Market Strategy
November 13, 2009

Investment Strategy Outlook

Please refer to Appendix – Important Disclosures.

Benefit of the Doubt Still with the Bulls – Cyclical Rally Intact

Highlights:

- **Fed May Face Decision on Dollar**
- **Valuations Pricing in Robust Recovery**
- **Individual Investors Still Skeptical on Equities**
- **Seasonal Tailwinds Support Stocks**
- **Breadth Divergences Emerge**

Outlook Summary

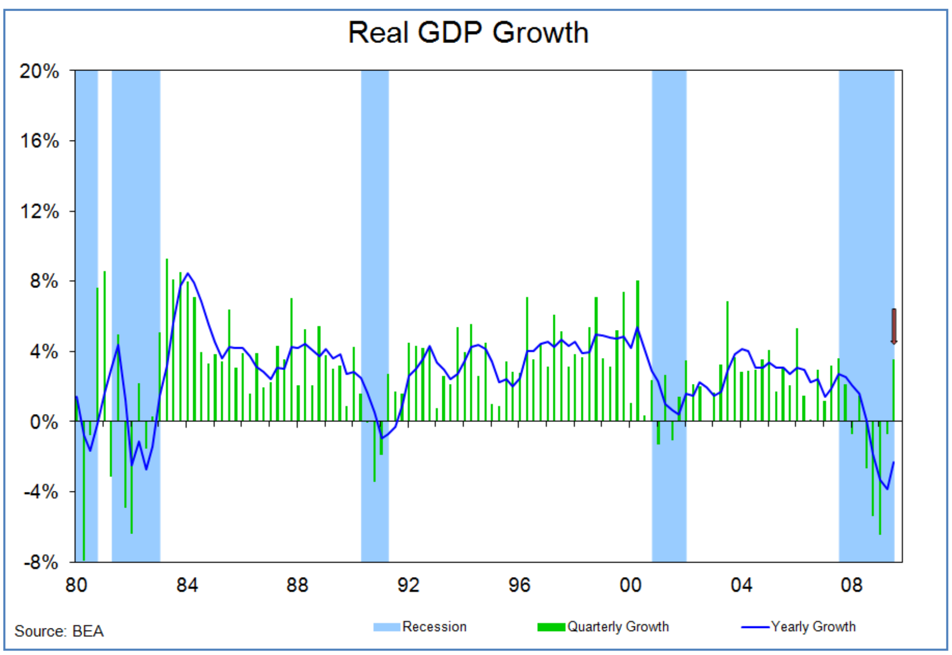
Marketweight Exposure to Stocks, Underweight Bonds

Further Equity Gains Likely to Be Harder Fought as Trends Moderate

Leadership Trends Favor Upgrading in Size, Quality

Emerging Market Leadership Intact Across Regions

Our review of **the weight of the evidence suggests favorable conditions for stocks** into year-end. The move by the Federal Reserve away from crisis-level involvement in the financial markets and valuation levels that appear to have discounted a robust economic recovery could soon represent fundamental headwinds. For now, the technical indicators hold sway and favor continued, albeit more moderate, gains in the stock market. Seasonal patterns are favorable into year-end, but the trends are cooling. We are wary that the recent (minor) breadth divergences could persist and develop into headwinds. We are also watching the sentiment indicators for evidence of capitulation on the part of skeptical individual investors.



The apparent ending of the recession has led us to view the **Economic Fundamentals as no longer bearish**, but the absence of a persuasive engine of growth and still weak labor market conditions keeps our rating from being bullish. The essence of the economic data released over the past month can be described by two numbers: 3.5% and 10.2%, the former being the pace of expansion in overall economic activity in the third quarter (July, August, and September) and the latter being the officially reported unemployment rate as of October. The former shows that the economy saw a return to growth in the third

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quarter following four consecutive quarterly declines in output. This was the largest quarterly increase in output since the third quarter of 2007. *While this return to growth is certainly welcome, we caution against viewing this as the beginning of a new and lasting uptrend.* Much of the growth in the quarter can be attributed (directly or indirectly) to intervention by the Federal government. Moreover, while 3.5% growth is certainly better than what has been experienced in recent quarters, it pales in comparison to the post-WWII average of 7.3% growth in the first quarter following a recession. Going forward, growth could be buoyed by:

- Stability in the housing market
- Favorable trade conditions
- A slowing and reversal of the inventory drawdown
- Continued intervention by the federal government.

These, however, are temporary effects, and **the emergence of a lasting uptrend in growth is unlikely absent stability in the labor market and an improved outlook for income and consumption growth.**

Indicator Review

Fundamental Factors		
Federal Reserve Policy	Neutral	0
Underlying Economic Fundamentals	Neutral	0
Valuations	Neutral	0
Technical Factors		
Investor Sentiment	Neutral	0
Trends/Seasonal Tendencies	Bullish	+1
Tape/Breadth	Bullish	+1
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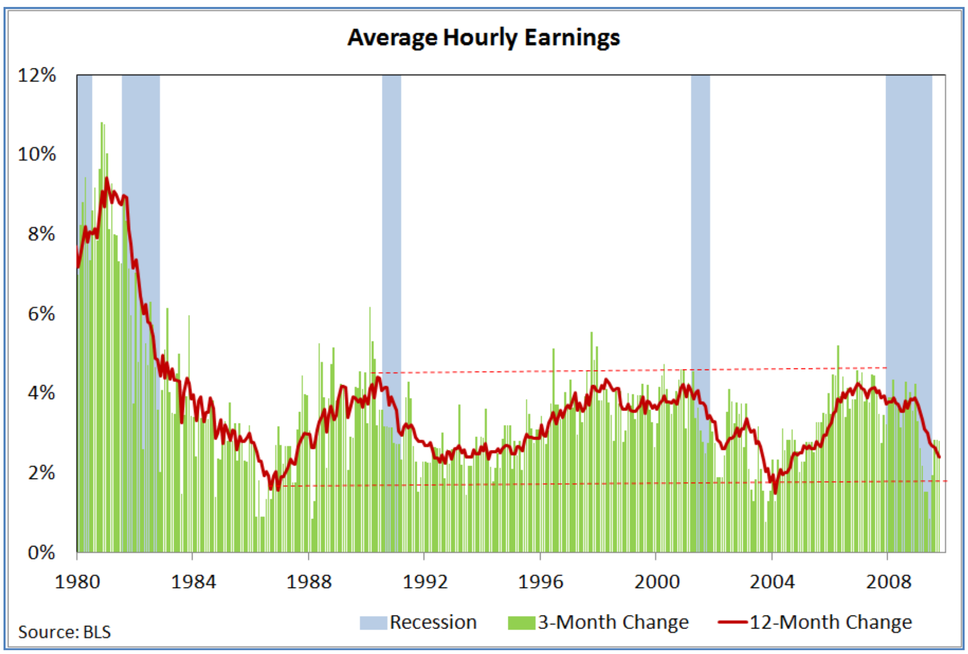
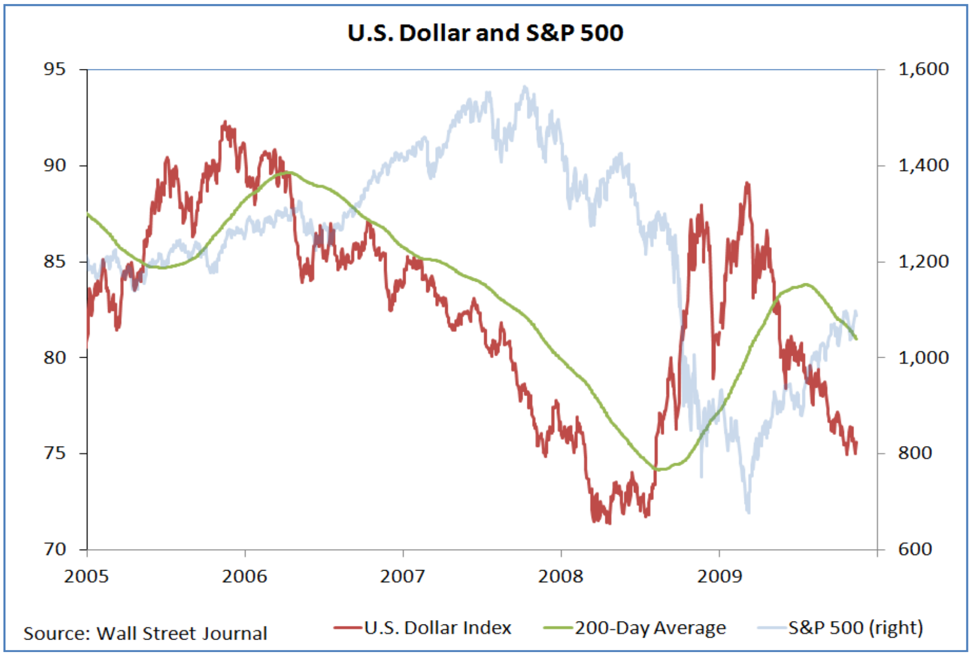
Weight of the Evidence	Bullish	+2



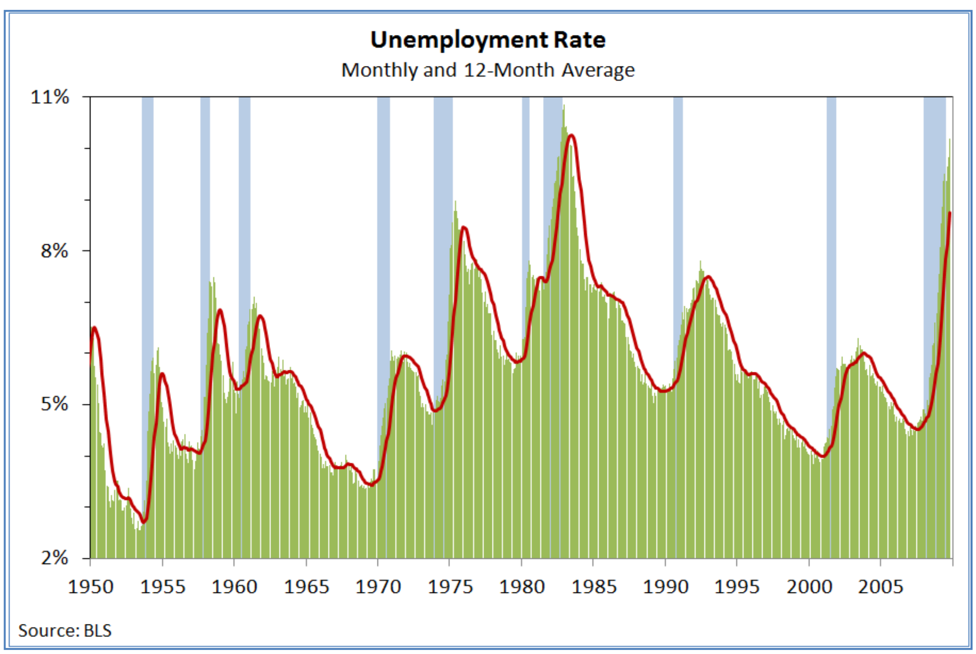
The latter number, the 10.2% rate of official unemployment, is the highest such number since early 1983 and brings the post-WWII peak of 10.8% into much sharper focus. A broader measure of unemployment, which adds in frustrated workers who have dropped out of the labor force (i.e. they are no longer actively looking for a job, and thus are excluded from the official unemployment rate), as well as those who are working part-time but would like to work full-time, is now at 17.5%. While this excess supply of labor is keeping downward pressure on wages (limiting the ability of inflationary forces from entering the economy even with massive fiscal and monetary stimulus), it also represents a headwind for economic growth going forward.

Looking at the payroll side of the labor market, companies have mitigated the number of necessary layoffs (this is hard to believe when more than seven million jobs have been lost since the start of the recession) by reducing the average workweek. This is estimated to have “saved” nearly three million jobs over the course of the recession. Improving economic conditions will likely be met at the margin by an expansion in the workweek, further delaying a meaningful upturn in new hiring. Alternatively, companies may rely on temporary workers, rather than adding to their permanent payrolls. **Expanding hours rather than adding to payrolls may mean that the unemployment rate may not fall rapidly once it peaks (likely in 2010, and maybe not shy of 11%).**



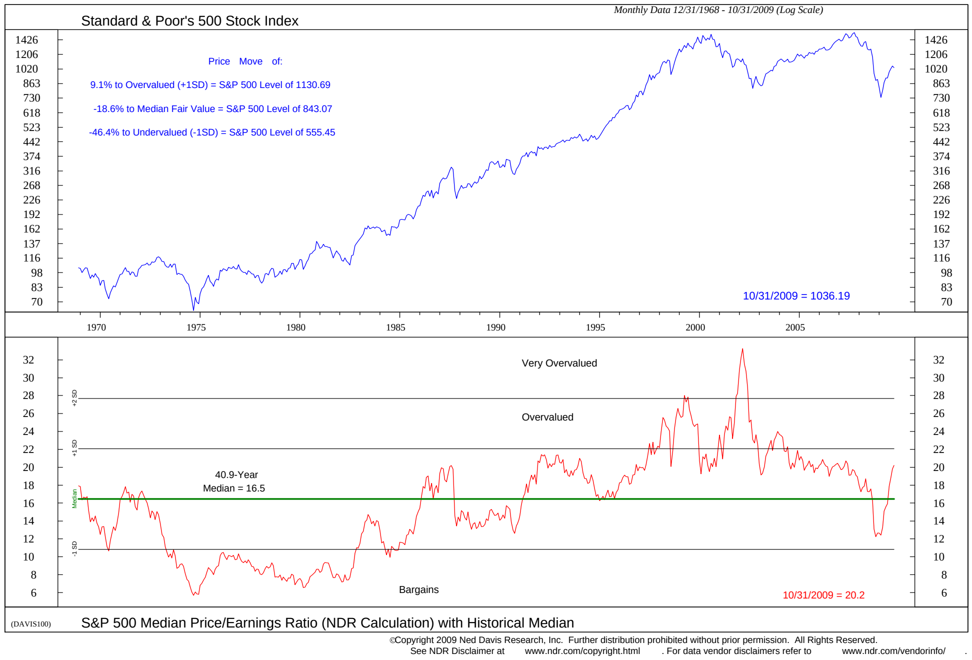
The latest communiqué from the Federal Open Market Committee (FOMC) reiterated its previously announced view that the current accommodative stance will not soon be reversed. While active tightening by the Fed remains over the horizon, the winding down of the Fed's asset purchase program and the ongoing lack of monetary velocity could be headwinds, suggest that **Fed Policy is neutral.** The Federal Reserve has completed its purchase of $300 billion of Treasury securities and is winding down its purchasing of $1.3 trillion of agency securities and debt (which is $25 billion less than the previously announced total of agency purchases, due in part to a lack of supply of agency debt). This represents a step back from the quantitative easing regime that was pursued as the financial crisis emerged.

Efforts by the Fed to re-start economic activity through monetary policy have been stymied by the collapse in the velocity of money, the rate at which money changes hands in the economy. Banks have been recipients of funds from the Federal Reserve, but instead of lending it out, they have essentially invested it in fixed income securities, using the currently steep yield curve to begin to re-build their balance sheets. This has limited the effectiveness of the Fed's actions in stimulating economic activity, and may also contribute to a false sense of security surrounding health and operational outlook for banks.

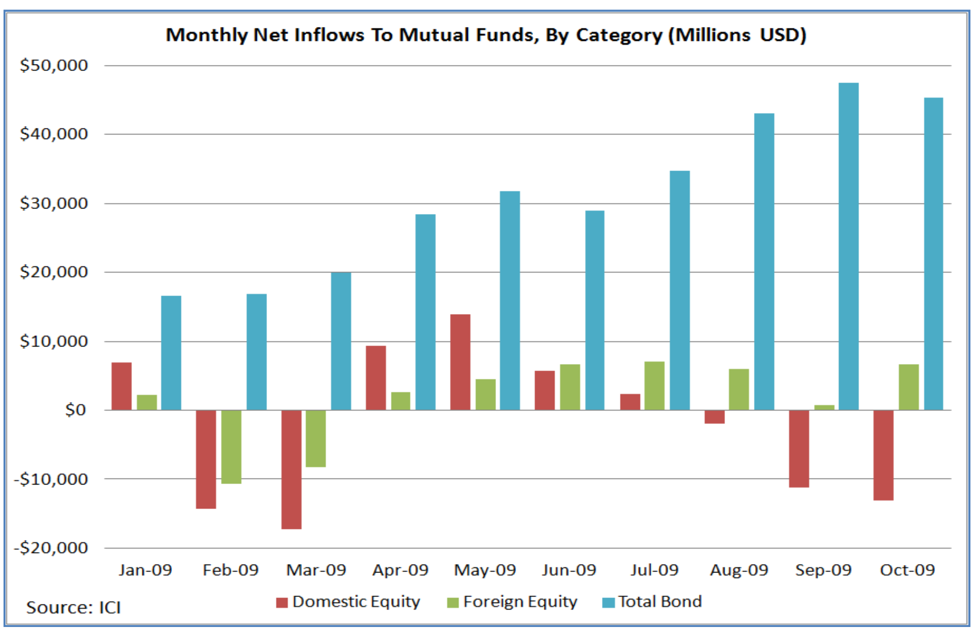


While the Fed is unlikely to continue to supply crisis-level support to the financial markets, it is also making clear that economic and financial market conditions continue to warrant an exceptionally low level of interest rates, and will so for an extended period. It cited three observable conditions that investors can monitor for clues about when this period might end: low rates of resource utilization (thought to refer to both plant/equipment as well as labor); subdued inflation trends;

and stable inflation expectations. To this list, we would add a fourth: the foreign exchange value of the dollar. A moderate decline in the dollar supports domestic economic growth, has supported a rebound in asset prices, and could help ward off deflationary outcomes. Acceleration in this downtrend could put pressure on the Fed to raise interest rates to support the currency, which would raise the risk of deflation and increase the likelihood of rapid return to recession.

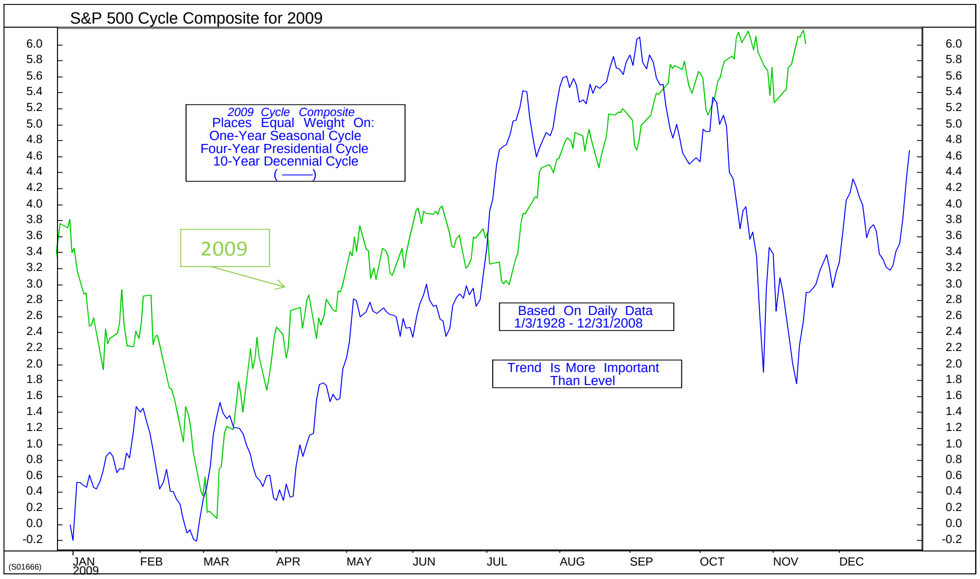


With the stock market rallying in anticipation of improving economic and business conditions, **valuations have become stretched but for now, we continue to view them as neutral.** Stocks were insufficiently cheap at the start of the rally to suggest that conditions favored the emergence of a secular bull market. Now, reflecting the rally in stocks that has outpaced modestly improving business conditions, our valuation measures have expanded and appear to have priced in a robust recovery. The improvements in earnings seen thus far have been due largely to cost controls and productivity enhancements (the gains seen non-farm business productivity over the past two quarters have been the largest in nearly 50 years). **Validation of the current valuation levels likely requires sustained improvement in business fundamentals, notably an expansion in revenue and sales.** The expansions seen in price/sales ratios thus far has been consistent with the pattern typically seen in the wake of a market bottom, but this pattern would also suggest that these ratios should be peaking. *If business revenue and sustainable earnings do not pick up shortly, valuation measures may appear unsustainably stretched and could become a headwind for stocks.*



Investor sentiment remains mixed and is rated neutral, as the gap between individual investors and market professionals remains wide. The Investors Intelligence survey of advisory services shows that bears (27%) have moved to their highest level in four months, but they continue to lag the bulls (44%). The Consensus Bullish index shows a similar trend – while optimism among market letter writers has waned somewhat in recent weeks, it remains elevated. **Individual investors continue to steer clear of domestic equity mutual funds (which have seen outflows in 11**

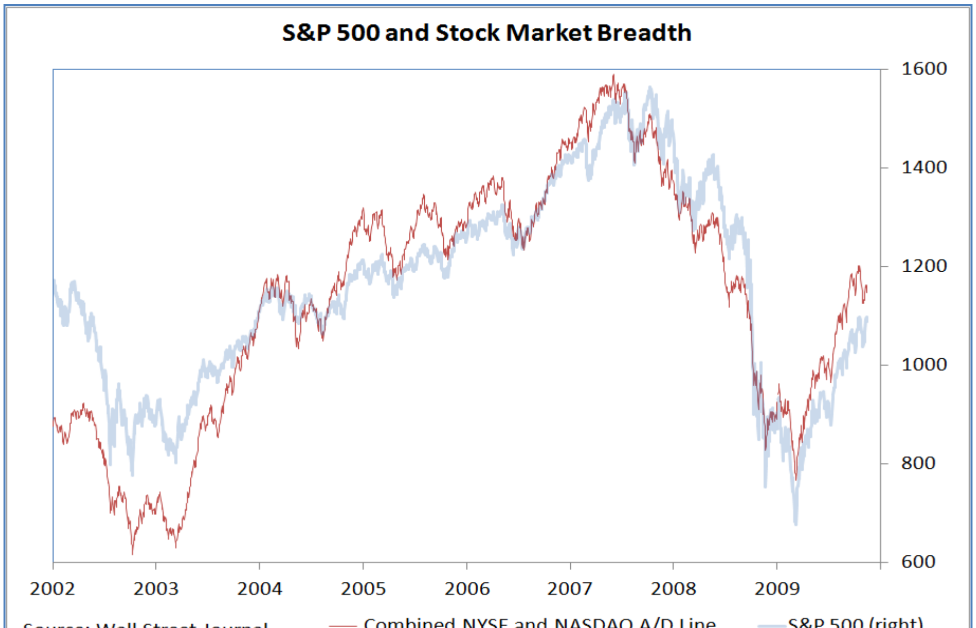
consecutive weeks), but portfolio managers of those funds have become increasingly bullish, moving cash that was on the sideline back into the stock market. Cash that individual investors had stashed on the sidelines (in money market funds) has moved primarily into bond funds, with foreign equity funds also seeing net inflows.



Source: Wall Street Journal, Ned Davis Research

This persistent skepticism on the part of individual investors can be seen in the AAII sentiment. Bears rose rapidly over the second half of October, and by the first week of November outnumber bulls by more than 2-to-1 (22% to 56%). With individual investors apparently in the midst of a secular shift away from equity exposure, the levels that have historically represented excessive optimism may not soon be seen. For now, the sentiment among individual investors, and its implication for the stock market, may best be measured by the flow of optimism/pessimism, rather than the level of pessimism. We are on the lookout for evidence that the recent shift in preferences among individual investors has reversed. This could be seen in a surge in optimism in the AAII data or inflows into domestic equity mutual funds. Either of which would warrant monitoring.

The composite cycle suggests the risk of a pullback has lessened, and with November and December having been historically the two strongest months of the year for stocks, **the Seasonal Patterns/Trends are again bullish**. The correction seen over the second half of October fell within the pattern expected by the composite cycle, as well as historical tendencies for corrections within cyclical bull markets. Now, seasonal tailwinds offer support in to the first quarter of 2010. While these prospective patterns are supportive of further gains, and it has been historically hard to put the market down heading into year-end, the recent trends suggest that the rally is becoming tired. *As the cyclical rally ages, upside moves are attracting less support (volume in the latest moves has been particularly anemic) and are increasingly struggling at resistance levels. Pullbacks remain swift and support levels can appear tenuous.*



Source: Wall Street Journal

Broad participation has been a signature of the rally off of the March lows and **Breadth Trends remain bullish** for the indexes. While still at the point of being curiosities to be

resolved rather than indictments of the rally, divergences have emerged. These divergences remain minor (although increasingly widespread), and become more troubling the longer they persist. Among the divergences that have been seen are those between:

- Large-caps and small-caps – large-caps have made new highs, while small-caps have not, and small-caps failed at support while large-caps held key levels;
- The Dow Industrials and Transports – the Industrials have made new highs in November, while the Transports appear to be tracing out a triple-top;
- The NASDAQ Composite and the NASDAQ 100 – the larger-cap NASDAQ 100 has made new highs, while the broader Composite has not;
- The S&P 500 and the NYSE+NASDAQ Advance/Decline line – the index made a new high early-November, the A/D line did not.

Participation across sectors has narrowed, and breadth within sectors has deteriorated. At this point, these divergences do not represent a timing call, but are reflective of an aging and increasingly tattered cyclical bull market. **There is insufficient evidence to conclude that the rally has run its course, but with broad market support beginning to wane, the indexes may find further appreciation will be increasingly hard fought**.

Asset Allocation/Strategy Thoughts:

- Small-cap leadership appears to have past. In additional to the small-cap break down described above, valuation measures suggest that small-caps have become expensive and small-caps face seasonal headwinds into year-end. Investors should move with the emerging trend that favors trading up in size in quality, factors that tend to see improved leadership with the aging of cyclical bull markets. We maintain a modest bias towards growth over value, although this is largely a function of our sector calls (Financials, which are heavily represented in the value indexes, have been losing relative strength).
- At the sector level, we are focused on higher-quality exposure weak dollar beneficiaries (across the Industrials, Energy, and Technology sectors), with an increasing interest in adding to defensive positions (in Health Care and Consumer Staples). Investors should look to use strength to rotate out of early-cycle leaders that have failed to keep up with the most recent broad index moves (Financials).
- The secular bull market in commodities may have gotten ahead of itself in the near term, as optimism on commodities (and inversely, pessimism on the dollar) appears excessive. For investors that are looking to add to commodity positions, we would recommend waiting for pullbacks.
- International exposure should continue to be tilted toward Emerging markets, with strength being seen across regions (Latin America, Europe, Asia). Emerging markets in Europe are gaining strength, although there is little evidence that interest in Latin America (Brazil, Argentina) or Asia (China, both Shanghai and Hong Kong) has peaked.
- Fixed income investors should continue to focus on the short-end of the yield curve both within Treasuries and higher-quality Corporates.

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Model Portfolio	Mix: Stocks / (Bonds + Cash)	Risk Tolerance	Strategic Asset Allocation Model Summary
All Growth	100 / 0	Well above average	Emphasis on providing aggressive growth of capital with high fluctuations in the annual returns and overall market value of the portfolio.
Capital Growth	80 / 20	Above average	Emphasis on providing growth of capital with moderately high fluctuations in the annual returns and overall market value of the portfolio.
Growth with Income	60 / 40	Average	Emphasis on providing moderate growth of capital and some current income with moderate fluctuations in annual returns and overall market value of the portfolio.
Income with Growth	40 / 60	Below average	Emphasis on providing high current income and some growth of capital with moderate fluctuations in the annual returns and overall market value of the portfolio.
Conservative Income	20 / 80	Well below average	Emphasis on providing high current income with relatively small fluctuations in the annual returns and overall market value of the portfolio.
Capital Preservation	0 / 100	Well below average	Emphasis on preserving capital while generating current income with relatively small fluctuations in the annual returns and overall market value of the portfolio.

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Asset Class / Model Portfolio	All Growth	Capital Growth	Growth with Income	Income with Growth	Conservative Income	Capital Preservation
Equities:						
Suggested allocation	95%	80%	60%	40%	20%	0%
Normal range	90 – 100%	70 - 90%	50 - 70%	30 - 50%	10 - 30%	0%
Fixed Income:						
Suggested allocation	0%	10%	30%	40%	45%	60%
Normal range	0 - 0%	10 - 30%	30 - 50%	40 - 60%	45 - 65%	55 – 85%
Cash:						
Suggested allocation	5%	10%	10%	20%	35%	40%
Normal range	0 - 10%	0 - 20%	0 - 20%	10 - 30%	25 - 45%	15 - 45%

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