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Participant NEWS

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Special points of interest:

- "...the Dow broke 10,000 increasing more than 55% from its low in March."
- "Government spending does not have the ability to generate the sustainable growth needed to keep an economy on its feet."
- "The market is going to be in a tough fight."

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2009, What a Year!

As time passes and the story begins to unfold, we start to gain more information about the effects of our government's decisions on the financial markets. America obviously made some mistakes in the past but no one is impervious to failure; not even Tiger Woods. Last quarter we mentioned that government regulation for the healthcare industry and the financial markets was unknown. As the fourth quarter comes to a close, we have taken a few steps closer to finding out more details and their possible effects on the economy. We also commented on the lack of consumer and commercial borrowing in the U.S. and the fourth quarter proved to be a continuation of that tepid lending. In addition, we had multiple CEOs resign, a group of traders indicted for using insider information and the unemployment rate continued to increase. Despite all of the aforementioned, the Dow broke 10,000 increasing more than 55% from its low in March. We had a record number of companies beat earnings expectations, multiple banks come out from under the TARP (Troubled Asset Relief Program) and it looks like M&A (mergers and acquisitions) activity is back. As the short term environment continues to show promise, we still have a few concerns that loom in the not so distant future.

As for the markets, risk taking continued to drive returns in the 4th quarter. Emerging markets, REITs (Real Estate Investment Trusts) and high yield asset classes all had a stellar quarter. Commodities, as measured by the Dow AIG Commodity index, also benefited from the expected growth in emerging markets and returned 9.01%. The S&P 500, a broad measure for the 500 largest U.S. companies, increased by 6.04% but was out matched by the Dow Jones Industrial Average, a condensed measure of the 30 largest U.S. stocks, which gained 8.10%. On the other hand, investments in developed foreign countries did not fare as well. The MSCI EAFE, a measure that encompasses Europe, Australia, and the Far East, was only able to muster a return of 2.22% for the quarter. Most of the underperformance came from the strengthening of the U.S. dollar. The dollar index, a measure of the dollar's value relative to a basket of currencies, fell approximately 3% for the first 2

months of the quarter but quickly reversed those losses by gaining 4.7% in December. All in all, it was yet another good quarter for those investors willing to take some risk.

We kicked off the fourth quarter by receiving news that the economy grew by 3.5% during the third quarter. That number was later revised down to 2.2% but even so, it was the first quarter since the third quarter of 2008 where we had seen any growth in our economy. Also, the unemployment rate decreased to 10% from 10.2% in November and we only lost 11,000 jobs. Losing jobs is never a good sign but from the beginning of 2008 when the economy started to shed jobs, we had averaged over 300,000 job losses a month. So a loss of 11,000 could be a sign the economy is healing. Economic growth and fewer job losses have also allowed the consumer to bounce back. In November, retail sales increased by 1.3% on a monthly basis and 1.9% on a year-over-year basis. Holiday spending also increased this year by approximately 1%. Consumers are not the only group that started to spend money. The cash on hand at companies in the United States reached a 40 year high in October but as the fourth quarter matured, more and more companies began to invest that idle cash. NBC and Comcast

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entered a partnership, Warren Buffet bought Burlington Northern and Exxon Mobil bought XTO Energy. The presence of M&A activity is yet another sign the economic activity is picking up. Other companies, particularly financials, were using their cash to exit the TARP program. Bank of America, Citigroup and Wells Fargo all participated in paying back the taxpayers.

Even with the market running hot and the economic environment starting to perk up, we still have a few concerns about the future. In the middle of November, Ben Bernanke, the Chairman of the Fed, commented on persistent high unemployment and tepid lending being factors that could weaken the economic rebound. These concerns are not far off from our own and we have seen a few statistics that confirm our worries. Companies posted their third quarter results early in the fourth quarter and approximately 80% of all companies beat their earnings estimates. Even though earnings were very strong, we saw that revenue was down by approximately 10%. Most of the outperformance can be attributed to cost cutting a.k.a. layoffs. If revenue growth continues at this lackluster pace, companies will most likely hold off on hiring which will lead to persistent high unemployment. Also, consumer credit fell for the 9th straight month. It has fallen a total of 4.26% from its peak in February of 2009. Four percent may not sound like a big drop, but when put into nominal terms, the amount of money in the consumer's hands has decreased by \$37.5 billion. One out of every four home owning Americans is underwater, meaning their mortgage value is greater than their home value, so consumer credit is likely to stay at these depressed levels for some time. In essence, poor revenue growth and depressed lending could be serious headwinds for the economy.

Our other concerns lie with United States Government. There are two influential bills and one stimulus package the government is currently working on. The health overhaul is in the final stages. Reconciliation between the House and Senate bills and a signature from the president is all that stands in its way. As for the financial overhaul bill and the second stimulus package, they are still in their infancy. We are not positive on what the final proposals will look like but when all of these initiatives are combined, we have to ask ourselves; how is the government going to be able to afford all of these new programs? Essentially, there are three ways to pay for these programs; print more money, borrow the money and/or raise taxes. With all of the “new” money created thus far, printing money may not be the best

solution. That leaves the government with only two options; borrow or raise taxes. Increasing taxes has never been beneficial for a weak economy. It takes money out of the hands of the consumer who generate the largest percent (over 60%) of economic activity. We understand these programs will increase government spending, which is a component of GDP (gross domestic product), but it is only a band-aid. Government spending does not have the ability to generate the sustainable growth needed to keep an economy on its feet. So now we are down to our last option; government borrowing. With rates at such low levels, it may look attractive, but taking a longer term view it may end up being quite harmful. The total Federal debt outstanding is \$12 trillion, which is 84% of nominal GDP. The IMF (International Monetary Fund) is forecasting the U.S. Government debt to be 108% of economic output in 2014. This is almost a doubling from the debt level in 2007, which was 62%. This increase could have serious consequences on the economy. We have recently seen issues with Dubai who had to renegotiate their debt contracts, in turn, increasing their borrowing costs substantially. Greece is also feeling the pain after Moody's and S&P downgraded their debt. If the United States reaches the aforementioned debt levels, the consequences could potentially lead to another crisis.

So where do we stand? Right now, we are actually in a neutral stance. The recent tailwinds have carried us from an extreme low but the headwinds mentioned above look to be quite strong. The market is going to be in a tough fight. If we see another round of good earnings, especially solid revenue growth, non government jobs being created and the Fed removing their “easy money” talk, we could see the market move a bit higher. However, if we see increases in taxes, higher interest rates and a jobless economic recovery, we would likely see the market move lower. 2010 should continue to be a period of major economic transition.

If you have any questions regarding your investments, please feel free to contact Cornerstone at 1-800-923-0900.

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