

# Market Update

## December 2009 Review

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### **“It was the best of times, it was the worst of times...”**

The capital markets staged a strong recovery in 2009 as massive amounts of stimulus from central banks around the world pulled the global economy back from the brink of financial collapse. The Federal Government was no exception; providing unprecedented support to corporate America, credit markets and first-time homeowners fueling investor optimism, which helped the equity and credit markets, post strong returns during the year. The S&P 500 Index gained 1.9% in December and rebounded 26.5% in 2009, following a 37% decline in 2008. The blue-chip Dow Jones Industrial Average (“DJIA”) provided strong results as well, as the index rose 1.0% for the month and 22.7% for the year. Continued strong returns from the technology sector helped the NASDAQ Composite Index rise 5.9% for the month and 45.3% for the year. The magnitude and swiftness of the capital market recovery was eye opening. Since the market lows experienced in March, the DJIA has gained 59%, the S&P 500 Index has risen 65%, and the NASDAQ Composite Index has returned 79%. From a sector and style perspective, technology and materials outperformed defensive oriented sectors such as utilities and consumer staples, while growth outperformed value despite a strong rebound from financials.

International markets also participated in the recovery over the past year, led by resilient emerging markets. The MSCI Emerging Markets Index rebounded 79.0% for the year, while the developed markets, as represented by the MSCI EAFE Index, posted a solid gain of 1.5% in December and 32.5% in 2009. Fueling investor optimism overseas within developing markets were improved readings in consumer spending, improving corporate profits, decreasing unemployment and low consumer debt levels. The emerging markets of Asia, outside of Japan, appear to be leading the world out of the global recession. The International Monetary Fund (“IMF”) forecasts growth in developing Asia will be 7.3% in 2010, compared with a considerably weaker 3.1% globally. The IMF also reports that China alone has accounted for more than half of the world’s economic growth in the past three years.

	Dec	2009
DJIA	1.0%	22.7%
S&P 500	1.9%	26.5%
NASDAQ	5.9%	45.3%
MSCI EAFE	1.5%	32.5%
Barclays Aggregate	-1.6%	5.9%
Barclays U.S. Corp. High Yield	3.3%	58.2%

The rebound in the financial markets was not limited to equities. The credit markets also recovered from last year’s pummeling as government programs helped to restore liquidity and investor confidence. The Barclays Capital U.S. Aggregate Index, the barometer for the U.S. bond market, gave back -1.6% in December as government yields move higher on concerns of increased debt issuance, but gained a healthy 5.9% in 2009. As conditions improved in the bond markets during the course of 2009, investment grade and high yield companies raised \$1.18 trillion through the

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new issuance of corporate securities, as both high and low quality companies were able to refinance debt, while improving corporate balance sheets. The credits from low quality companies performed particularly well in 2009, as the Barclays Capital CAA U.S. High Yield Index returned nearly 91% for the year, erasing much of the damage done in 2008. Overall in 2009, corporate credits handily outperformed government securities as investors returned to the credit markets with a vengeance in 2009 to take advantage of record spreads and higher yields outside of government and money market type instruments.

With the turn of the calendar, investors look to a better decade than the one that just ended. To U.S. investors, the past 10 years have brought two recessions, a credit crisis, a housing market bubble, and the near collapse of the global financial system. The S&P 500 Index experienced its first decade of losses in 90 years, as the index level dropped 23%. Compare that to the previous decade of the 1990s, when the index gained 316%. The tech-heavy NASDAQ Composite Index has posted more dismal numbers, thanks to the tech bubble burst in the early years of this past decade. Despite a strong 2009, the index is down 44% in the 10-year period ending in 2009, versus a gain of 794% in the 1990s.

Although the markets performed well in 2009 and the economy has stabilized, 2010 will bring many challenges. While the "Next Great Depression" may not have materialized in 2009 as some had feared, the issues facing the economy and investors in 2010 are plentiful. Low interest rates, corporate delevering, increased capital and retail spending, contained inflation in the near-term, and improving levels of manufacturing activity point to an economy that is on the mend. However, what will the economy and corporate America look like after all the government stimulus is removed from the system? Elevated unemployment, a less than lucent housing and commercial real estate market, a weak dollar, and mounting government debt continue to weigh on the minds of investors. Some, in this camp, worry that the economic rebound has merely been a by-product of government spending and question the sustainability of economic growth absent such massive stimulus.

Using the most recent recession at the beginning of the decade as an example, we are seeing similar patterns emerge despite some pundits' beliefs that we are in a "new normal" economic environment. But is a "new normal" really anything new? Back in the heyday of the late 1990s when tech stocks reached far-fetched valuations, weren't there pundits proclaiming that new startup companies without earnings selling for higher valuations than blue-chip companies with decades of earnings and pristine balance sheets was becoming the "new normal"? Legendary investor Sir John Templeton cautions us that "the four most dangerous words in investing are 'this time it's different'."

In the tech bubble, low quality companies (denoted on the included table as Cs and Ds by S&P) reached tremendous valuations, while higher quality companies (denoted as As on the table) were left in the dust. However, following the bubble burst, high quality companies, or those with growth and stability of earnings and dividends, easily outperformed low quality firms during the 2000-2002 recession. The tables turned coming out of the recession in 2003, as low quality firms rallied and provided returns nearly double those of high quality companies as stocks that were battered the hardest during the recession came roaring back to life, as is often the case.

Following the cyclical nature of the markets, from 2004 through 2008, medium (Bs) to high quality fared better than low quality. As one might expect, those stocks that were hurt the most (i.e., highly leveraged companies and generally low quality firms), rallied tremendously in 2009, vastly outperforming higher quality companies. While low quality has outperformed for most of 2009, the trend has shown signs of reversing in the fourth quarter, suggesting that high quality may once again return to the forefront.

S&P Quality Ranking											
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	YTD as of 11/30/09
As Total Return (High Quality)	8.98%	1.53%	-5.62%	-17.70%	23.50%	8.33%	3.74%	15.41%	-1.66%	-32.53%	15.73%
Bs Total Return (Medium Quality)	33.10%	-12.91%	-16.00%	-25.94%	-33.03%	12.58%	7.46%	16.32%	11.83%	-38.52%	29.31%
Cs & Ds Total Return (Low Quality)	95.71%	-60.86%	-45.54%	-50.69%	41.30%	-0.53%	-5.04%	7.54%	-2.23%	-60.76%	59.13%
S&P 500 Index	21.04%	-9.10%	-11.89%	-22.10%	28.68%	10.88%	4.91%	15.79%	5.49%	-37.00%	24.07%

Source: FactSet and Standard & Poor's, 11/30/09

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Although the coming years may be different than the past several years, it may not necessarily be new. The global economic climate is in a constant state of flux and it seems reasonable, as history has shown, to expect that global markets will continue to move in unpredictable cycles.

As we reflect on 2009, one has to appreciate the concerted effort of global government central banks to mend the financial system. As signs emerged that a financial apocalyptic event would not materialize, investors' appetite for equities and riskier fixed income securities returned. While the markets' recovery is certainly a relief, there is a sense that the rally was driven primarily on news that was "less bad." That the sharp sell-off experienced in 2008 and the first few months of 2009 were driven on fear rather than fundamentals. As we look ahead, investors will be looking for signs that the economy is in fact growing and that such growth can be sustainable absent government stimulus. Understanding and appreciating the long-term strength of the economy and taking a long-term investment approach from a logical, non-emotional perspective, can help the investor hold onto, reestablish, or create an appropriate life and risk oriented personal investment strategy. Extreme market reactions, both positive and negative, can be very distracting for investors. Despite recessions, wars, and political change, stocks, real estate and bonds all provided the potential for good long-term returns. We suggest investors continue to remain focused and disciplined in 2010 on their long-term goals and maintain a diversified investment portfolio. It is important to remember that asset allocation\* is one of the most effective methods of optimizing performance and moderating risk. The term asset allocation simply means the apportioning of asset categories such as stock and fixed income investments and cash equivalents.

## *Definitions & Disclosures:*

An index is a measure of value changes in a representative grouping of stocks, bonds, or other securities. Indexes are used primarily for comparative performance measurement and as a gauge of movements in financial markets. You can not invest directly in an index and, for comparative purposes; they do not reflect the effect of the various fees inherent in actual investment vehicles.

The S&P 500 Index is a market value weighted index showing the change in the aggregate market value of 500 U.S. stocks. It is a commonly used measure of stock market total return performance.

The Dow Jones Industrial Average is a price weighted index comprised of 30 actively traded blue chip stocks; primarily industrial companies, but including some service oriented firms.

The NASDAQ Composite Index is a market-value weighted index that measures all domestic and non-U.S. based securities listed on the NASDAQ Stock Market.

The MSCI Emerging Markets Index (EM) is a free-float-adjusted market-capitalization index developed by Morgan Stanley Capital International. It is designed to measure the equity market performance of 26 emerging market countries.

The MSCI Europe and Australasia, Far East Equity Index (EAFE) is a market capitalization weighted unmanaged index developed by Morgan Stanley Capital International to measure approximately 1,100 securities in 21 major overseas stock markets. It is a commonly used measure for foreign stock market performance.

The Barclays Capital U.S. Aggregate Index covers the U.S. Dollar denominated investment grade, fixed-rate, taxable bond market of SEC-registered securities.

The Barclays Capital CAA U.S. High Yield Index covers the U.S. Dollar denominated, non-investment grade, fixed income, taxable corporate bond market. Securities are classified in this index if the rating of Moody's, Fitch, and S&P is CAA.

The Barclays Capital U.S. High-Yield Corporate Index is a market value-weighted index which covers dollar-denominated, fixed-rate, below-investment-grade debt securities.

\*Diversification does not guarantee against a loss, and there is no guarantee that a diversified portfolio will outperform a non-diversified portfolio.