

Capital Market Review

Fourth Quarter, 2009

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Summary

The global recovery, while weak and fragile, is progressing. The recovery is led by some of the largest emerging market economies: Brazil, China, and India. Sound fiscal policies during the past decade have allowed these countries (and other emerging market countries) to establish counter-cyclical economic policies. For the short term, most emerging market economies remain export driven (as opposed to consumption driven) so economic conditions in the West still matter. Over time (many years), this will change.

Expectations for U.S. real GDP growth have been revised higher. Leading indicators and the ISM Purchasing Managers index have strongly rebounded. Inflation and interest rates remain low. That is the good news. The bad news is that, while we are in recovery, it appears to be extremely mild, particularly when compared to prior recoveries. Unemployment is high, wage growth and consumer sentiment is low, and the housing market is preparing for a large increase of foreclosed properties. The availability of credit to both consumers and businesses remains constrained.

The range of potential 2010 economic outcomes is extremely wide. A reasonable case can be made for



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either a stronger- or weaker- than expected recovery. We believe employment growth, consumer spending, and successful monetary stimulus reduction will be the key factors. Regardless, in these transitional periods, it is imperative to adjust to new information.

All major assets classes had positive returns during the fourth quarter led by real estate and commodities with returns of about 9%. Stocks returned 5.9%, while bonds had a 0.2% quarterly return. Emerging market stocks outperformed both U.S. and developed market stocks. In the U.S., large stocks outperformed mid which outperformed small. Growth outperformed value.

For 2009, stocks and real estate each produced strong returns of above 28%. Commodities returned just under 19%, while bonds returned 5.9%. Emerging market and developed international stocks both outperformed the U.S. market. Within the U.S., mid-cap was the best performing company-size segment while Growth significantly outperformed the Value approach. High yield and investment grade corporate bonds performed well as Treasury's lagged.

Economic Conditions

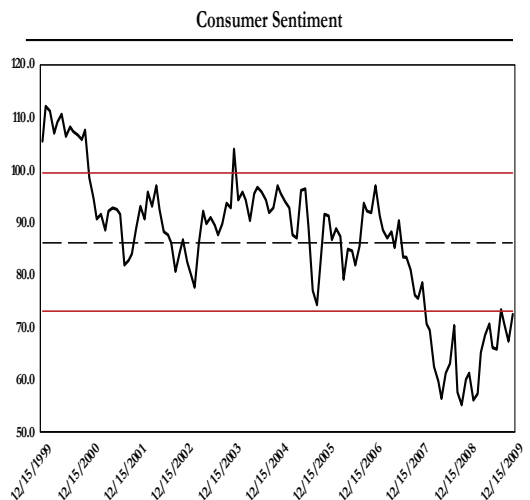
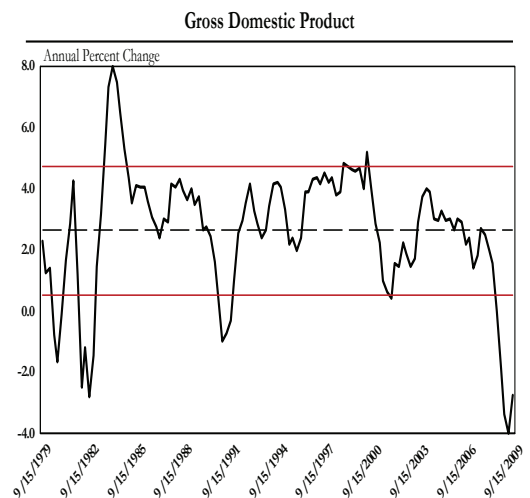
After eight quarters of misery, the global economy, led by Asia, is recovering. The synchronized worldwide stimulus programs have averted economic disaster. Major Western economies are on a path to recovery. Although, global recovery will remain fragile until Western consumer demand improves.

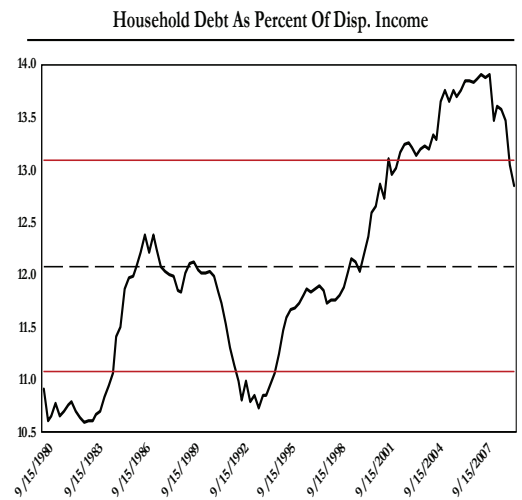
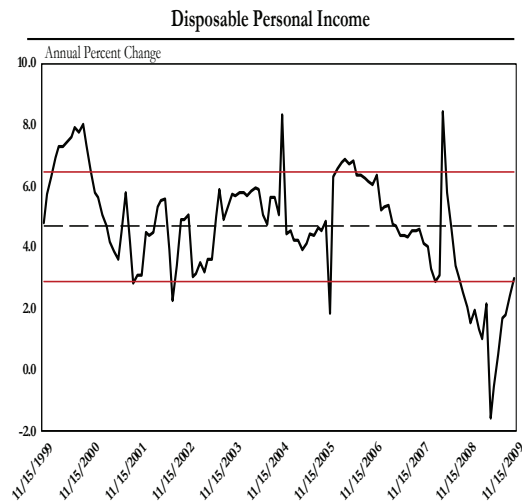
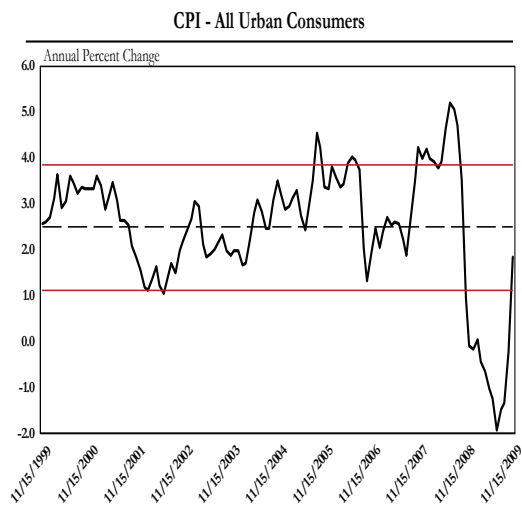
The global recovery is being led by the major emerging economies, notably China, India, and Brazil. The fiscally prudent policies these governments have deployed during the past decade have provided them with enough policy space to boost demand.

It is unlikely that emerging markets will see a return to the pre-crisis pattern, with soaring exports fueled by consumer borrowing in the West. Emerging economies that rely on exports will face greater headwinds than those that rely on an increasing amount of domestic demand (Brazil and India). It will take years for the export-led economies to transition to a consumption driven economy.

U.S. Economic Conditions

In the U.S., third quarter real GDP growth of 3.5% suggests that the recession ended this summer and that a mild recovery has begun. GDP growth was mostly, if not entirely, fueled by monetary and fiscal support from the federal government.





During 2010, real GDP growth should accelerate during the first half of the year. But as the benefits of government stimulus begin to wane, economic growth should slow during the second half of the year. Consensus expectations are for 2010 GDP growth of between 2.5% and 3.0%. Compared to other first-year recoveries, expected growth will be significantly below average.

While layoffs have slowed, hiring remains dormant. Although, there are some initial signs of improving labor market conditions (increase in overtime, for example). We expect the unemployment rate to peak in the second or third quarter of this year at around 11%.

Many economists believe the US economy needs to annually grow between 2.75% to 3.0% to simply maintain the existing unemployment rate. As a result, we expect painfully slow labor market improvement. It will likely take several years until the unemployment rate is back to pre-recession levels.

The freefall in housing is over, but the market will not fully stabilize until the second half of 2010. Expect further price declines as a supply of homes (from the foreclosure process) is about to be put onto the market. Most believe the additional price declines will be concentrated in the first half of this year. The good news is that, relative to history, housing is extremely affordable.

Business conditions have significantly improved during the past six months. Prior to expanding, given the depth and severity of the recession, businesses will need time to grow more confident. That assumes businesses have access to credit, which in today's market, is more limited than usual.

Productivity has been soaring. While it cannot continue at its current pace, many believe that businesses are finally seeing the benefits of the technology revolution a decade ago. Unless new job categories (industries) are created, higher productivity, at the margin, will limit future job growth.

In addition, the uncertainty caused by Washington's policy debates cannot be underestimated. Health care and financial reform, climate change legislation, and the expiring of the Bush tax cuts are a few of the obvious issues. Today, businesses must operate under a higher-than-normal degree of uncertainty and the stakes are unusually high.

The consumer faces a number of hurdles over the next several months, including a double-digit unemployment rate, little wage growth, tight credit conditions, falling

housing prices, and weak confidence. Without more hiring, household income simply will not support spending growth.

The rapid explosion in consumer spending is behind us. At the margin, consumers will begin to save more and reduce debt. There is already data implying this, although it is too early to tell whether the trend will continue (as we predict).

Inflation has been rising (from the deflationary conditions that existed in late 2008), but remains well within historical levels of 2% to 3%. We do not expect inflation to significantly increase. Demand is down, wage growth is weak, and there is too much excess capacity to drive significantly higher inflation. Some inflation is a good thing – economies do not work well in a deflationary environment.

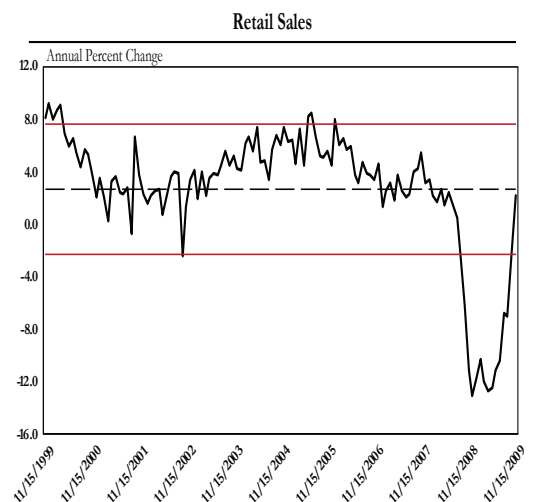
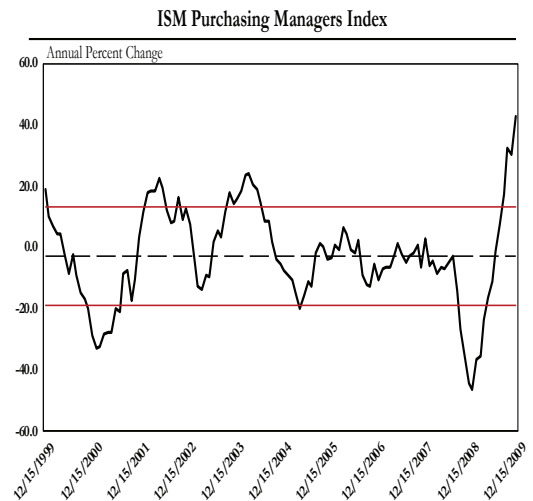
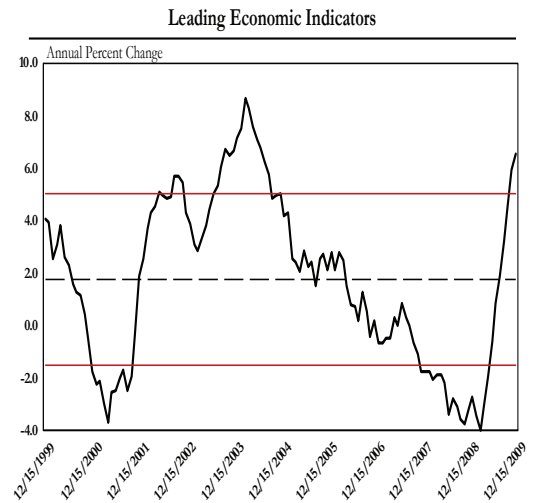
Interest rates can essentially go no lower. Real (after inflation) interest rates are already negative. The timing of when the Fed begins to raise interest rates is the key question. We think the Fed will be more cautious and will wait to ensure the economy is on solid footing prior to raising rates. In addition, the Fed will likely signal its intention well before actually implementing a policy change. With that said, once the Fed makes its intentions known, markets may not react well.

Among all this rather gloomy forecast is the index of leading indicators which, when viewed in isolation, suggests quite a strong recovery. Interest rates and inflation are also quite low. So there are factors that could lead to an above-average rebound.

Economic forecasting is a highly error-prone activity – even under “normal” circumstances. Forecasting at economic turning points, with any degree of accuracy, is nearly impossible. Today’s range of potential economic outcomes is extremely wide. A reasonable case can be made for stronger than expected growth as well as a double-dip recession. We expect the strength of this recovery will depend on a combination of job creation, successfully reducing the massive stimulus, and consumer spending. Regardless, in transitional periods, it is particularly important to be flexible and continuously adjust to new information.

Fourth Quarter Asset Class Returns

Capital markets continued to rally during the fourth quarter, albeit at a somewhat slower pace (for stocks and bonds). Real estate and commodities performed the best during the fourth quarter with returns of 9.2% and 9.0%, respectively. U.S. stocks returned 5.9% while



U.S. bonds eked out a return of 0.2%.

For 2009, U.S. stocks and real estate were the best performing asset classes, both producing returns greater than 28%. Commodities returned 18.9% while the U.S. bond market returned 5.9%.

Stock Market Returns

Emerging market stocks had another strong performance quarter returning 8.4% and produced a jaw-dropping 2009 return of just under 75%. India, Indonesia, Brazil, and Russia each had 2009 returns above 100%. During the fourth quarter, developed international stocks lagged the U.S., but were slightly ahead of U.S. market returns for the full year (31.8% versus 28.3%).

In terms of company size, mid-cap stocks outperformed large- and small-cap stocks during 2009. Specifically, mid-cap stocks returned 40.5%, while large and small stocks returned 28.4% and 27.2%, respectively.

Partially due to strong performance in Technology and Healthcare, Growth stocks outperformed Value stocks during both the fourth quarter (7.6% versus 4.2%) and 2009 (37.0% and 19.8%).

2009 U.S. stock market performance was concentrated in three economic sectors. Only the Technology (59.9%), Materials (45.2%), and Consumer Cyclical (38.8%) sectors had returns above the S&P 500. Other sectors lagged the S&P 500, rather dramatically, but none more so than Telecommunications (2.6%) and Utilities (6.8%). Consumer Staples and Energy returned around 11%, while Finance, Healthcare, and Industrials returned in the 15% to 17% range.

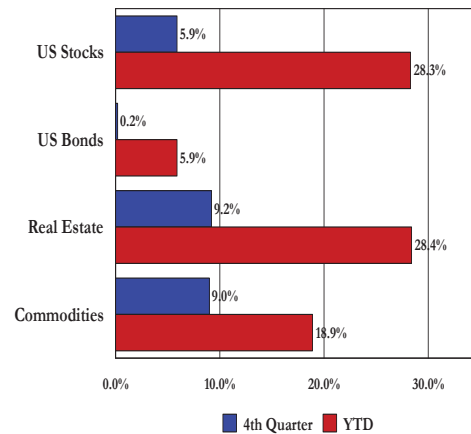
According to Merrill Lynch research, lower-quality stocks significantly outperformed higher quality stocks during 2009. With near perfect consistency, as one went down the stock quality spectrum (using the S&P common stock ratings), stock returns went up. The highest quality stocks, those rated A+ by S&P, returned 27.9% while those stocks rated C&D returned 122.9%. The dramatic return difference between high and low quality stocks will likely not continue.

Bond Market Returns

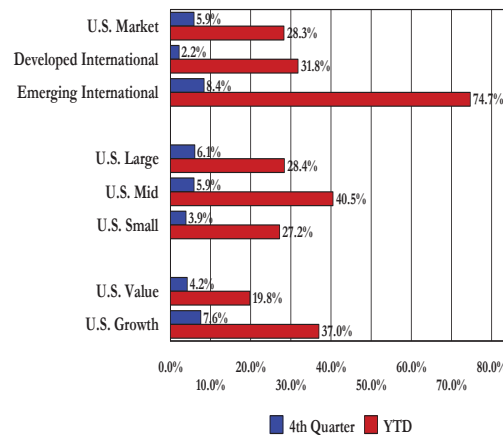
It is not too surprising that, as a worldwide depression was avoided, riskier bond segments outperformed investment grade bond segments. For 2009, high yield bonds returned 58.2% while emerging market bonds returned 29.8%.

U.S. investment grade bonds returned 5.9%. While this

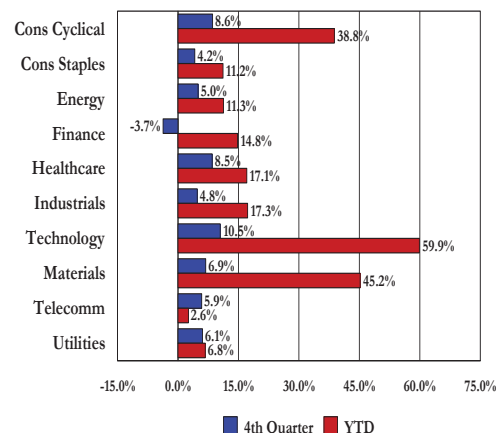
Capital Market Returns
Periods Ending December 31, 2009



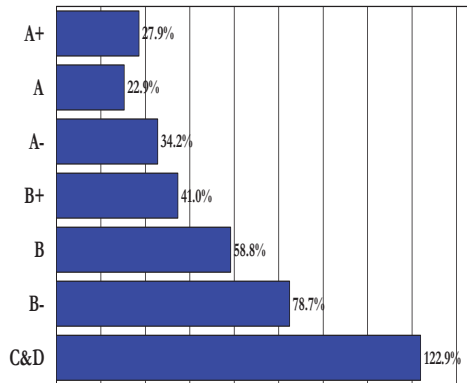
Stock Market Returns: By Nationality, Size, and Approach
Periods Ending December 31, 2009



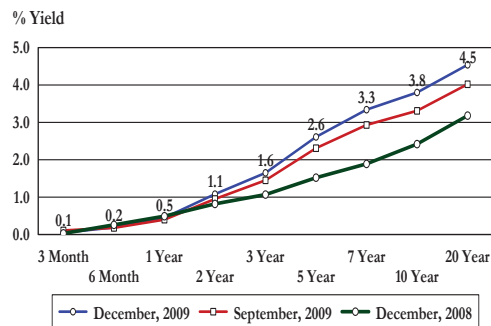
U.S. Stock Returns By Sector
Periods Ending December 31, 2009



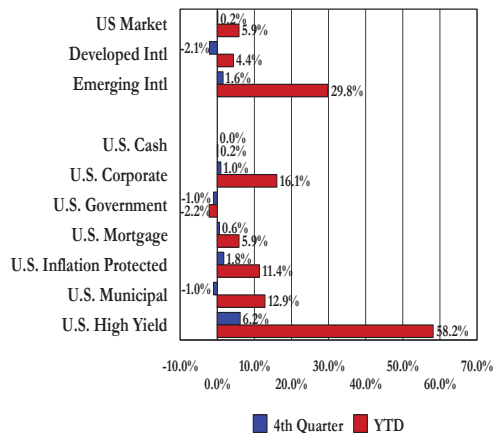
Stock Performance By Quality
 Year Ending December 31, 2009
 1600 Stock Universe



Bond Market: U.S. Government Yields To Maturity



Bond Returns By Nationality and Sector
 Periods Ending December 31, 2009



return appears “normal” there was significant volatility in terms of underlying sector performance. Investment grade corporate bonds returned 16.1% while mortgage-backed bonds had a market-like return. U.S. government bonds returned -2.2%.

Municipal bonds, which performed poorly in 2008, rebounded strongly with a return of 12.9%.

The returns by maturity shown, while accurate, are misleading because they only focus on government bonds. There was an enormous flight to quality at the end of 2008 and that started to reverse itself during 2009. Keep in mind, that other bond segments (like mortgages and/or corporates) would exhibit substantially different maturity returns.

The yield curve is very steep meaning yields on longer-maturity bonds are significantly higher than shorter maturity bonds. This makes banking extremely profitable (lend at high rates, borrow at low rates). The Fed will maintain this low-rate policy so banks can have time to heal their balance sheets.

Bonds that focus on riskier segments have done exceptionally well during 2009. Namely, emerging market and high yield bonds have, by far and away, been the best performing bond segments. Within the investment grade space, municipal bonds performed well as several large states finally passed budgets. Investment grade corporate bonds have also performed well during 2009. US Treasuries have been the laggard compared to other bond segments. This is not too surprising as the “flight to quality” trade that occurred during the fourth quarter of 2008 is being reversed.

Barclay’s Capital did an analysis with respect to 2009 returns by various bond quality segments. As with stocks, the lower the bond quality, the higher the return. The performance difference was quite large. Between the highest quality segment (AAA) and the lowest level of investment grade (Baa), the return difference was 1.9% versus 27.0%. All segments of high yield produced returns greater than 40% with the riskiest segments having returns of well over 100%.

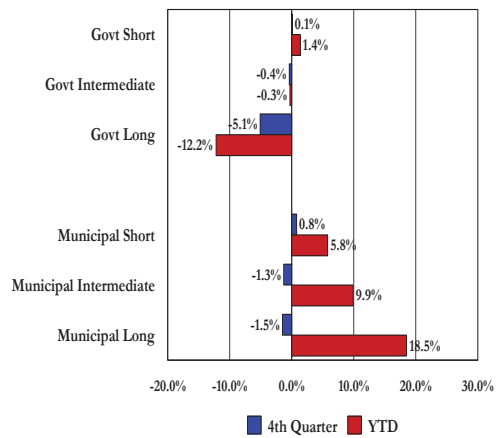
Current Portfolio Strategy

As a summary of our present strategy, we have been overweighted toward developed international and emerging markets, real estate, mid- and small-cap stocks and high yield bonds. We have also maintained a value tilt to the portfolio. The most significant underweighting has been to large U.S. stocks.

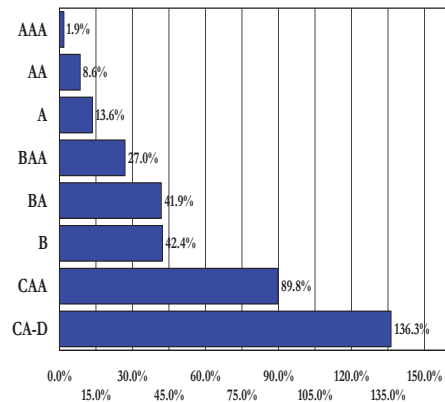
Within the stock segment, we will likely increase the emerging market allocation but will be waiting for some level of pullback after the tremendous run of the past year. We will likely reduce the allocation to small cap and to a lesser extent mid cap and will redeploy toward large cap stocks. We are closely watching real estate, and will likely be reducing and/or eliminating the allocation, as it appears to have moved to overvalued status. Our value tilt has not recently benefitted portfolio results, but at this stage we plan on maintaining the value bias.

Bonds are a somewhat difficult story. The easy money has been made in high yield and corporate bonds as credit spreads are back to near pre-recession levels. Investment grade yields are extremely unattractive and will likely be rising, providing a real threat of bond price depreciation. There are not many great choices. Our current strategy is to maintain the overweighted position to high yield and corporate bonds, consider some floating-rate bond securities (interest rate will float as yields rise), and possibly a small investment in a preferred stock exchange traded fund.

U.S. Bond Returns By Maturity and Taxability
Periods Ending December 31, 2009



U.S. Intermediate Corporate Performance By Quality
Year Ending December 31, 2009



Source: Barclays Capital