



#### **4<sup>th</sup> Quarter 2009 Market Outlook/Strategy**

Economic forecasts for 2010 paint an interesting picture. During a normal recovery growth is typically 6 - 7%. This cycle will be different as the U.S. experienced a recession combined with a credit crunch. This pairing typically leads to weaker recoveries, which is consistent with market forecasts. The median forecast for GDP growth in 2010 is 2.6%. Forecasts range from 1.5 - 3.9%, a difference of 2.4%. The ranges for 2009 and 2008 were 5% and 4%, respectively. The tighter range for 2010 implies less uncertainty, and all forecasts expect positive growth. One concern is this strong consensus indicates a surprise in either direction could have a significant market impact.

The Federal government has been the primary engine of growth, and its level of support will be a key determinant of the trajectory of the recovery. We expect monetary and fiscal policies will remain highly supportive. The consumer sector, which accounts for about 70% of GDP, is facing much greater challenges. If discouraged and part time workers are included, the unemployment rate is 17%. While unemployment is likely to peak in the first quarter, it will remain stubbornly high. The consumer is also burdened with too much debt and less wealth as a result of declines in housing prices and the stock market. In general, the consumer sector is poorly positioned to be a strong contributor to growth. The success and the timing of the handoff from public to private sector spending will be an important influence for GDP growth in 2010 and 2011.

The traditional measures of inflation will be well behaved. Inflation tends to decline for 1-2 years following a recession. This cycle is experiencing high unemployment and tremendous slack. Consumer and wage inflation will decline in 2010. However, asset inflation driven by low interest rates is reemerging. The market is also concerned about the inflationary implications arising from the dramatic increase in federal debt. We see this as a concern, but the tipping point will not occur in 2010. Core inflation will decline and market expectations will adjust to this reality. The federal debt and asset bubble issues are not likely to play out until 2011 or 2012.

Monetary policy will remain on hold during 2010, fiscal stimulus will continue, and the underlying weakness in the consumer and banking sectors will slowly recover. The greatest risk to the economy is the timing and magnitude of the withdrawal of government support. With the Fed holding interest rates at current levels, investors will reach for yield by moving out the yield curve and investing in riskier asset classes.

Our strategy emphasizes sectors that should thrive in a moderate growth environment. We expect credit sectors will outperform government alternatives. The corporate sector provides the best combination of improving fundamentals, good liquidity and attractive relative value. CMBS fundamentals continue to deteriorate, but the sector remains undervalued. We view Build America Bonds (taxable municipals) as having cheap valuations despite near term supply issues. This sector offers one of the best relative value opportunities available in the investment grade universe and we will add to this sector in the first quarter. The mortgage sector is trading at very tight levels and while government support has been helpful in enhancing performance, the unwinding of quantitative easing will cause this sector to cheapen. Interest rates should remain in a narrow trading range as the Fed holds rates steady and the moderate growth scenario unfolds.