

Could Rip Van Winkle Tell The Difference?

Stephen Rhea

Dear Clients & Friends:

January 15, 2010

Alex Thompson

At the end of 2008, investors were peering into an abyss... panicked by the threat of an unprecedented financial meltdown caused by a worldwide credit paralysis. Today, we report a strong recovery in stocks and most credit markets for 2009. Our worries focus on a serious recession, but not the end of the world as we know it.

Lance Hollingsworth

John Laughlin

Like Rip Van Winkle, if you went to sleep in early 2008 and awakened at the end of 2009, you would see little evidence of the panic that occurred. With unemployment still high and sales for many businesses slow, how could the markets come back so strongly?

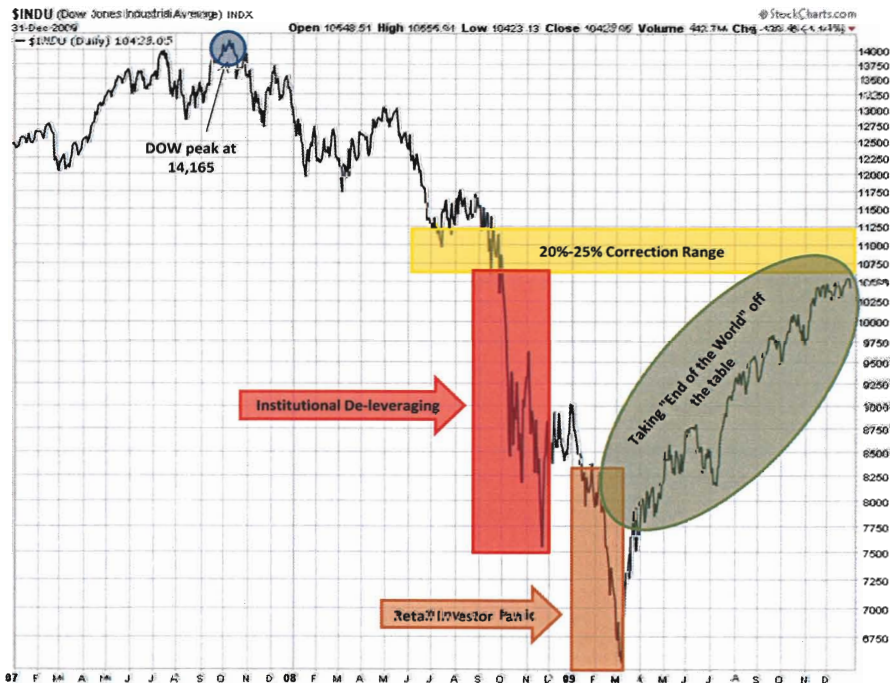
Sarah Haizlip

Amery Staub

	<u>4Q</u>	<u>YTD</u>
Dow Jones Industrial Average	8.0%	22.7%
S&P 500 Index	6.0%	26.3%
NASDAQ Composite	8.3%	54.6%
MSCI EAFE Foreign Equity	2.2%	31.8%
Barclay's Aggregate Bond Index	0.2%	5.9%

At its worst point in March 2009, when the stock market was down 55% in the preceding 15 months, a cyclical bull market began that drove the S&P 500 up 63% and the EAFE foreign index up over 74%. The stock and bond market sectors that experienced the greatest loss of value during the crisis posted the highest returns in the rebound. Corporate bonds showed a similar pattern to stocks. For example, after suffering more than we expected in 2008, Loomis Sayles Bond fund reported a 35% total return for 2009. We took profits in this fund as corporate bond spreads tightened below their historical average.

In reviewing the last 24 months, we find the following chart to be helpful:



The chart measures a period from the market peak in late 2007 to the end of 2009. A normal decline of an overextended stock market going into an economic recession could have taken the Dow Jones Industrial Index down 20%-25%, the range shown in yellow. The panic of 2008 caused a drop far below the yellow to 6550 for the Dow on March 9. This was followed by a recovery rally back up to the yellow range by December 31, 2009.

The first leg down was driven by the forced de-leveraging of the major banks, investment houses, and hedge funds. The second leg down was dominated by a panic among retail investors. The recovery rally occurred as investors realized that “the end of the world” was off the table.

This may help explain why some pundits describe the current markets as “normal,” even though they remain well below their peaks. The markets seem normal when considering the economic recession and expected cycle of corporate profits.

Outlook: Onward and Upward

We don't believe that a double-dip recession is imminent. By their upward movement, the markets continue to signal that the economic recovery is on track. There are a number of potential spoilers and, as usual, they each have a range of potential outcomes that make predictions complicated. Here are some of the things we are watching:

- **Gross Domestic Product** – The economy is showing good signs of improvement in just about all areas. Of all the predictions about the shape of the recovery, we believe the most likely is a square root “√” recovery where the rebound is strong and then the economy moves sideways for a while. We'll be watching for signs of a different outcome.
- **Stock Market Returns** – The markets lead the economy by several months, and the pattern of market returns so far has been a square root shape. Phase one was a dramatic drop. Phase two was a torrid recovery rally. We are now in phase three – a levelling off followed by more moderate growth. We believe this can continue until mid-2010. Stock prices could always get a little ahead of corporate profits, so we will be watching the quarterly earnings expectations to assess the odds of a correction. One has to come eventually.
- **Interest Rates** – Although the conventional wisdom is for the Fed to raise short-term rates soon, we believe that the Fed could keep rates at current levels for most of 2010. One reason is that unemployment is likely to remain stubbornly high. Another reason is that inflation measures have remained low and are forecast to end 2010 up 1.5-2.0%. The banking system, although much improved, needs another year to get back to health. Finally, Fed Chairman Bernanke has vowed not to repeat the Depression era mistake of raising rates too soon. Long-term rates are another story. 20-year rates are already up about 2% in the past year, and we expect they will move even higher in 2010. We will take this into account in our fixed income strategies.

- Unemployment – Don't expect to see unemployment drop below 8% very soon. One reason is the way unemployment is measured. Job seekers who have become discouraged stop looking for jobs and are not counted as unemployed job seekers. As the economy improves and jobs become more available, these individuals could begin looking for work again. As they rejoin the ranks of the unemployed, they will keep the rate itself elevated and difficult to move lower.

We will continue to monitor these developments and try to position your portfolios to best benefit in the ever changing environment.

Tax Season Begins: Realized Gains and Losses Reports

For most clients' taxable accounts, we have enclosed 2009 Realized Gains & Losses reports along with 4th quarter performance reports. Please keep these with other tax documents you turn over to your tax preparer. If you have any questions about the Realized Gains & Losses reports, or would like us to also send a copy to your tax preparer, just let your Summit advisor know.

Reminder: IRA-to-Roth Conversions

IRA holders are now allowed to convert all or part of their IRA to a Roth IRA, regardless of their income level. Benefits include tax-free withdrawals for the IRA holder and heirs. Income tax must be paid on the amount converted, but can be spread over two years. Whether a Roth conversion is a smart idea very much depends on your specific situation. Please contact your Summit advisor for an initial review. You should then discuss the final decision with your CPA.

Estate Taxes

Contrary to what Summit and most other financial advisors predicted, Congress did not extend the \$3.5 million federal estate tax exclusion last month. Therefore, there is currently no estate tax due for those who die in 2010. Over the next few months, Congress still has an opportunity to pass an extension retroactive to January 1, 2010. We expect clarification early in this year's legislative session.

In Memory: Herbert Rhea

Summit has lost a dear friend and business advisor with the recent death of Herbert Rhea. We extend our deepest sympathy to Herbert's family, including his son and Summit partner, Stephen Rhea. We will strive to honor Herbert's legacy by practicing what he taught us: quality advice, detail-oriented service and follow through, confidentiality, valuing our associates and their families, and perhaps most importantly, putting client interests first in everything.

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

Summit Asset Management LLC