

Quarterly Market Review

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Perspective: What a Difference a Year Makes

As 2009 wound to a close, it was hard not to look back at the global financial markets just 12 months ago and realize how far and how quickly the recovery had come. To quote our *Outlook* from one year ago in this same Market Review:

However, just as a strong April and May disguised the very weak returns of June, the stomach churning drop in October masks a broader rally in December that continues through the first week of the New Year. We will only be able to look back several years from now to see if the fourth quarter of 2008 represented the bottom of this bear market, or simply a pause in the decline. But for those investors with suitable long-term horizons, the current market uncertainty also presents many opportunities.

As it turned out we were off by just a few weeks and another stomach churning drop. The fourth quarter 2008 rally did fizzle out, and in fact nearly turned into a rout until the first week of March of 2009. Before the market rally was ignited in March, the Russell 1000 Index was down more than 23% and the Russell 2000 was down more than 34% for the year.¹

But slowly global governments came together to begin providing massive amounts of liquidity to the worldwide financial system and began providing backing to the banking system to restore trust, though too late to save many institutions. Accommodative monetary and fiscal policies thawed the frozen financial markets and allowed many market participants to liquidate positions to meet margin calls and investor redemption demands. Through the remainder of the year, the global equity and fixed income markets rallied providing handsome returns in nearly every asset class. But the “bill” for all of this relief has yet to come due, and 2010 may see some of those costs come home. Certainly as the curtain rises on 2010, the money market fund industry is struggling to provide positive yields of any sort to their clients as 90-Day T-Bills are currently yielding just 6 basis points. And while forecasts for the first signs of inflation, and thus the need for the Fed to hike interest rates, range from the second half of 2010 to early 2011, the increasing issuance of Treasuries to fund many of these support programs will eventually force rates higher, with or without the Fed. The biggest issue will be how the various government programs are eliminated and the excess liquidity supplied to the markets over the past year is eventually withdrawn. Premature withdrawal of government support in 1937 was one of the causes of the extension of the Great Depression.

Domestic Equity Markets Overview

The fourth quarter of 2009 started out on shaky ground with the domestic equity indexes falling sharply in October. However, a solid November and December wiped out the early losses and put all of the Russell style indexes firmly in the black. Returns for the quarter ranged from 7.9% for the Russell 1000 Growth Index down to 3.6% for the Russell Small Cap Value Index². In the large cap space, Technology

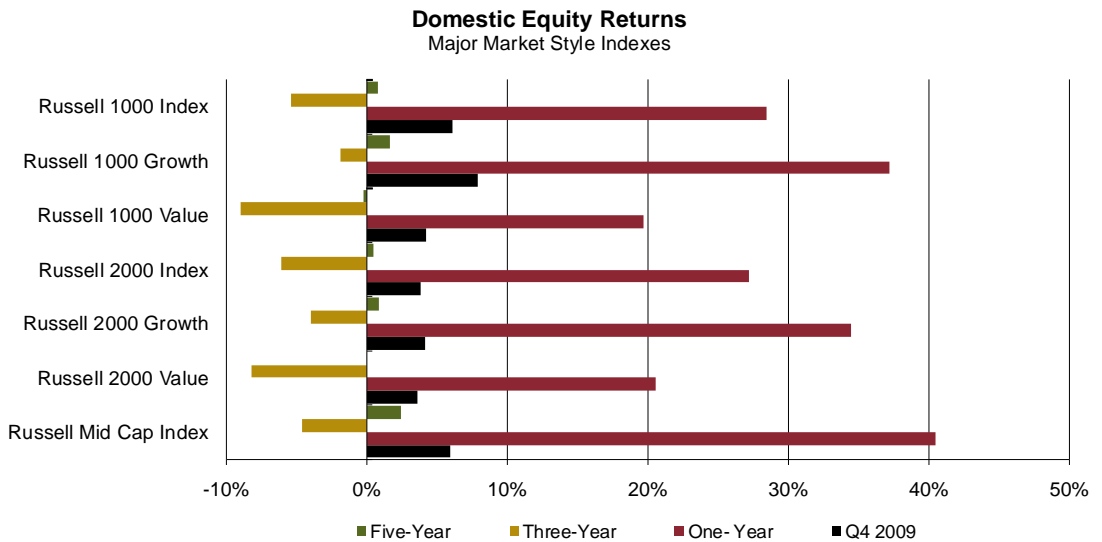
¹ Russell Investment Group

² Russell Investment Group

continued to lead the way in the final quarter, but significant positive contributions were made by every sector, except Financials which were down slightly. Similarly there was strength across the board in the small cap space led by the Materials sector.

For the year, the equity markets rebounded sharply after 2008's losses carried through the first 10 weeks of 2009. Only the Russell 1000 Value Index returned less than 20% for the year, and the Russell Midcap and Midcap Growth Indexes were both over 40%³. However, all of the domestic indexes are still down between 7 and 13% for the two year period ended December 2009. The clear leader for the year was the midcap growth space as the Russell Midcap Growth Index was up 46.3% for the year. The index was driven by the Technology and Consumer Discretionary sectors. Technology represents 22.7% of the index and returned 68% for the year⁴. The twin impacts of high exposure to Technology and low exposure to Financials drove the growth style indexes ahead of their value counterparts for the year, regardless of market cap.

Looking into 2010, many active managers believe that the minor trend toward fundamentally sound companies that began in the last few weeks of the year will continue, reversing the 2009 trend. Many companies saw their stock prices rise based on cost cutting measures and better than expected (“less bad”) sales. However, for the coming year, those companies that actually can increase their top line growth should have the advantage as the focus begins to shift to a sustainable recovery.



Source: Russell Investment Group

International Markets Summary⁵

The international developed markets were muted during the fourth quarter with the Russell Developed Large Cap ex-North America Index up just 2.3%. The returns were further muted by the dollar reversing its most recent trend in the fourth quarter, strengthening against most of the major currencies with the notable exception of the British Pound and the Canadian Dollar. One of the major differences between the domestic and international markets in the fourth quarter was the drivers of returns. Where the major

³ Russell Investment Group

⁴ Russell Investment Group

⁵ All index return data and currency data is quoted from Russell Investment Group

driver in the U.S. was the Technology sector, that sector actually had negative returns for the quarter overseas. The international markets were led by Materials and Consumer Staples names. The individual country leaders were the Norway Index (+15.3%), Singapore Index (+8.9%) and the United Kingdom Index (+6.4%), while the Greece Index (-19.6%) was the major drag due to significant turmoil in that country's financial markets.

The emerging markets however bested all of the domestic indexes in the fourth quarter up nearly 8.0%, and turned in the best year in the Russell Emerging Markets Index's history, up 78.9%. There was strength across the board in the emerging markets as most countries in the Russell Emerging Markets Index had returns in excess of 20% for the year and many were in the 60-90% range, in local currency terms. In addition, the dollar continued to fall against most of the emerging market currencies, including a whopping 57% against the Brazilian Real. The managers we spoke to were generally bullish on the emerging markets, noting the average emerging market consumer has seen job opportunity and wage growth and has little debt. This positive outlook is somewhat muted as the market over the course of 2009 has priced in a substantial recovery for 2010 already, and valuations are not as inexpensive as they were a year ago.

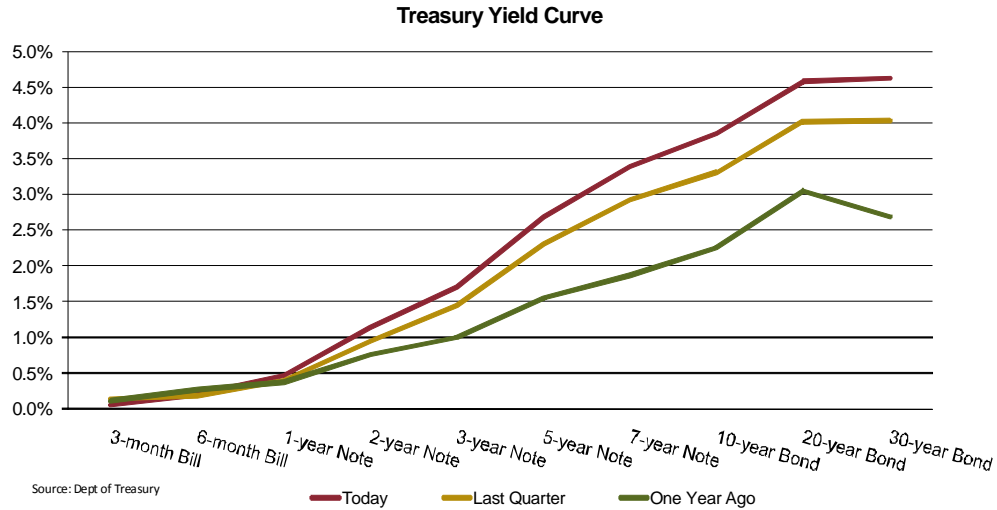
Fixed Income Summary⁶

After a relatively sleepy start to the quarter, the taxable fixed income markets went on a quick rollercoaster ride for the final 60 days of the year. The Treasury yield curve dipped in November, sharply in the case of the 2-10 year portion of the curve, and then jumped in December wiping out any gains for the quarter⁷. The Barclays Treasury Index was down 3.6% for the year after being up 13.7% in 2008. Despite the shift in the Treasury yield curve both the corporate bond market and the MBS market managed gains in the quarter to add to already impressive years. The Barclays Corporate Index was up 1.4% in the quarter, finishing the year with an 18.7% return and handily wiping out 2008's 4.9% loss. Within the corporate sector, all three segments (Industrial, Financial, Utility) had positive returns in the fourth quarter, but the Financial sector (+2.6%) was the only sector return greater than one percent. This sector is still playing catch up after lagging during the first part of the rally early in 2009. The high yield segment of the market closed out its best year ever, with the Barclay's U.S. High Yield Index up 6.2% in the final quarter and 58.2% for the year. Prima interviewed a number of managers in this space during the fourth quarter and most do not believe the current fundamentals support the price action that has occurred in the lower rated credits in 2009. The end result will likely be a focus on higher rated credits, or at least more fundamentally sound credits. Default rate assumptions have also come down, with most managers believing that defaults have peaked at 12-13% and will very gradually fall back to normal.

The short end of the Municipal spectrum had a slightly positive fourth quarter, but maturities longer than seven years in general fell during the period. This was particularly true at the very long end, as the Barclays 20 Year Municipal Index was down 2.4%. Overall though, the muni market had a very good year, with returns rising with maturities. The managers Prima spoke to during the quarter believe a significant portion of the losses in the quarter were due to profit taking for the year and dealers clearing inventory off the books prior to the end of the year. The municipal market has a number of advantages which should create a positive environment for the first half of 2010. The current yield advantage over Treasuries on a nominal basis will create an incentive for non-traditional buyers to remain in the municipal market until yields are driven significantly lower. The continued issuance of Build America Bonds, federally backed municipal issues, may limit new issuance in 2010 particularly at the long end of the maturity spectrum. Finally, even the potential for rising tax rates could significantly stimulate demand.

⁶ All index return data quoted from Barclays Capital

⁷ U.S. Treasury Daily Yield Curve Rates



Outlook

The U.S., and indeed most of the global economies, faces a transition period in 2010, one that must be carefully handled. While the equity and fixed income markets have generally recovered structurally from the crisis of 2008, the recovery has been accomplished through government support and subsidy. But this support system is tenable only in the very short run and the global markets must move back to “normal” operations. But with still weak economic growth, high unemployment and an overleveraged consumer, that transition will be difficult at best domestically. The outsized gains in domestic fixed income and the emerging markets are highly unlikely to be repeated in 2010, or any time in the near future. Investors should moderate their return expectations going forward. For the average investor, this environment dictates an increased awareness of risk tolerance and dedication to risk management.

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