



Strategic Financial Guidance

**AMERICAN FINANCIAL ADVISORS, LLC**  
**Fourth Quarter 2009 Market Summary**

Glimmers of hope that the economy might finally be beginning a turnaround gave investors the courage to keep buying stocks during the fourth quarter of 2009, as one of the strongest rallies in Wall Street memory continued. Yet while the tone was vastly improved from the near panic that gripped the world's financial markets a year earlier, faith in the recovery remained fragile, and those still wary of signs of renewed economic distress found plenty of news to ponder.

### **The Stock Market**

After the spectacular gains of the third quarter, major equity benchmarks extended their advance somewhat more slowly during the year's final months. The Dow Jones Industrial Average rebounded another 7.37% - 10% with dividends included - bringing its full-year rise to 22.68%. The Standard & Poor's 500 index climbed 5.48% (or 6.04% on a total return basis) for a 12-month gain of 26.46%.

The stock rally remained broad, with only the financial sector losing ground after rebounding earlier in the year. The biggest winners included technology and consumer-driven companies, the backbone of many growth portfolios, which gained 10.24% and 8.96%, respectively, during the fourth quarter.

For 2009 as a whole, all 10 major industry groups that Standard & Poor's tracks recovered from early losses to close the year in positive territory; technology (up 59.92%) and the raw materials producers that will likely benefit as the economy starts growing again (up 45.23%) led the way. Even the battered financial sector ended the year 14.8% ahead.

Once again, stock prices moved higher despite weak corporate fundamentals. The urge to conserve cash in a tough business environment meant executives remained cautious about payouts to shareholders. U.S. companies reduced quarterly dividend payments by a total of \$58 billion, or 21%, during 2009, the biggest decline since 1938. But here, too, brighter times may be coming, with analysts predicting S&P 500 dividends will rise 6.1% in 2010.

During this recession, most emerging markets fared better than developed economies, and during the fourth quarter, the budding industrial powerhouses of China and Brazil both saw their equity markets jump more than 9% as capital flowed back to companies likely to lead the way out of the global recession. The MSCI EAFE Index, which tracks share prices in Western Europe, Australia, and the urbanized economies of the Far East, had much more modest advances of 1.80% for the quarter and 27.75% for the full year in dollar terms.

The value to U.S. investors of returns on foreign stocks depends on the U.S. dollar's exchange rate - when the dollar weakens, gains in international markets are worth more - and the greenback ended the year with mixed results. The dollar actually strengthened 3.19% against the euro between October 1 and the end of the year, but that had as much to do with Europe's lackluster economic outlook as it did with strength in the U.S. For the year, the dollar declined 1.67% against the euro and 4.20% against a basket of other currencies. The dollar gained ground only against the Japanese yen, while commodity-driven currencies such as South Africa's rand, Brazil's real, and the Australian dollar appreciated most against the U.S. currency.

Worries that government spending and interest-rate policies would further weaken the dollar and eventually fuel inflation also boosted commodities. Because oil, metal, grain, and other raw materials are quoted worldwide in dollar terms, a weaker dollar translates into higher prices. Gold, a traditional hedge against inflation, reached a new high of \$1,212 an ounce before retreating somewhat in December; it ended the year up 19% at \$1,096. Meanwhile, industrial commodities benefited from favorable exchange rates and recovering demand for raw materials.

## **The Bond Market**

Bond prices, buoyed during the financial crisis as investors sought safe havens, finally declined during the fourth quarter. As the federal government issued \$2.1 trillion worth of new debt to fund stimulus and bailout programs, the boost in supply amid waning demand drove prices lower and yields higher. By year's end, a representative portfolio of Treasury debt had shed 3.6% of its value, making 2009 the worst year for bonds since the late 1970s.

Hints that the Federal Reserve was preparing to end some of its extraordinary efforts to help the economy further eroded support for bond prices. During 2009, the Fed had bought some \$1.6 trillion in government, housing agency, and mortgage-backed securities. But that bond buying now seems likely to end, possibly as early as the first quarter of 2010.

The retreat from bonds was especially brutal for longer-term debt, which exposes investors to an increased risk that inflation and rising interest rates will erode returns. While short-term yields remained close to zero, in line with the Fed's overnight interest rate targets, declining demand for longer-term bonds pushed their yields upward, widening the gap or "spread" between two- and ten-year bond yields to a record 2.8 percentage points by mid-December.

Hungry for higher yields and with an increasing tolerance for risk, investors have continued to turn to corporate bonds, and though by the end of the quarter the spread between speculative or "junk" corporate yields and Treasury debt of the same duration had narrowed to 6.75 percentage points - far from the 20-point premium investors received in late 2008 - that still represents a considerable incentive. Yet risks remain high, with analysts expecting some 14% of high-yield corporate borrowers to default on their obligations during the first quarter of 2010.

## **The Economy**

We won't dwell on the recent recession and lost jobs because of the overwhelming coverage by the media. Rather we'll focus on our expectations. The most likely scenario in our opinion is that the recession is over and we have entered a period of slow economic growth. Stocks and bonds will produce single digit returns over the next ten years, but this time stocks will outperform bonds. A lack of private credit will hamper the rate of recovery.

The second most likely scenario is that we actually have a sharp recovery which is common after a recession. Stocks and commodities would do well in this scenario. On the other hand, we may slide back into a recession (the double dip) which would favor bonds. The last scenario, and the least likely, is a combination of inflation and unemployment, called stagflation. We are not worried about inflation, at least for the next few years because the overhang of real estate and unemployment will hold down the consumer price index. However, if India or China grow their internal consumption, their sheer size will drive up commodity prices and the dollar would likely fall. This would favor commodities and other inflation hedges.

Rather than position a portfolio for one scenario, we believe in diversified portfolios which will meet clients' needs regardless of which scenario unfolds. All of this speaks to our long-term view. In the short-run we see a bumpy ride as the Fed and China show signs of tightening albeit for different reasons. Let us add a caution about bonds. They will still serve to dampen the swings of portfolio values, but the returns of the next 10 years are not likely to match the 6+% of the last 10 mainly because interest rates have come down. As a result, the income piece is starting out lower.

Ultimately, the future will provide both opportunities and challenges. As corporate leaders try to steer their companies back to profitability and growth, investors who follow well-constructed investment plans could reap the rewards.