



**The “End of The World” Is Off The Table.  
But Will the Economy Live Up To Expectations?**

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Dear Clients and Friends:

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Although we face considerable economic challenges, fears of a worldwide economic collapse appear to be behind us. Stock markets continued the advance that began in mid-March. Since the low established on March 9<sup>th</sup>, most major markets were up in excess of 35%.

As shown below, broad equity indexes finished the quarter in positive territory for the year. Normalcy has been restored to most credit markets. Additionally, attractive yields and the appreciation potential of corporate bonds tempted many investors to venture beyond the safety of government bonds.

|                                | <u>2Q</u> | <u>YTD</u> |
|--------------------------------|-----------|------------|
| Dow Jones Industrial Average   | +12.0%    | - 2.0%     |
| S&P 500 Index                  | +15.9%    | + 3.2%     |
| NASDAQ Composite               | +20.0%    | +16.4%     |
| MSCI EAFE Foreign Equity       | +25.4%    | + 8.0%     |
| Barclay’s Aggregate Bond Index | + 1.8%    | + 1.9%     |

As we have noted, Federal policy making continued to influence future expectations. It was another busy quarter as additional Fed and Treasury programs helped to stabilize the financial system, a nearly \$800 billion economic stimulus package was set into motion and, more controversially, General Motors and Chrysler were walked into and out of bankruptcy. As we write, the administration is making a renewed effort to shift the policy agenda back toward their longer term priorities of energy, healthcare and education.

The Federal Reserve continued to be extraordinarily accommodating. The Open Market Committee reaffirmed after both the June and July meetings that it “will employ all available tools to promote economic recovery and to preserve price stability.”

Unemployment and foreclosures still have not peaked; however, consumer sentiment showed modest improvement during the quarter. Seven of ten leading economic indicators also went from negative to positive.

**Outlook – Muddy**

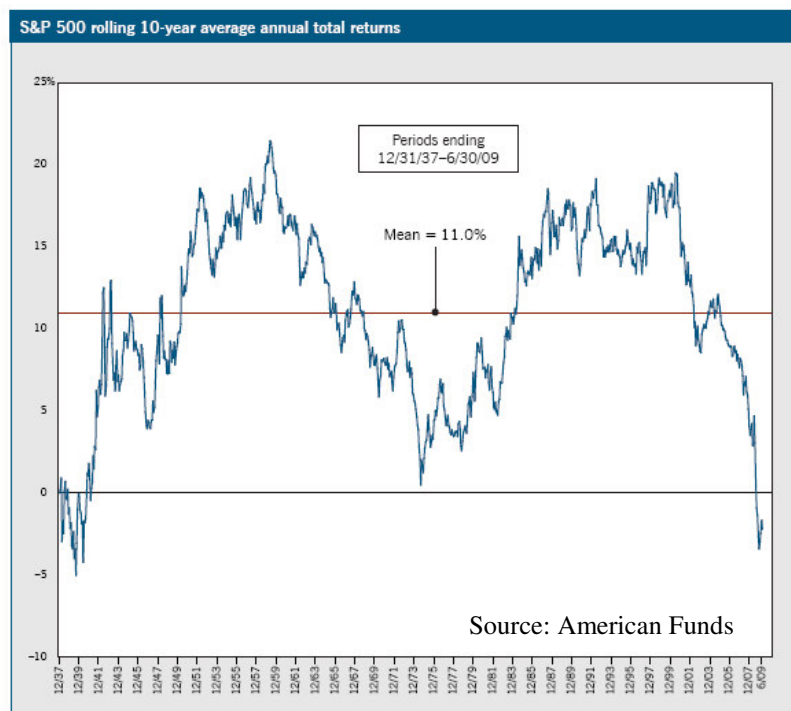
“Muddy” is the best way to describe our current outlook. In spite of encouraging news, the global economy continues to be fragile. In addition, U.S. plans for financial regulatory reform, tax reform, healthcare reform and U.S. energy policy have created a number of new uncertainties. The range of possible scenarios is very wide, making predictions particularly difficult.

Will the economy turn the corner on schedule? Many economists now predict the U.S. will show positive GDP growth by year-end, adding that the recession could technically end sometime this summer. The recent surge in equity and corporate bond prices appears to anticipate this positive growth.

At the lows in March, investor sentiment reached extremely depressed levels while stock/bond relative performance was at levels last seen in the 1930s. In the contrarian world of investing, both sets of data are a positive for stocks. Additionally, when the markets turned for the better, much of the recovery was powered by cyclical stocks that tend to perform best when the economy is growing.

In short, this evidence mimics typical market behavior at other historical bottoms.

Compelling evidence can also be found in this chart. It shows the rolling 10-year average annual total returns for the S&P 500. Between 1937 and 2009, the average return was 11%. For the ten-year period ending 6/30/09, the index returned -2.2%. Not since the late 1930s have the returns been so low. Difficult decades like the 1930s and 1970s were followed by strong returns.



Given this evidence, we continue to feel comfortable with our decision in April to rebalance client portfolios and increase exposure in areas we felt would benefit during an economic stabilization and recovery.

On the negative side, the unemployment rate will likely remain stubbornly high for some time, and recent home purchasers will remain challenged by values that have declined below their purchase prices. These factors will lead to a continued foreclosure problem. Additionally, the private sector continues the process of unwinding too-high debt levels while the public sectors (local, state, and national governments) are experiencing record deficits with expenses up and tax receipts down.

We also continue to watch both the dollar and the oil trades for expectations about the future. Even these indicators are showing mixed signals. The dollar serves as a safe haven and often strengthens in times of distress. Oil has been strengthening when economic growth is predicted. During the quarter, we saw the dollar weaken and oil prices rise, evidence that the world is less anxious and expects a brighter future. This was

the good news. Unfortunately, this trend was interrupted in early July as earnings concerns spooked the market.

In digesting these trends and other data, we think stocks could still have a ways to go. All it may take for the stock market to rise another 15-25% will be for the economy to reflect the expected improvement. Profitable investment opportunities should be available, including corporate bonds, emerging market equities, plus some commodity and sector funds.

#### Should we worry about inflation?

This is the most frequent question we hear. However, we don't believe inflation is an immediate problem. While many of the current government actions look to be inflationary fuel, there are numerous offsetting conditions that should keep it in check for the foreseeable future. Former Fed chairman Paul Volcker, who crushed runaway inflation during his term in the early 80s, recently stated in a speech, "This is not an environment in which inflationary pressures are at all likely for some time to come."

If inflation develops into a dominant focus, we will continue to adjust our tactics and deploy investments that respond in an environment of higher inflation and a weaker dollar. These tactics may include additional increases in our allocation to foreign investments, including emerging markets, or exposure to certain commodities.

#### **Other News - Tax Rule Changes**

- Investors in offshore entities, including hedge funds or funds held in retirement accounts, were surprised by an IRS announcement that they expect such investors to file a FBAR report by June 30 following each tax year. These will be information filings, not tax payments. We have been in contact with clients who are affected. This FBAR report is another example of closer scrutiny of previously benign concerns.
- No income cap on IRA-to-Roth conversions beginning 2010. You will hear an increasing discussion of this opportunity in the second half of 2009. High income investors, who have previously been prevented from converting their tax-deferred IRA balances to tax-free Roth IRAs, will have that opportunity when the income cap is lifted. Not all IRA holders should take advantage.
- It appears that the Obama administration will support a permanent federal estate exclusion at the current level of \$3.5 million per spouse. The top rate on estates larger than that level is reported to stay at the current 45%. We do not know if the exclusion unused by one spouse can be used by the other spouse.

Consult with your tax advisor for details.

Thank you for your faith in us and as always, please contact us if you have any questions.

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