

A Message from the Chief

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Greetings!

Both the Expansion Signals Checklist and the Market Meter showed continued improvement during the third quarter. When the initial estimate of Q3 GDP is released in late October, we expect it will begin with a “plus” sign. If so, that will be a welcome change after four consecutive “minus” numbers.

In last quarter’s Investment Strategy we noted that the recession was almost certainly ending and that the next debate would be over the sustainability of the expansion. The Investment Team discusses the economic outlook on a daily basis and we thought it would be enlightening to our clients to see both sides of those arguments. We therefore structured this issue’s extended Economic Outlook as a debate between an Optimist and a Pessimist. We lean toward the Optimist side shorter term but are very aware of the Pessimist point of view, particularly over the longer term. Thanks to Mark Shupe (Optimist) and Jeff Onuska (Pessimist) for generating the arguments.

In the Interest Rate Outlook, Jeff Doerfler writes that despite the assumption that the “Great Recession” has ended, the threat from inflation still does not seem imminent. The Fed is not expected to raise rates until later in 2010, although yields will begin to move up before the actual first Fed tightening. As the forecasts for the first rate increase push further out into 2010, the current low yield levels should continue to hold. Historically, investment-grade corporate bonds strongly outperform Treasuries even after the Fed begins to remove stimulus, so we favor this area.

In the Stock Market Outlook, Chris Keller tells us that the strong stock market rally over the past six months is a reminder to investors that stocks are a leading economic indicator. Most equity indexes posted double-digit percentage gains in both Q2 and Q3! We will continue to turn to our Expansion Signal Checklist and Market Meter to help us navigate during these interesting times. While these tools have directed us to fully invest our clients’ equity portfolios over the past 6 months, we remain vigilant for signs that a more conservative tactical asset allocation may be warranted.

As always, feel free to contact anyone on the Investment Management Team with questions or comments about this Investment Strategy report.

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The format for this Economic Outlook is a debate between an Optimist and a Pessimist. The Investment Team discusses these issues on a regular basis and we thought it would be enlightening to our clients to read both sides of the argument. Thanks to Mark Shupe (Optimist) and Jeff Onuska (Pessimist) for generating the arguments.

Opening Statements

Optimist: America's economic engine is powered by over 200 million participants determined to succeed. Our wealth of natural resources and open economic system has consistently delivered health, security, and growth. This is not the first severe recession we have experienced and current data indicates that we are in the early stages of a V-shaped recovery. The normal positive feedback loop from government to businesses to consumers will develop and result in a sustainable economic expansion.

Pessimist: The impact of the forced deleveraging of consumers, investors and the financial system will be a drag on global economic growth for years to come. We are worried that the V-shape will turn out to be the first half of a "W". The New Deal in the 1930s and Japan in the 1990s -2000s are vivid examples of huge government stimulus spending that did not ignite economic growth. One of the long-term effects of current US stimulus spending may be a depreciating currency. If the government printing presses break down under the weight of soaring deficits and debts, a W will emerge.

Moderator: What is the likely impact of government actions?

Pessimist: While there is an obvious positive effect on the economy from the government stimulus, the key question is sustainability. Cash for clunkers, moratoriums on foreclosures and first time homeowner incentives are all temporary. Deleveraging, de-globalization and reregulation will cause slower global economic growth. The downside to increased regulation such as new capital requirements and compensation oversight will be slower growth. The number of mortgage lenders has been reduced dramatically and the appetite to lend has been curtailed. The deeply indebted consumer will be forced to replace "shop until you drop" with "save to the grave."

Optimist: Given global monetary and fiscal stimulus, there is plenty of money available for an economic recovery. Growth will be driven by the pent-up demand for goods and services resulting from the severity of the recession. It is important that Federal Reserve tighten monetary policy in time to stem inflationary momentum. However this does not have to mean the end of the recovery - our economy has recovered from other brutal recessions with higher fed funds rates than we have now, most recently in 1981-82. Tightening will mean more long-term economic stability. The recent backlash on Main Street against increased government intervention should impact the growth of regulation.

Moderator: What's your outlook for the consumer?

Optimist: Consumer spending depends on employment. Initial and continuing jobless claims are down substantially from where they were earlier this year so this will not be a jobless recovery like the ones that began in 1991 and in 2001. Those were soft recoveries with GDP growth of less than 3%. The common wisdom is that higher rates of savings will impede economic growth, however if you believe that our current economic opportunity is in productivity gains (which have been remarkable lately) then increased consumer savings and reduced debt will mean substantial buying power in the future!

Pessimist: As consumer debt levels reached all time highs in 2008, savings rates reached all time lows. The savings rates have since rebounded at the expense of consumer spending. The home equity piggy bank has been broken, government retirement programs are suspect and higher taxes seem inevitable. In addition, it is estimated that there is a 7 million unit overhang in the housing market and delinquencies are still rising. To reach 5% unemployment we will have to create 14 million jobs in the next five years, which means we would need to create 250,000 jobs per month from 2010 to 2014. In a new era of cost cutting and productivity gains, this seems highly unlikely.

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Moderator: What is the outlook for corporate growth?

Pessimist: Corporate revenue comparisons for Q2 2009 were significantly negative. The consumer is on the ropes, so GDP growth for 2010 will be led by government spending. Corporate budget constraints will limit new hiring, capital expenditures and anything but modest inventory restocking.

Optimist: New orders for durable goods declined 2.4% in August, but the entire decline is attributable to aircraft, which is the most volatile segment. Continued earnings growth, normalized bank lending terms, and development of new markets will ultimately lead to increased business investment in inventories and equipment, not to mention increased hiring.

Moderator: What is your rebuttal to the opposing view?

Pessimist: Unfortunately, a “normal positive feedback loop” will not develop in 2010. The fragile economic recovery relies heavily on government stimulus spending, but as the money runs out, a sustained rebound will be elusive. Many Americans are out of work, and their ranks continue to increase which puts them in poor position to pay off the mounds of debt accumulated during the boom times. The negative feedback loop is thus likely to re-emerge.

Optimist: Many of the points made by our esteemed Pessimist are already or will soon become history. Improvement in residential housing inventories, employment and consumer spending will not be quick, but none of these is necessary for the current growth trend to continue. Regarding deleveraging, consumer demand and borrowing do not drive long-term productive capacity. If de-globalization means protectionism, most of the rest of the developed economies seem to be headed in the right direction and hopefully the US Administration will end its protectionist rhetoric and plans. Some re-regulation is required, but we think political gridlock will limit that damage.

Moderator: And in conclusion?

Optimist: Our economy has impressive positive momentum behind it and there is compelling value in the market prices of many of our publicly traded companies. The forces at work are the ones that have always worked; the productivity and invention of individuals and organizations that produce. So long as the trend is toward focusing more on the requirements of production, we have a bright future. In the short run, the argument for a “V-shaped recovery” is intact.

Pessimist: Less than 12 months ago, we were on the brink of financial Armageddon. We have made substantial progress towards stabilization of the global economic system, but the progress is due to unprecedented and massive global government intervention. It remains to be seen whether or not the engine of private sector growth has been reignited. Trees don't grow to the skies and massive governmental and personal debt levels take years to pare down. Let's hope the green shoots survive the coming winter!

Moderator: Thank you, gentlemen. The shorter term Optimist perspective seems to be playing out, but it may be months before it is obvious which longer term outlook proves correct. While we believe the risk of Depression has been averted, the Pessimist has a strong point about the impact of de-leveraging. We will continue to update clients as the debate continues!

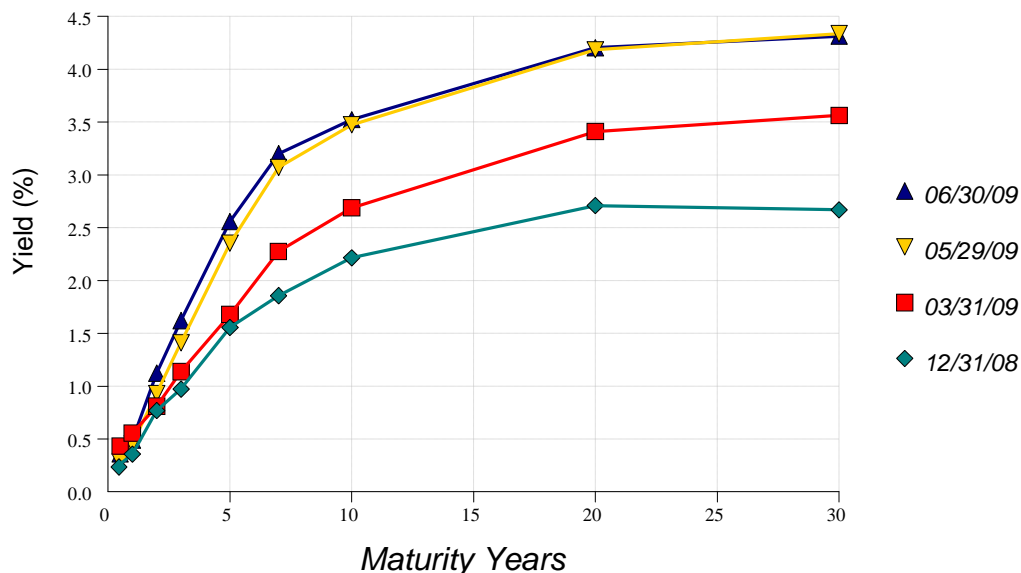
Despite the assumption that the “Great Recession” has ended, the threat from inflation still does not seem imminent. The Fed is not expected to raise rates until later in 2010. The prospects for the economic recovery will determine the timeline for the onset of the Fed tightening cycle and ultimately higher interest rates. In the meantime, the bond market must confront the end of Fed easing. This involves the gradual pullback of the many asset purchase programs being utilized by the government. The Fed is already scaling back its “hand-holding” in many of the funding markets. Many quantitative easing programs are winding down of their own accord. Against this backdrop, yields should begin to move up in the intermediate-to-long end while short rates will be anchored by the low Fed Funds rate.

It is important to note that dating back to 1921, interest rates typically move up very little during the first six months of expansion. Short rates will likely move up while BBB yields have historically continued to fall well into an economic recovery. Inevitably, yields will begin to move up before the actual first Fed tightening. As the forecasts for the first rate increase push further out into 2010, the current low yield levels should continue to hold.

Investors who continued to avoid corporate paper over the last year missed an epic credit market rally investment grade yields continued to contract significantly through the last quarter. Investment-grade corporates benefited from outperformance in the lower-quality BBB sector. The yield of the investment grade index fell to the low of 4.7% last seen in 2003. The low level of yields will eventually put a floor on any further spread contraction. The low volatility of yields also aided outperformance in mortgage-backed bonds.

Our forecast for a fairly stable yield curve leads us to continue to maintain our over-weighted bias to spread product (corporate and agency paper). Despite the significant contraction in corporate yields relative to treasuries, the sector will continue to benefit as spreads are unlikely to widen during an economic expansion. A gradually improving economy would bode well for corporate bonds. Historically, investment-grade paper strongly outperforms Treasuries even after the Fed begins to remove stimulus. Buying individual corporate bonds has become more difficult due to the high premiums of most bonds in the investment-grade arena. In many cases the use of targeted mutual funds is the best strategy to achieve fully-diversified exposure, realize an attractive yield, and produce solid total returns.

Treasury Yield Curve



The equity markets' strong performance over the past 6 months is a reminder to investors that stocks are a leading economic indicator. The skeptics continue to point to the byproducts of recession as reasons to remain cautious - an unemployment rate approaching 10%, a real estate downturn now in its third year, consumers choosing to save and pay down debt instead of spend, corporations taking a cautious approach to their spending plans, etc. Meanwhile, equities have taken their direction from improving economic data, better than expected corporate profits, and an uptick in merger and acquisition activity.

The Spring rally continued through the third quarter as the S&P 500 jumped 15.6%. As is usually the case in recovery scenarios, international stocks (led by emerging markets) and domestic small & mid cap stocks have led the market higher. In terms of sector performance, the technology, materials and consumer discretionary sectors have been the best performers. This too is consistent with past recovery cycles.

July delivered one of its best performances on record as investors reacted favorably to the release of second quarter earnings. Not only did cost cutting allow companies to exceed analyst expectations, their forecasts for the remainder of the year were reassuring for investors. An improvement in the tone of the economic data also provided fuel for the rally. ISI reported that 70% of economic data over the Summer months exceeded economists' expectations, which sparked hope that "the Great Recession" was ending.

So what now? September and October have been difficult months for stock historically (think 1929, 1987 and 2008). This September was able to buck historical trends by rising 3.7%. The markets could get their direction in October from the tone of the 3Q 2009 earnings reports. While benefits from cost cutting are likely to persist, market participants will be looking for an improvement in sales trends. As always, management's comments regarding business trends for the remainder of this year and into 2010 will be of interest. Investors will be looking for signs that the economic recovery is sustainable and not just a short-term improvement induced by federal stimulus dollars.

We will continue to turn to our Expansion Signal Checklist and Market Meter to help us navigate during these interesting times. While these tools have directed us to fully invest our clients' equity portfolios over the past 6 months, we remain vigilant for signs that a more conservative tactical asset allocation may be warranted.

Equity Market Performance 2009

