



Stephen Rhea

## Stay the Course

Alex Thompson

Dear Clients & Friends:

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Lance Hollingsworth

The U.S. stock market experienced its best quarter in ten years as investors abandoned their fear that the U.S. is entering into a depression. In 2008, stocks and bonds declined steeply and the only positive performing investments were government-backed Treasury bonds. In 2009, the reverse has been true. Treasury bonds have been the under-performer and virtually all other stock and bond investments have soared.

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	<u>3Q</u>	<u>YTD</u>
Dow Jones Industrial Average	15.8%	13.5%
S&P 500 Index	15.6%	19.3%
NASDAQ Composite	15.6%	4.5%
MSCI EAFE Foreign Equity	19.5%	29.0%
Barclay's Aggregate Bond Index	3.7%	5.7%

The bull market for stocks has most likely entered the second of three stages. The first stage was the high growth stage. This second stage is still characterized by upward movement, but at a more gradual and normalized rate. The third stage is where markets typically start to diverge and then roll-over, preparing for the next bear market.

Based on the weight of the evidence, the probability of another bear market right now seems limited. The economy is recovering, inflation and interest rates are contained, and sentiment and valuation indicators are far from threatening. However, as noted below, recognize that September and October are known for their "seasonal headwinds." September bucked this historical trend and so far October is doing the same. We are entering one of the more important earnings seasons in quite some time. These announcements and company outlooks may make things feel unstable in the short run.

There are five reasons to expect the market to settle into a more moderate uptrend:

- We are now in the second stage of the bull market, which is historically milder.
- September and October are historically volatile, due to seasonal headwinds.
- Markets tend to move higher at a more gradual rate after the recession ends, and the recession most likely ended in the 2<sup>nd</sup> quarter.
- Stocks on average are not yet overvalued, but not cheap either.
- Investor optimism is not excessive (this is a positive), but pessimism is no longer excessive either (this is a negative).
- The S&P 500 index was also recently as high as 20% above its 200 day moving average. Historically, this has meant a continued upward bias, but limited.

## **Outlook: What a Difference a Year Makes**

On the inflation and earnings front: both are about to start picking up somewhat -- if only from a technical standpoint. It was a year ago, at the end of September 2008, when earnings tanked, the credit markets came to a standstill and the stock market crashed.

Beginning this month, the year-over-year comparisons start to become very easy. As forward-looking investors compare their future expectations with the past 12 months, the comparisons for earnings, inflation and market performance will become quite favorable. As simple as it sounds, favorable 12-month comparisons can affect investor attitude, and attitude affects the markets.

In reality, the earnings growth seen so far (and what will likely continue in the next quarter or two) shows improvement based on cost cutting. Sales have actually fallen by 11% for the S&P 500 year-over-year. This is normal for recessions: businesses cut costs, primarily by laying off employees, and they do not resume spending and hiring until they believe the future of their business offers promising growth. Meanwhile, productivity soars and earnings improve.

At some point, investors will need to see sales growth resume in order for earnings growth to move upward in a sustained fashion. Historically, cost cutting has caused earnings to turn upward at the trough of the recession, and sales growth has been responsible for earnings sustainability.

Just as some companies are said to be leading or lagging indicators of the business cycles, earnings and sales growth tend to be leading and lagging evidence of where a company is in its cycle. Therefore, the earnings and sales cycles occur in businesses at different stages during the economic recovery. Some businesses will show sales increases early, while others must wait. Businesses that were dependent on sales growth driven by heavy doses of credit availability will probably have to wait the longest.

Lastly, the value of the U.S. dollar has declined, which is a continued positive for foreign markets, both developed and emerging. Our outside research has noted that the U.S. dollar may have taken the place of the Japanese Yen as the currency of choice for the "carry trade." While the Fed is not likely to raise rates any time soon, rate expectations could rise sooner than they would otherwise if continued dollar weakness evokes concerns that the Fed will be forced to raise rates to defend the currency.

## **In Summary**

2009 has been a year in which stock market performance has reflected extreme fear and risk aversion on market weakness (first quarter), the revival of risk appetite on market strength (second and third quarters), and now a moderation of returns (expected in the fourth quarter).

**Reminder: Roth Conversions**

A new rule allows IRA holders, regardless of income level, to convert all or part of their IRA to a tax-free Roth IRA in 2010. Taxes on the conversion must be paid, but can be spread over two years, with tax payments therefore delayed until April 2011 and 2012. For this conversion to be appropriate for the investor, the taxes should be paid with assets outside of the IRA.

Be forewarned that representatives in most sectors of the financial services industry may descend upon IRA holders with sales pitches and incentives to take advantage of the new rule. Our analysis, confirmed by our discussions with CPAs, tells us that Roth conversions do not fit everyone. Therefore, superficial analysis presented by some salespeople may be very wrong for you. Please contact your Summit financial advisor to determine whether you should consider a Roth conversion.

**Investing in the Future**

Markets continue to change, and so must we. Summit continually looks for ways to enhance our investment process and implementation. We recently made a significant investment in technology to advance our portfolio management capabilities. This software will aid us in implementing our investment strategies quickly, allowing us to capitalize on new opportunities more effectively. We look forward to sharing more details in the near future.

**Paperless Statements Made Easy**

Recent developments at Schwab have made it easier for Summit's clients to get their statements, trade confirmations, and other shareholder documents delivered electronically rather than by paper mail. In addition to the added security and convenience of eDelivery, Summit clients who participate may also enjoy lower equity trading costs. Our team will work hard over the coming months to help you take advantage of these benefits. You will be receiving letters and e-mails from Summit and Schwab to help you get started. In the meantime, call your advisor for more information. Schwab eDelivery is a great way to lower your cost, get rid of unwanted paper, and help the environment!

Summit continues to grow. We appreciate the referrals you have sent to Summit. Thanks to you, we have been able to meet and help numerous new clients during the recent uncertain times.

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

*Summit Asset Management LLC*