Quarterly Review (4Q 2009)

The Capital ReCap

Closing Out 4Q 2009

Economic Activity

In general we have seen good economic reports this past quarter. Yes, their have been some poor readings and there has been some month to month fluctuation in reports, but in general the reports have shown the economy is strengthening. Below is a quick recap of the economic data from 4Q:

- ISM indexes show growth in both manufacturing and services sectors
  - ISM non-manufacturing hovered above the growth mark of 50 for majority of the quarter, before dropping in the last month.
  - ISM manufacturing continued to show growth, staying above the 50 threshold.
- Unemployment peaked at 10.2%, before receding back down to 10% to close the quarter.
  - Initial claims and continuing claims began to trend lower.
- Consumer confidence ebbed and flowed with employment through out the quarter.
- Housing market stabilized… thanks to the housing credit and the extension of the housing credit.
- Saw an initial GDP reading of 3.5%, but this was revised down to a reading of 2.2% (still a positive sign for the economy).
- Both price indexes (CPI & PPI) showed prices rising at a slow pace.
- Fed kept rates low… as they continued to stand by their desires to keep these rates in the 0-0.25% range.
- We saw productivity high during the latest reading… a sign that companies are producing more with fewer workers.

Equity Activity

Equity markets showed that they weren't going to let the bear out of hibernation just yet. The bulls kept running and markets hit fresh 2009 highs through out the fourth quarter. The bullish rally is now going on nine months and seems poised to continue. The major highlights on the equity front were a slew of M&A activity and good earnings reports. Below is a quick glance at the highlights in the equity markets for 4Q:

- Banks were in the positive spotlight for once
  - JPM, GS saw their quarterly profits jump… while C saw their losses narrow substantially.
  - Also, BAC, WFC and C repaid their TARP funds.
- Credit card companies Visa and Mastercard showed profits… a sign that the consumer is slowing beginning to spend again.
- The VIX index rallied to above 30, before dropping below 20 late in the quarter.
- M&A action was abundant:
  - Warren Buffett's Berkshire Hathaway bought Burlington Northern
  - Comcast bought the GE unit, NBC Universal

  - Exxon Mobil bought natural gas provider XTO Energy
  - The final tally for the quarter: $30 billion in M&A action for October and $83 billion for November.
- Close to 80% of the S&P 500 companies beat their quarterly estimates in the fourth quarter.
- Performance for the quarter through 12-28-2009
  - Dow up 8.59%, S&P up 6.69%, Nasdaq up 7.95%
  - 10 year Treasury up 65bps to 3.84%
  - GLD up 9.81% and OIL up 7.55%

Other Market Activity

- The Dow crossed the elusive 10,000 mark
- Health care legislation made it through both the House and Senate
- Dubai had debt issues, resulting in Moody's cutting the rating on some Dubai controlled debt.
- Greece had their credit rating reduced by both Fitch's and S&P.

What Lies Ahead?

We feel that this upcoming quarter should continue to bring much of the same that this fourth quarter has provided investors. The economy should continue to strengthen and the positive indicators on the consumer front should help to boost companies top line revenues. We have seen the retail numbers improving thorough out the fourth quarter which should give most investors a good feeling about first quarter earnings.

Continuing on the economic front, we are bound to run into some hurdles primarily with employment and the dollar. Employment showed some signs of reversion, but we have to be weary about this occurring due to seasonal hiring's. Employment will most likely continue to plague the markets in the first quarter, but should not damper the positive returns that are likely. We will most likely continue to see volatility with the dollar into Q1, which will affect investment strategies. A weak dollar will be good for commodity based companies along with export driven sectors. A strong dollar will benefit those companies who are mainly domestic companies along with the smaller market capitalized companies.

The data that investors have received during the fourth quarter does not give us any indication that inflation will be of concern in the first quarter. The Fed has also mentioned that they will begin to unwind some of their programs through out the upcoming quarter. This will likely have a minimal affect on rates in the first quarter, but will definitely influence rates through out 2010. As the Fed begins to unwind these programs we will most likely see rates begin to rise; whether this is a slow rise or a sharp tick up investors must position themselves in anticipation for higher interest rates.

Another theme for the upcoming quarter will be businesses, businesses, businesses. In order for our economy to sustain the third quarters GDP results and to grow GDP in the future we will need to depend on businesses in the near term. The consumer is still heeling and the government is beginning to lessen their stimulus, thus we will count on businesses to help continue moving GDP in the right direction.

Housing should continue to make positive strides. The new home buyer credit was extended until April and the government also added some incentive to existing home buyers. This should continue to prop up the housing market, in what is usually a slow home buying period. The credits will be in full force during Q1, which will be beneficial to investors. The stilts will be removed though in the second quarter and this could lead to some concerns on the housing front towards the end of the first half of the year.

A Longer Term Perspective

With all of our observations for the first quarter some may ask what should we do now to position ourselves for the longer term? The immediate future does look bright and we feel that we will continue this bullish run for a bit longer. Although, we still believe that that their will be a correction sometime towards the middle of the upcoming year. We can take some steps now in order to position ourselves most appropriately based on the information that we currently have.

As has been mentioned in previous weekly recaps, we still believe that investors should continue to move more into the large cap space within their growth allocations. We are going to want to make sure that we are investing in lower beta, or lower market sensitive securities for the longer term. Although investors may be giving up some of the 'home run' returns, this will protect them from holding too many companies that may 'strike out' in the upcoming year. The larger cap space should provide more protection during the correctional period in this upcoming year in relation to the smaller cap, higher beta companies. Also, the large cap companies stand poised to benefit more during times of a weakening dollar because of their ability to generate revenue via exports.

We also believe that their will continue to be opportunities to reap positive returns in foreign investments. There are some countries that are currently in a long term, secular, bull market and could provide investors a good opportunity to limit their exposure to corrections domestically. Also, investing abroad tends to help alleviate volatility due to the dollar and interest rates. Argentina, Peru, China and Brazil are a few of the countries currently experiencing a secular bull. The one aspect that is similar in the majority of those countries that are experiencing a secular bull is that they are located in Latin America or Asia.

On the income side, the easy money is gone. Investors will now have to depend on bond selection more than ever in order to find the best yields. With the outlook of having interest rates increase through out the year and with the perception of continuing to have a steep yield cure; investors should look towards higher yielding bonds, corporate bonds and quality sovereign debt. Other areas that seem poised to do well in the upcoming year, based on valuations, are commercial mortgage backed securities along with asset backed securities.

Overall, we see that 2010 will be a year of returning to normalcy. Markets should react more to fundamental factors rather than speculation and asset allocation should work again. During 2009 investors were comparing the reports that they were receiving to the numbers of 2008, which were the worst we have seen in awhile. This led to investors having the mentality of 'it's bad, but not as bad.' In this upcoming year investors will demand to receive information that gives them reason to believe things really are good. Markets will be negatively affected if this does not happen. It will be harder for companies to continue to provide good reports as they will now be compared to better 2009 numbers, rather than the dreadfully low numbers of 2008.