FREEDOM'S
insight

Winter, 2010

Glimmers of hope that the economy might finally be beginning a turnaround gave investors the courage to keep buying stocks during the fourth quarter of 2009, as one of the strongest rallies in Wall Street memory continued. Yet while the tone was vastly improved from the near panic that gripped the world's financial markets a year earlier, faith in the recovery remained fragile, and those still wary of signs of renewed economic distress found plenty of news to ponder.

Market Scorecard (Total Return)
December 31, 2009

Index	4th Qtr. 2009	YTD 2009
Dow Jones Industrial	8.10%	22.68%
Standard & Poor's 500	6.04%	26.46%
NASDAQ Composite	6.91%	43.89%
Russell 2000	3.88%	27.17%
MSCI EAFE	2.18%	31.78%
Dow Jones US Select REIT	9.18%	28.46%
Barcap Aggregate Bond	0.20%	5.93%

The Stock Market

After the spectacular gains of the third quarter, major equity benchmarks extended their advance somewhat more slowly during the year's final months. The Dow Jones Industrial Average rebounded another 7.37%–8.10% with dividends included – bringing its full-year rise to 22.68%. The Standard & Poor's 500 index climbed 5.48% (or 6.04% on a total return basis) for a 12-month gain of 26.46%, and the technology-rich Nasdaq Composite finished up 6.91% for the quarter and 43.89% for the year.

For 2009 as a whole, all 10 major industry groups that Standard & Poor's tracks recovered from early losses to close the year in positive territory; technology (up 59.92%) and the raw materials producers that will likely benefit as the economy starts growing again (up 45.23%) led the way. Even the battered financial sector ended the year 14.8% ahead.

The urge to conserve cash in a tough business environment meant executives remained cautious about payouts to shareholders. U.S. companies reduced quarterly dividend payments by a total of $58 billion, or 21%, during 2009, the biggest decline since 1938. But here, too, brighter times may be coming, with analysts predicting S&P 500 dividends will rise 6.1% in 2010.

The Bond Market

Bond prices, buoyed during the financial crisis as investors sought save havens, finally declined during the fourth quarter. As the federal government issued $2.1 trillion worth of new debt to fund stimulus and bailout programs, that boost in supply amid waning demand drove prices lower and yields higher. By year's end, a representative portfolio of Treasury debt had shed 3.6% of its value, making 2009 the worst year for bonds since the late 1970s.

Hints that the Federal Reserve was preparing to end some of its extraordinary efforts to help the economy further eroded support for bond prices. During 2009, the Fed had bought some $1.6 trillion in government, housing agency, and mortgage-backed securities. But that bond buying now seems likely to end, possibly as early as the first quarter of 2010.

The retreat from bonds was especially brutal for longer-term debt, which exposes investors to greater risk that inflation and rising interest rates will erode returns. While short-term yields remained close to zero, in line with the Fed's overnight interest rate targets, declining demand for longer-term bonds pushed their yields upward, widening the gap or "spread" between two- and ten-year bond yields to a record 2.8 percentage points by mid-December.

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INSPIRED INVESTING

FREEDOM FINANCIAL SOLUTIONS
Inspired Investing

(Continued from Front)

Hungry for higher yields and with an increasing tolerance for risk, investors have continued to turn to corporate bonds, and though by the end of the quarter the spread between speculative or "junk" corporate yields and Treasury debt of the same duration had narrowed to 6.75 percentage points – far from the 20-point premium investors received in late 2008 – that still represents a considerable incentive. Yet risks remain high, with analysts expecting some 14% of high-yield corporate borrowers to default on their obligations during the first quarter of 2010.

The Economy

According to Federal Reserve chair Ben Bernanke and the Fed's interest rate policy board, economic activity "continued to pick up" between October and December as the housing market and household spending revived. Yet jobs remained scarce, and the Fed seemed likely to maintain its short-term interest rate targets – a fundamental tool for regulating the economy – at near zero. While low borrowing costs ordinarily feed inflation, the Fed expects the slow recovery in business activity to keep price rises "subdued" for some time.

Meanwhile, the ability to borrow and invest money cheaply continued to melt the otherwise frozen budgets of businesses and consumers. U.S. gross domestic product (GDP) increased at an annualized rate of 2.2% during the third quarter as consumers in particular started spending again. Yet the rate of expansion has been weak at best, and that GDP number was revised downward sharply from an original reading of more than a percentage point higher. Forecasts for growth during the fourth quarter range from 3.5% to 4.0%.

While consumers spent more as the year wound down, sales paled in comparison to the cheerful retail environment of 2007 and early 2008. Households bought only slightly more in November than they did going into the disastrous holiday season of the previous year. Everyday purchases increased modestly but spending on big-ticket items at furniture and department stores remained significantly depressed on a year-over-year basis. Analysts expected to see a similar increase when retailers reported numbers for the all-important December shopping season.

U.S. companies continued to eliminate jobs throughout much of the quarter, but at a slower pace. The 75,000 positions lost in December represented a dramatic improvement from the monthly rate of 600,000 to 700,000 layoffs seen earlier in the year, and revised data showed that 4,000 jobs had been created in November. Yet unemployment remained at the psychologically critical 10% level, with businesses reluctant to add new jobs while so much economic uncertainty remains. Roughly 6 million Americans had been out of work for 27 weeks or longer in December, and millions more had been forced to accept part-time positions or leave the work force entirely.

One bright spot for the unemployed has been the absence of significant price increases. Still, inflation is not dead but merely "subdued," in the Fed's terms, with the Labor Department's consumer price index (CPI) edging 1.8% higher during the 12-month period that ended in November. The price of gasoline climbed by almost a quarter during that time, while food and home heating costs declined. Once again, health care costs outpaced the broader economy, rising 3.5%.

Despite the recession's lingering shadow, many on Wall Street and Main Street have been relieved that Federal Reserve and other government entities managed to contain the worst of the financial crisis. Slow growth is better than no growth, and early signs of an upswing in manufacturing activity may be cause for optimism. And the housing slump seems to be easing in many areas of the country.

The employment picture remains worrisome, though, and while corporate balance sheets have gotten stronger, some unwelcome surprises remain likely as the Federal Deposit Insurance Corporation continues to bail out failed banks and the Federal Reserve scales back its commitment to take on the tainted and still potentially toxic assets that spawned the credit crunch in the first place.

And even a smooth recovery may carry hidden dangers. A bloated money supply, coupled with ultra-low interest rates, could still generate inflation strong enough to stall economic expansion, as could a sharp increase in oil prices. And if persistent trouble in the housing market spreads, that could again raise the threat of a "double-dip" recession.

Ultimately, whatever scenario develops will contain both opportunities and challenges. As corporate leaders try to steer their companies back to profitability and growth, investors who can stomach the risks and follow well-constructed investment plans could reap the rewards. ■

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This summary offers an overview of the economy and market environment at a specific point in time and is subject to change. It is not offered as investment advice or intended to predict or depict performance of any investment or portfolio.

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