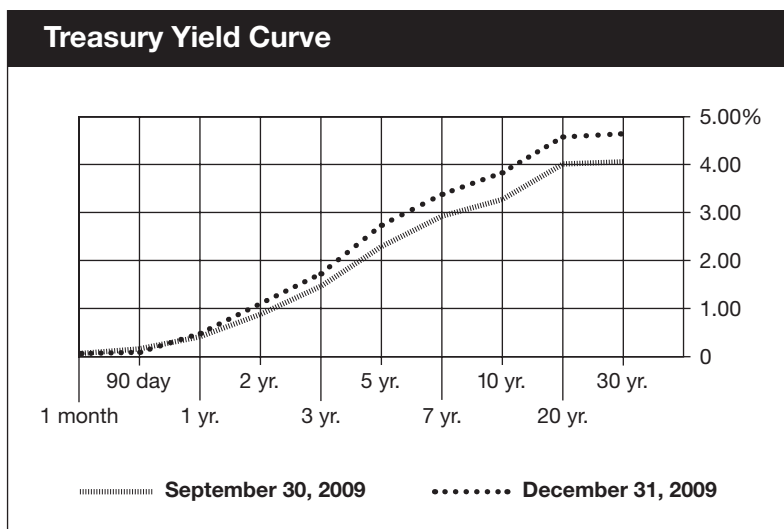
Many economic indicators improved in the fourth quarter. While 11,000 jobs were lost in November, this is significantly better than the average of 700,000 jobs lost in each of the first three months of 2009. We've also seen the Leading Economic Indicators Index post eight consecutive months of positive numbers. This index, consisting of ten different economic indicators, is designed to forecast future economic growth six to twelve months out.

The Institute for Supply Management, a trade group of purchasing executives, reported its manufacturing index rose to 55.9 in December. This was the fifth straight month of expansion and the highest reading for the index since April 2006. A number above 50 indicates growth. This index stood at just 32.9 one year ago. Home sales have also shown a marked improvement, both in unit sales and prices.

Fixed-Income Markets

The Federal Reserve first eased monetary policy back in August of 2007 when they lowered the federal funds rate by 50 basis points to 4.75%. Today it stands at a target rate of 0 to 0.25%. To provide support to the mortgage lending and housing markets and to improve overall conditions in private credit markets, the Fed has been in the process of purchasing \$1.25 trillion of agency mortgage-backed securities and about \$175 billion of agency debt. They are gradually slowing the pace of these purchases, and anticipate they will be done by the end of the first quarter of 2010.

We have already begun to see prices move lower and interest rates increase (see chart). Markets are now anticipating that the Fed will begin tightening monetary policy sometime in the second half of this year.



Equity Markets

What a difference a year makes. After a dismal 2008, the stock market came roaring back in 2009, making it the best year since 2003. This performance was even more impressive considering that in early March equities were at the bottom of a brutal bear market that began in October 2007. At that time, stocks were off more than 55% from their highs. From that low, the S&P 500 rose 64% in a little less than nine months to close the year at 1,115. The market, however, is still more than 28% below its October 2007 high.

All ten market sectors were positive for the year. Best sectors included; Technology (+60%) and Materials (+45%), while the worst sectors were Utilities (+6.8%) and Consumer Staples (+11%). International markets, especially emerging markets, easily outperformed domestic markets, providing returns in excess of +50%.

Index	4th Quarter 2009	2009
S&P 500	+5.5%	+23.5%
DJIA	+7.4%	+18.8%
Nasdaq	+6.9%	+43.9%
Russell 2000	+3.5%	+25.2%

Reflects price changes only

Outlook

The recovery will not be robust. Consumers continue to struggle. We are not likely to see strong consumer spending for some time. Replacing the consumer as the engine of growth for the economy will be exports (aided by a weak dollar), government spending, and inventory rebuilding.

At some point in 2010 the Federal Reserve will probably reverse course and begin tightening monetary policy. If they wait too long, inflation could spiral out of control. If they change course too early, they risk triggering a double-dip recession.

Another big concern is the policy and mindset of those in Washington. Massive amounts of spending are creating record budget deficits. Our national debt currently stands at over \$12 trillion and is growing. At some point we will be faced with higher interest rates, potentially higher inflation and higher taxes. This may present a challenge for the financial markets.

Going forward, we remain cautious. In order to address a potential future increase in inflation, we have introduced a commodities exposure to investment accounts where appropriate. Commodity prices typically increase in periods of rising inflation. In addition, concern over higher interest rates has dictated shorter durations for our fixed-income portfolios.

