

Market Update

May 2009 Review

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Renewed Appetite for Risk

May 2009 saw the equity markets positive for the third consecutive month, the first time this has occurred since October 2007. Domestic fixed income, with the exception of treasury securities, also advanced in May delivering equity type returns. There is concern that the rebound has been a bit too drastic and that the markets are anticipating an economic resurgence that may prove elusive. So, the question remains, is the worst behind us or is this merely a bear market rally?

We know that markets are forward looking in nature and as a result it is not surprising to see markets rebound or recover well before a recession is officially declared over. We posed the following question to Dr. David Kelly, Chief Market Strategist at J.P. Morgan. If two consecutive quarters of declining Gross Domestic Product ("GDP") signifies the start of a recession, as is conventional wisdom, what statistic(s) signifies the recession to be over? Dr. Kelly responded that there are multiple leading and lagging economic indicators to consider. The Business Cycle Dating Committee of the National Bureau of Economic Research maintains a chronology of the beginning and ending dates of U.S. recessions. They define a recession as "a significant decline in economic activity spread across the economy lasting more than a few months normally visible in production, employment, real income and other indicators. A recession begins when the economy reaches a peak of activity and ends when the economy reaches a trough." Between trough and peak, the economy is in an expansion. It can take between 6-18 months for the Committee to actually determine the starting date of a recession. It is likely that we will be in the midst of recovery well before the recession is technically declared over. So, how will we know when the recession is over before waiting for the government to tell us? We must rely on the interpretation of current information to ascertain whether the trend is real or a false read.

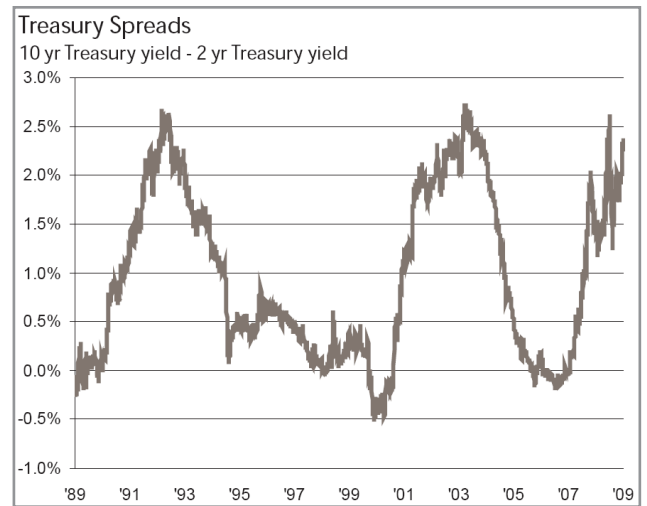
Since hitting an intra-day low of 6440 on March 9th, the Dow Jones Industrial Average ("DJIA") has rallied over 2000 points or 32% as of the end of May. Carrying over momentum from April, the investment markets had their third consecutive month of positive performance in May with the S&P 500 Index up 5.6%, the DJIA gaining 4.5% and the NASDAQ Composite Index advancing 3.5%. The international equity markets also advanced during the month with the MSCI EAFE Index gaining 11.1%. Emerging markets continued their torrid pace, as the MSCI EM Index rose 16.7% in May. The fixed income markets continued the "flight-from-quality" trend, a dramatic reversal from most of 2008, with the riskier bond indices advancing sharply

	May	YTD
DJIA	4.5%	-1.6%
S&P 500	5.6%	3.2%
NASDAQ	3.5%	13.1%
MSCI EAFE	11.1%	6.5%
Barclays Aggregate	0.7%	1.3%
Barclays U.S. Corp. High Yield	6.1%	28.7%

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higher led by high yield, bank loans and securitized debt. Treasury prices remained under a wave of strong selling pressure as prices declined and yields along the mid-to-long end of the curve moved higher.

What is driving this surge in the investment markets? More importantly, is it sustainable? Part of the reason for this renewed optimism is a growing belief that the economy is finally stabilizing. Consumer confidence has risen to its highest level since last fall, retail sales have shown improvement over the past few months, and the housing market is showing signs of life as we have seen modest increases in mortgage applications and pending home sales. Manufacturing activity has improved, and business inventories have been declining and will ultimately need to be replenished. We have seen a significant decline in the VIX index, a popular measure of stock market volatility, which has fallen to less than half of its peak in the days following Lehman's collapse. The credit markets have also shown improvement as the spread between the three-month LIBOR rate and the three-month treasury, which had widened to 4.6% last fall, has declined to a much more normal 0.8%. The yield curve remains somewhat steep, by historical standards, with the spread between the short end of the curve and the long end widening (see chart). While an inverted yield curve may forewarn of a recession, the steepness of the current yield curve has historically been a predictor of positive economic activity and a potentially encouraging sign for bank profits. Banks make money by borrowing short and lending long where they pay depositors lower short-term rates on deposits, while charging borrowers higher long-term rates. Healthy, profitable banks will bode well for the recovery of the economy as long as credit is made available to not only marquee institutions but small businesses and consumers as well.



Source: J.P. Morgan

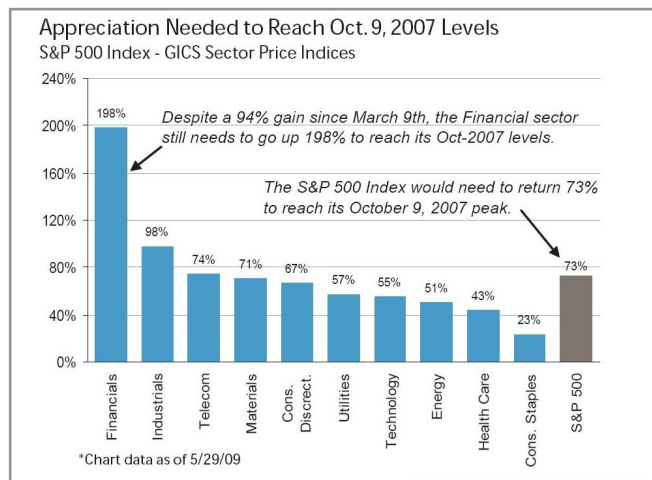
Sometimes, even bad news isn't necessarily so bad. Although several high profile banks still need to raise additional capital, the government's stress test of banks proved to be less ominous than originally thought. Concerns that rising unemployment will stifle the recovery isn't necessarily true, as unemployment is defined as a lagging economic indicator, and history has shown that capital markets tend to recover well before unemployment rates peak. Recent increases in oil and gasoline prices, as well as government spending have renewed inflation fears. However, inflation can't get going until the economy hits full employment, defined as an unemployment rate of roughly 5%. Wages play a critically important role in inflation and the labor market is too competitive when there is higher unemployment to allow for wages to accelerate. As it will likely take a few years to get close to full employment again, the federal government and Federal Reserve should have time to remove the massive stimulus injected into the economy, a scenario reminiscent of the 1980s.

While we have suggested there are clear signs we are heading in the right direction, we are not suggesting we are out of the woods just yet. The following are signs to look for that could change the trend direction from positive to negative. If the availability of credit remains elusive, we could expect a delayed cyclical rebound in auto sales, home building and inventories. Should consumers further entrench and remain frugal, then more government spending could be necessary to further stimulate the economy, which could stoke inflationary fears. If mounting debt and refinance

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problems dominate the commercial real estate market, a renewed crisis of confidence may occur in the financial services sector. Should oil prices spike again due to weather, global growth or political unrest, or if government actions or inactions inhibit risk taking could result in slower economic growth, which would not bode well for the markets.

We have had a breathtaking bounce over the past three months, but it is still noteworthy to see how much farther we need to go to reach the peak levels of October 9, 2007 (see chart). It also serves to reinforce the tenet that markets are unpredictable, and successfully identifying market tops and bottoms remains an elusive goal. Are we on our way to a sustained economic and market recovery? The markets, a leading indicator, are showing signs of renewed optimism as are the conclusions of a group of 45 economists representing the National Association for Business Economics Outlook. They conclude that while we are likely to see a decline in second quarter economic activity and challenges to the overall economy, they also expect economic growth to turn positive in the second half of 2009. Three quarters of the economists in the survey expect the recession to end by the third quarter of 2009. Just don't tell the Business Cycle Dating Committee until 2010.



Source: J.P. Morgan

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.

Gross Domestic Product ("GDP") is the market value of the goods and services produced by labor and property in the U.S. It is comprised of consumer and government purchases, net exports of goods and services, and private domestic investments. The Commerce Department releases figures for GDP on a quarterly basis. Inflation adjusted GDP (or real GDP) is used to measure growth of the U.S. economy.

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 Chicago Board Options Exchange Volatility Index (VIX) shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options.

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.

Barclays Capital U.S. Aggregate Index is an unmanaged market value-weighted index for U.S. dollar denominated investment-grade fixed-rate debt issues, including government, corporate, asset-backed, and mortgage-backed securities with maturities of at least one year.

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

