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Third Quarter 2009 Summary and Commentary

Summer is over and while many of us are thinking “all good things must come to an end,” in 2009 we are finding out that even the bad things will eventually come to an end. It has been approximately one year since the collapse of Lehman Brothers, Merrill Lynch became part of Bank of America, and AIG was taken over by the government. Six months ago, in early March, there was talk of a return of the Great Depression and fear was rampant. We did not know it at the time, but it appears that *may* have been the bottom of the stock market and we have seen a strong recovery in the markets since. For those of you who experienced a long vacation drive in your car with your kids (or grandkids), you probably remember that persistent question, “Are we there yet?”

In this quarter’s newsletter we will look at the cross currents of data from the economy and the stock market to assess where we are today and more importantly, where we may be going in the future and how this will affect our investment portfolios.

Is the Recession Officially Over?

After 21 months of the most significant recession we have seen since the Great Depression, the U.S. economy has started to move toward retracing some steps to growth. In mid-September, Federal Reserve Chairman Ben Bernanke stated what consumers and investors have been waiting (and hoping) to hear: “From a technical perspective, the recession is very likely over at this point.”

Whether or not the recession is “officially” over is irrelevant. It will not be “officially” over until the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER) announces the recession has ended. The NBER could take months to gather and analyze the data to conclusively state when the recession has ended.

For everyone who lives in the real world, it appears the worst is behind us and the economy is on the mend. The pessimism of March has been replaced by cautious optimism. The road to recovery could be bumpy and long, but it looks as though we are started on the way back.

The Positives We See

At the most recent Fed meeting on September 22nd and 23rd, the decision was made to keep the federal funds target rate at a range of 0.00-0.25%. This is important because the federal funds rate serves as a benchmark for other interest rates and can affect the level of economic activity and growth. Higher interest rates can slow economic growth by making it more expensive for consumers and businesses to borrow. Lower interest rates are generally a positive stimulus to the economy allowing businesses to expand and consumers to borrow at a lower cost. Additionally, the yield curve slope is positive and steep and this can be an indicator of economic expansion and credit markets beginning to function at pre-Lehman levels.

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Corporate America is emerging from this recession leaner, meaner, and ready to grow. Companies have taken advantage of low interest rates by eliminating much of their short term debt and replacing it with longer term debt that is more predictable and has lower borrowing costs. This is important because companies expand their payrolls as they see growth and their ability to expand is crucial to their economic growth.

Near term inflation is not a concern. The Consumer Price Index (CPI) actually declined in the most recent 12 month period, following a 0.1% rise in 2008, the smallest in 54 years. The Core Personal Consumption Expenditure (CPE) Index is also at its lowest trailing 12 month change since September 2001 at 1.3%. Inflation is the opportunity for industries to raise prices. As long as we continue to have high unemployment, wage driven inflation will not be an issue. Another metric to predict inflation is industrial capacity utilization. This measure reached a 50 year low earlier this year. Although it has risen slightly in the last few months to a reading slightly under 70%, it is still a long way from 80% - the historic level that indicates increased pricing power and potential inflation pressure.

The Conference Board reported the Index of Leading Indicators (LEI) increased for the fifth straight month. This index is meant to forecast the direction of the economy over the next six to nine months. In addition to the monthly LEI increases, the trailing 3 month and 1 year numbers are also positive. The Institute for Supply Management (ISM) reported the ISM non-manufacturing index rose during the month of September to the highest levels since May 2008. The increase in this index is an indication that the service sector of the economy is expanding.

Manufacturing activity rebounded in the 3rd quarter due to inventory restocking and a boost from government stimulus programs like "Cash for Clunkers."

The corner offices of companies are getting more bullish about the future of the economy. The Business Roundtable survey reported that 51% of CEOs expect their companies' sales to rise over the next 6 months.

Mergers and acquisitions activity, while still low, is beginning to pick up. Initial Public Offering activity is also increasing. These are positive signs of the return of risk taking and economic recovery.

The \$787 billion government stimulus program has deployed only about 10% of those funds so far. The largest portion of the remaining 90% is scheduled to be allocated in 2010.

The residential housing market appears to be showing signs of stabilizing. The S&P/Case Shiller Home Price Index has shown the price of existing homes starting to increase and the number of new home sales is increasing.

Technology spending is likely to increase, as companies that have put off investing in technology during the downturn, begin to spend to increase productivity driven by the belief that the worst of the recession is behind us.

A well coordinated global response to the recession appears to have started a synchronized global recovery. U.S. export growth is up sharply year after year. Stocks (domestic, international, and emerging market) and bonds all had a positive quarter and continue their upward movement off of the March 2009 lows. A declining dollar has helped to drive positive returns in the international markets. The emerging markets have yet to slow down and credit spreads on bonds continued to tighten as the bond market showed signs of a continued recovery.

Areas That Still Have Us Concerned

Since the recession began in December 2007, the U.S. economy has lost 7.2 million jobs and the unemployment rate has doubled. The "headline" unemployment rate reached 9.8% (a 26 year high) in September. Many economists predict it will exceed 10% before we see any kind of a decrease. If we add in all the people who are working part-time because they can't get full-time jobs, and those that are "marginally attached" or "discouraged" workers, we reach a number the government call U-6 unemployment. This number is not reported in the news media, but it reached 17% in September.

The consumer accounts for almost 70% of the U.S. GDP. Even if the rate of new job loss continues to decline, we may see persistently high unemployment for the foreseeable future. If the consumer has a less than optimistic appraisal of job security, job growth and income growth, spending may grow more slowly than in past recoveries. In September, the Consumer Confidence Index dipped to 53.1 from 54.5 in August. A reading above 90 means the economy is on solid footing, and above 100 signals strong growth. A consumer that is deleveraging (paying off bills and increasing savings) and has marginal confidence in their future economic condition could provide slower growth to the economy as a whole.

Residential real estate, while showing some signs of hitting a bottom, still faces some significant challenges. High U.S. unemployment can continue to push up the rate of mortgage delinquencies, which in turn drives up personal bankruptcies and home foreclosures. During August, a record 7.58% of U.S. homeowners were at least 30 days late on their mortgage payments. Since the price of residential housing is a matter of supply and demand, the question of the size of the “shadow inventory” continues to be a drag on a housing recovery. If the inventory of unsold homes remains high, residential home prices may still need more time to stabilize.

Commercial real estate still continues to be the 10,000 pound gorilla in the room. There are trillions of dollars of commercial real estate that will need to be re-financed between 2009 and 2013. The deleveraging of U.S. real estate will create many challenges for the commercial real estate market. Two trends that will create a potential refinancing shortfall in this market are declining commercial real estate values and lower loan to value ratios in lending. It is estimated that loan maturities from Commercial Mortgage Backed Securities over the next 5 years will total \$1.4 trillion. This is the same amount that matured over the past 15 years when capital was readily available.

The period March-September 2009 saw the S&P 500 rally by 45.8%. This has not been a high quality rally as the most highly leveraged companies have outperformed the lowest levered ones by nearly 20% since April. The question now is whether the market is on a sugar high based upon temporary government stimulus or are we on the path to sustainable economic growth? Many companies have increased their bottom lines by aggressively cutting costs and decreasing payrolls. This has helped drive stock prices higher even though top line/sales growth has been less than impressive. This quarter, Wall Street will be focused on top line earnings growth and future guidance and the market will want to see positive numbers in order for this rally to continue.

Other clouds on the horizon are the geopolitical concerns of Iran’s nuclear program, the potential impact on the global economy should Iran decide to attempt to block the Strait of Hormuz, and the ongoing wars in Iraq and Afghanistan.

At home, we still face the issues of entitlement program reform, an unsustainable Federal Budget deficit and the prospect of higher income, capital gain, dividend and estate taxes.

Review of 3rd Quarter 2009

Index	Q3 Performance %	Description
Dow Jones Industrials	15.7%	Large Cap Stocks
S&P 500 Index	15.6%	Large Cap Stocks
NASDAQ Composite	15.7%	Large Cap Tech Stocks
Russell 1000 Growth	14.0%	Large Cap Growth Stocks
Russell 1000 Value	18.2%	Large Cap Value Stocks
Russell 2000 Growth	16.0%	Small Cap Growth Stocks
Russell 2000 Value	22.7%	Small Cap Value Stocks
Russell 3000	16.31%	Small Cap Value Stocks
MSCI EAFE	14.9%	Europe/ Australasia/ Far East
MSCI Emerging Markets Equity	21.0%	Emerging Markets
30-Day Treasury Bill	0.0%	Short-Term Bonds
Barclays Capital US Aggregate Bond	3.7%	US Government Bonds

