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This Time It's NOT Different

U.S. Economic Forecast				
	Actual	2010 Forecast		
Indicator	2009	1st Half	2nd Half	Full Year
Real GDP Growth (annualized rate)	-1.9% ^a	3.5%	2.8%	3.2% ^a
Inflation (Consumer Price Index)	-0.2% ^d	1.0%	1.8%	1.4% ^a
Core Inflation (CPI less food & energy)	1.7% ^d	1.0%	1.4%	1.2% ^a
Unemployment ^b	10.0% ^d	10.3%	9.4%	10.0% ^a
Fed Funds Rate ^b	0.00-0.25%	0.00-0.25%	0.50%	
10-Year U.S. Treasury Bond Yield ^b	3.55% ^c	3.10-3.60%	4.00-4.50%	
Crude Oil (per barrel) ^b	\$69.51 ^c	\$80-\$85	\$90-\$95	

Explanatory notes: a) 4th quarter over 4th quarter; b) end of period figure; c) Price as of 12/14/09; d) 12-months ended November. Sources of data: Bloomberg, Bureau of Labor Statistics, Bureau of Economic Analysis.

Executive Summary. The clouds, which were gathering and intensifying at this time last year, appear to be parting as we approach 2010. Thankfully the current trends within the economy are promising. Leading indicators continue to point higher. Yet, some of the lagging indicators remain ugly at this point.

When we review the outlook of the major components of the economy, we are encouraged. As the title states, we think the recovery will be fairly typical in most respects. Thus, we forecast the economy will grow at a 3.2% rate for 2010. While this is faster than most estimates, it is below what would be considered a “V-shaped” economic recovery.

As a result of an improving U.S. economy and tepid growth in Europe, we expect a stabilization and modest appreciation of the U.S. Dollar during 2010. Nevertheless, there are still clouds capable of raining on the parade. Among them are the chance of a double-dip recession and questions about the strength of the consumer.

From a thematic angle, we feel that investors will have to work harder in 2010 to find investment prospects. Because of the 2009 rally, many of the easy pickings and obvious mispricing opportunities are gone. As such, we believe that investors will need to use a rifle rather than a shotgun to attempt to outpace the market. On the other hand, we don't think investors need to fret about inflation (at least not in 2010).

Economic Outlook

Preface: “Live by the sword...”

A former manager and mentor told me early in my career that, “anyone can regurgitate data. We get paid to take a position.” He was spot on. Thus, it is our duty to provide our outlook based on the currently available facts and figures.

Unfortunately, when you take a position—and it is written and distributed—people can and will invariably keep score. While we could bemoan incomplete data, we deserve some praise for our 2009 forecast along with some scorn. We were certainly right on several points, such as continued market volatility and that the recession would last about 20–24 months (much longer than widely believed at the time), but dreadfully off of mark on others like the unemployment rate. As the section title says, we “live by the sword, die by the sword.” Happily, “It’s just a flesh wound...”¹

More importantly, we want to make it clear that our thoughts pertain to the next 12 months. Therefore, investors may want to consider our views relative to their time horizon, which may be longer than 12 months, their risk tolerance, and their overall investment strategy.

Economy. It has been called the “Great Recession”² by some and the “Great Panic”³ by others. We won’t argue with either. Without a doubt, the economy has been through a meat grinder that included four consecutive quarters of negative Gross Domestic Product (GDP) from the third quarter of 2008 through the second quarter of 2009. Rhetorical Great Depression comparisons aside, the most recent similar episode was the mid-1970s, which was marked by five quarters of

negative GDP during a seven quarter span from 1973 to 1975.

However, as we mentioned last year, the sum total of all the issues we faced were not fatal to the U.S. economy. The clouds, which were gathering and intensifying at this time last year, appear to be parting as we approach 2010. Nevertheless, there are still clouds capable of raining on the parade.

Thankfully the current trends within the economy are promising. Leading indicators—such as building permits, weekly unemployment claims, average weekly manufacturing hours—continue to trend higher. Coincident indicators are either slowing their descent (nonfarm payrolls) or improving (industrial production). Meanwhile, many lagging indicators, such as commercial & industrial loans and the average duration of unemployment, remain ugly. Then again, they are expected to lag a recovery.

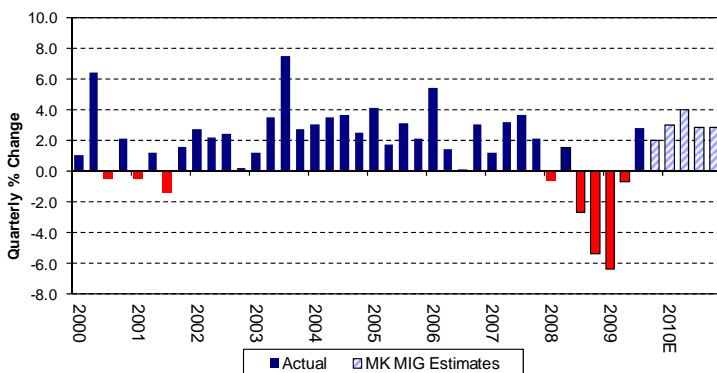
We forecast that GDP will grow at a 3.2% rate for 2010 (measured on a fourth quarter 2010 over fourth quarter 2009 basis). This is faster than most estimates yet below what would be considered a “V-shaped” economic recovery (a sharp decline immediately followed by a sharp increase).

When we review the major components of the economy (GDP), we are similarly encouraged. The biggest component, the consumer, is surprisingly stable. Consumer spending (formally known as personal consumption) is largely dependent on jobs and wages, and to a lesser extent, sentiment. Despite massive job losses, consumer spending has been steadily improving since the spring. Monthly retail sales have shown a significant rebound. Surely, some of you may discount this improvement as being single-handedly caused by the “Cash-for-Clunkers” program. But, retail sales excluding both food and auto-related sales have achieved positive month-over-month growth for six out of the last seven months, according to U.S. Census Bureau data. Still, we expect that wage gains will be very tough to ask for in this sort of environment. Therefore, while we expect consumer spending to be a positive contributor to GDP, it will remain in a relatively weak position.

Jobs. The jobs situation is among the biggest headwinds for the economy. There have been 4.2 million nonfarm payroll jobs lost in 2009 through

**Gross Domestic Product
(2000 - 2009 MK MIG Estimates)**

Source: Bureau of Economic Analysis, Morgan Keegan Market Intelligence Group



November, and 7.3 million since the recession began in December 2007. Such sharp job cuts instigate a vicious cycle of lower incomes that trigger lower sales which set off further job losses.

Unfortunately, the unemployment rate has already exceeded our original forecast. Accordingly, we have revised up our peak unemployment rate forecast to 10.5% from 10.2%. However, we have retained our conviction that the unemployment rate peak will occur early in 2010.

The conviction on the timing of the peak is based largely on the weekly initial unemployment insurance claims. The initial unemployment claims figure is among the best “real-time” leading economic indicators. Initial claims peaked at 674,000 in late March, and have steadily declined ever since. During prior recessionary periods, there has been roughly a ten month lag between the peak in initial unemployment claims and the unemployment rate. Similarly, continuing claims peaked mid-summer.

On the other hand, there has been a gradual in-

crease in the number of temporary workers, a.k.a. “temp jobs,” which are a leading indicator of non-farm payrolls. The number of temporary jobs has increased 21% since July 2009, according to the American Staffing Association (ASA) Staffing Index. As an aside, temporary workers perform temporary

Economic Outlook

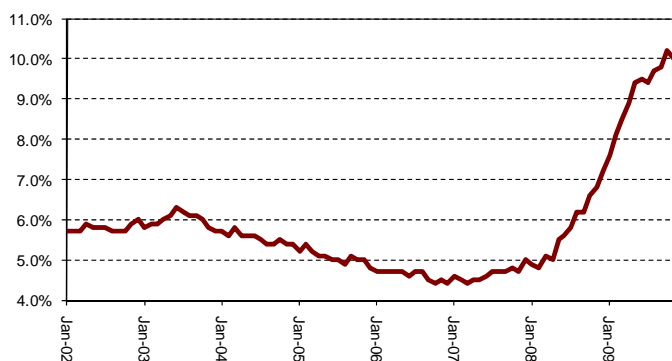
GDP Component	Comment	Outlook
Personal Consumption	Although a positive contributor, the high unemployment rate and tepid wage gains will weigh heavily on consumer spending and confidence	<i>Positive</i>
Business Investment	Expansion plans and overall capital spending remain on hold, as does commercial building; exception being high return on investment tech projects	<i>Negative</i>
Residential Investment	Residential building activity modestly improves thanks to historically low mortgage rates and home buyer tax credits	<i>Positive</i>
Inventory Investment	Inventory replenishment has begun, which will be the big driver of economic growth for the next few quarters	<i>Positive</i>
Net Exports	Dollar stabilization and stronger U.S. consumer demand for imports offset stronger global demand for exports	<i>Neutral to Negative</i>
Government Purchases	Despite weaker tax revenue, federal stimulus dollars flow as state and local projects ramp up	<i>Positive</i>

and contract work. The classification of part- and full-time workers is based on the number of hours worked per week (part-timers are 1 to 34 hours; full-timers are 35 hours or more).

More temp jobs is definitely a positive sign. Thus, the trend of monthly job losses should continue improving well into the first few months of 2010. Eventually, net job gains will reappear, most likely in the spring months. However, due in part to the nature of the job losses sustained over the past two years, we believe that the unemployment rate will remain high for the foreseeable future. Our expectation is that the unemployment rate will be around 9.4-9.5% by the end of 2010. Ultimately, it may very well take until 2012 for the jobs market to “normalize.”

Unemployment Rate

Source: Bureau of Labor Statistics, Morgan Keegan Market Intelligence Group



Business Investment. Given the gradual slide into the recession, many businesses began crimping capital expenditures in 2007. Many corporate IT budgets have been stripped down to “break-fix” only mode for three years. And time in technology is like dog years, where hardware replacements are precipitated by new software and vice versa. Therefore, many firms have a backlog of technology needs. Moreover, there have been new innovations that can immediately deliver savings to the bottom-line. For instance, server virtualization is estimated reduce to hardware and operating costs by as much as 50% and energy costs by 80%.⁴ Thus, we believe such high return on investment projects will increasingly get the scarce budget dollars.

However, general expansion plans will remain on the backburner in favor of further consolidation. Examples would be a large company consolidating multiple back office operations into one location but putting off building a new plant for future production. Furthermore, commercial building faces strong headwinds, as property values and rents continue to decline, while vacancy rates rise. Funding difficulties abound as these factors cause banks and investors to shy away from risk.

Yet, it is important to realize that commercial construction lags the rest of the economy. In fact, the commercial construction lag is one of the longest within the economy—even behind employment. Perhaps this lag is due to the long lead time required to get projects from the planning stage to eventual completion. Consequently, it may be mid-to-late 2011 before commercial construction sees a noticeable recovery.

Unfortunately, such delayed expansion plans and little commercial building will more than offset the

technology or consolidation efforts. Therefore, we expect overall business investment to remain lack-luster in 2010.

Housing. Housing, or residential investment, turned positive this past quarter, adding 0.53% to overall GDP in the third quarter 2009. No, that is not a typo. It had been a drag on the overall economy for the past 14 quarters. Although that was an extended interval, it is not unprecedented. In fact, such housing collapses seem to coincide with deep recessionary periods. For example, there was an 11 quarter streak from mid-1955 to early 1958. There also was an eight quarter slump from 1973 to early 1975. Then, another housing plunge that had 14 negative quarters out of 16 quarters from late 1978 to 1982.

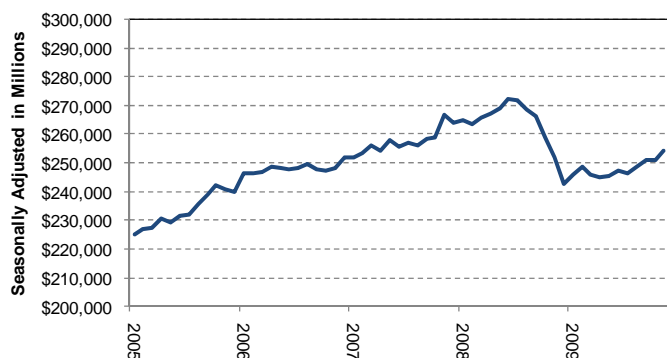
The good news is that housing has built up a solid trend. Existing home sales appear to have bottomed in the spring and have strung together month-over-month sales gains in six of the last seven months (through October), according to the National Association of Realtors. There have also been four straight months of year-over-year gains.

New home sales have also improved, as month-over-month sales rose during five of the last seven months (through October), according to the U.S. Census Bureau. Moreover, October had the first jump year-over-year in new home sales, which last occurred in November 2005.

Yet, the bad news is that the improvement in the housing market may be overly influenced by federal programs. First, there is the \$8,000 first-time home buyer tax credit, which was part of the American Recovery and Reinvestment Act of 2009 (better known as the “Obama Stimulus Package”). It was

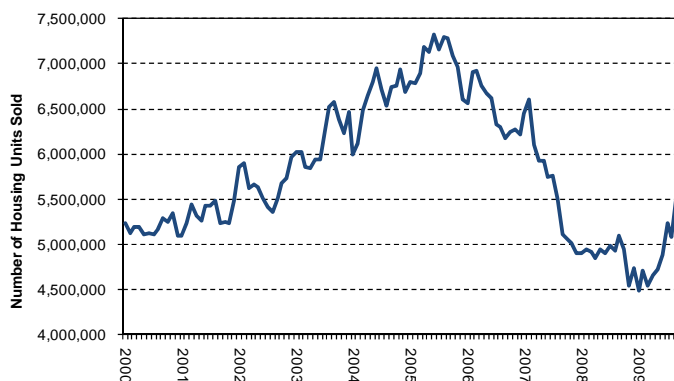
**Retail Sales LESS Food and Autos
(January 2005 - November 2009)**

Source: U.S. Census Bureau, Morgan Keegan Market Intelligence Group



Annual Rate of Existing Home Sales

Source: National Assoc of Realtors, Morgan Keegan Market Intelligence Group



set to expire on December 1, 2009, but was extended to April 30, 2010, as part of the Worker, Homeownership And Business Assistance Act Of 2009. This legislation also created a \$6,500 “repeat” homebuyer tax credit.

Secondly, the myriad of foreclosure programs such as the Home Affordable Modification Program (HAMP) may be merely prolonging the process. The mortgage delinquency rate rose to a seasonally adjusted rate of 9.6% of all loans (through October) and another 4.5% are in the foreclosure process, according to the Mortgage Bankers Association. Even within the HAMP program, only 20% of the estimated delinquencies over 60 days are ultimately receiving loan modifications.⁵ Thus, we expect foreclosures and delinquencies to rise further because of job losses and rising unemployment

On the other hand, housing affordability is very supportive, either through low mortgage interest rates or with lower home prices. Yet, the overall housing market will likely struggle to make significant strides with respect to home values, perhaps until 2011 at the earliest. Nonetheless, we believe that housing will be a modestly positive contributor to GDP.

Business Inventories. We believe that inventories will be the biggest driver of economic growth during 2010. Given the gradual nature of the slowdown over 2007 and 2008, businesses kept inventory levels very lean. To wit, inventories shrank for six of seven quarters from the fourth quarter of 2007 through the second quarter of 2009.

Total business inventories grew an average of just 0.7% month-over-month in 2008 and have shriveled an average of -1.22% year-to-date in 2009 (through September), according to the U.S. Census Bureau. This is compared to a monthly average of 0.29%

since 1992.

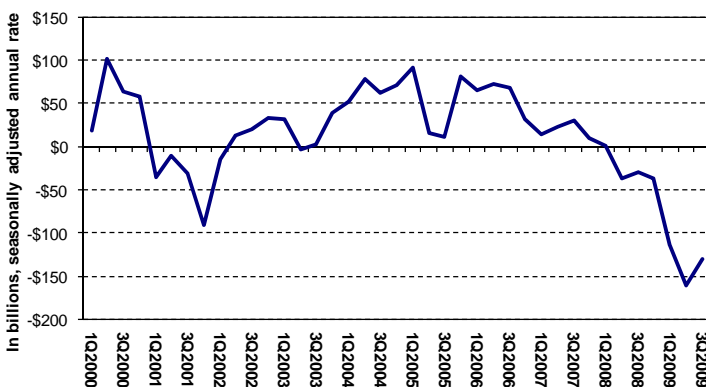
Inventory replenishment has begun and should continue for the next few quarters if not years. Understand that we are not projecting a massive upturn in the size of inventories. We believe companies will remain very disciplined and will err on the side of lean, staying with just-in-time stocking. On the other hand, the breadth of inventory replenishment will be wide. Most industries are affected, not just a few (like autos or aircrafts). Therefore, **any** increase in aggregate demand will spark a virtuous cycle – tight inventories mean that essentially any new orders lead to increased manufacturing, leading to hiring, which lead to more demand.

Net Exports and the Dollar. Bashing the U.S. Dollar trade turned into a spectator sport in 2009. Given four consecutive quarters of sharp economic decline, it was somewhat warranted. The recession in Europe and Japan was much shallower than in the U.S. However, that “obvious” comparison is no longer valid.

We believe that the favorable comparative growth outlook for the U.S. during 2010 over our developed peers will reverse the Dollar’s slide. Again, we believe that the U.S. will achieve GDP growth of 3.2% in 2010 while Europe (EU27) and Japan are expected to garner growth of 0.3% and 1.7%, respectively.⁶ Moreover, there are several unstable economies in Europe, colloquially known as the “PIIGS” (Portugal, Italy, Ireland, Greece and Spain). With recent debt downgrades by rating agencies for Greece, Portugal, and Spain, there is an increasing likelihood that the broad European Union or the European Central Bank (ECB) may need to lend a hand to struggling members.

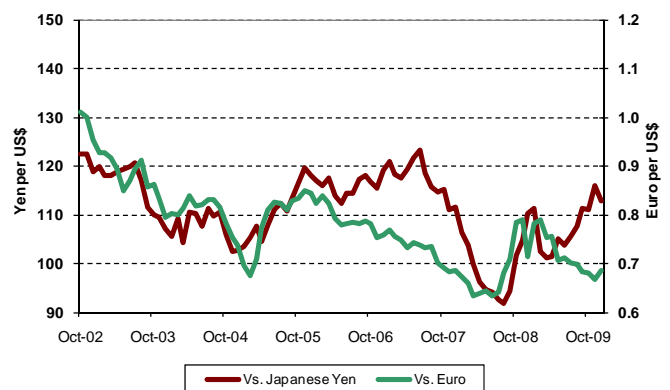
GDP: Change in Private Inventories

Source: Bureau of Economic Analysis, Morgan Keegan Market Intelligence Group



U.S. Dollar vs. Foreign Currencies

Source: Baseline, Morgan Keegan Market Intelligence Group



Another factor for our favorable outlook for the Dollar is overall interest rates. We forecast that the Federal Reserve will begin to unwind its quantitative easing in the first half of the year and will begin raising rates in the second half (see the Federal Reserve section). Meanwhile, the aforementioned problems will hamper efforts by the ECB to raise rates as aggressively as they would like. Thus, we feel interest rate differentials will remain narrow.

Lastly, the plunging U.S. Dollar has forced several central governments and banks, including Thailand, South Korea, Russia and the Philippines, to buy U.S. Dollars to stem the soaring appreciation of their own currencies.⁷ A stabilization and modest appreciation of the U.S. Dollar likely means that China will not revalue its currency (known as the yuan).

Unfortunately, this also means that American goods will no longer be “on sale” for international consumers. On the other hand, an improving global economy should lead to more demand of U.S. goods.

Ultimately, it appears that many of these competing issues will cancel each other out. Thus, we believe that net exports will probably be neutral-to-negative for U.S. GDP in 2010.

Government Purchases. Obviously, government spending is on the rise. The continued wars in Iraq and Afghanistan require further military spending. Additionally, roughly \$400 billion is scheduled to be paid out in 2010 from the Obama Stimulus Plan.

Government purchases accounted for 19.9% of total GDP, which is largely based on U.S. spending. Therefore, this figure represents what the government bought rather than the size of total government (i.e. budget). For example, government in this context does not include Social Security, which is a transfer payment to individual consumers. Most people are surprised to learn that 19.9% is below the average of 25.2% since 1947 and has been gradually falling since its peak of 37.4% in 1953.

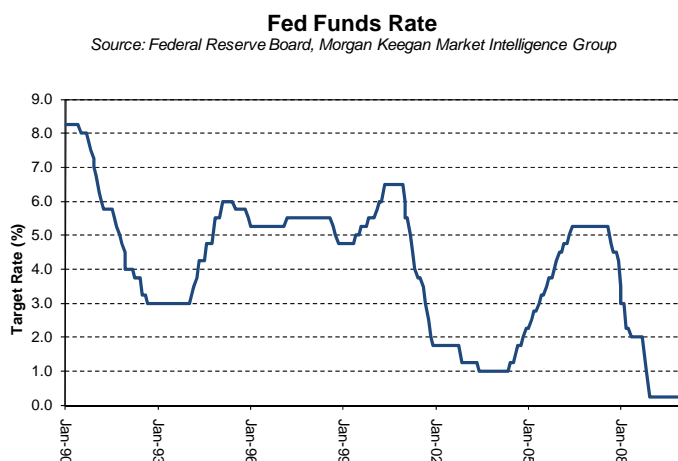
The Federal Reserve. In 2007 and most of 2008, the Fed was admittedly behind the curve with respect to the oncoming recession. Moreover, the Fed and the U.S. Treasury bungled the handling of Lehman Brothers and its subsequent collapse.

However, the Fed quickly grasped the reins and has performed admirably in the face of adversity. In addition to lowering the Federal Funds, which eventu-

ally fell to a range of 0.00-0.25%, the Fed coordinated a response by the global central banks. It also instituted a “quantitative easing” plan, whereby the Fed began to expand its balance sheet through a series of programs such as Term Auction Facility (TAF), Term Commercial Paper Funding Facility (CPFF), Money Market Investor Funding Facility (MMIFF), Term Asset-Backed Securities Loan Facility (TALF). By buying or loaning against a broad array of assets, the Fed kick-started some of the markets frozen during the credit crunch that ensued after the Lehman collapse. Accordingly, the Fed deserves both criticism and praise.

Looking ahead, the Fed will have to unwind its balance sheet and normalize the various credit markets that it rescued. This is an area of concern for many market watchers. While this is an enormous undertaking, we believe that the Fed will time it mostly right. In fact, it has already begun to quietly unwind some of the assets held in the Term Commercial Paper Funding Facility, which have dropped to \$14.6 billion from \$293.9 billion a year ago. Nonetheless, the Fed has a long way to go and it will be a delicate process.

Further reductions in the Fed’s balance sheet will be the precursor to eventually raising interest rates. However, given Chairman Bernanke’s knowledge of history, we believe the Fed will proceed with extreme caution with respect to rate hikes. Rate hawks are already clamoring for a hike to tamp down the eventual inflation that they expect will result from the low interest rates. Yet, Bernanke is acutely aware of the consequences of hiking too early, lest he spur a relapse in recession (much like the one that occurred in 1937 amidst the Great Depression). Therefore, we be-



lieve that the Bernanke Fed will be err on the side of allowing for some inflation rather than being perceived as hampering economic growth. This is especially true in an environment with the unemployment rate above 10%.

As such, we expect that the Fed will raise the Federal Funds rate to 0.50% in the second half of 2010. Eventually, we believe that the Fed will shift to higher rates in 2011 (but that's the 2011 forecast).

Inflation. A year ago, the ongoing threat was deflation. While deflation is usually associated with a sustained decline in prices (rather than temporary), it typically involves a decrease in the money supply caused by tight monetary policy. Obviously, with historically low interest rates and substantial injections of cash through corporate bailouts and the Obama Stimulus Plan, deflation was not a concern.

Conversely, some investors are fretting about rampant inflation. However, inflation, as measured by the Consumer Price Index (CPI), has been collapsing at a rate not seen since the 1950s. The 12-month rate of CPI declined at a rate of 0.2% in October, as the energy component slid 24.0%. There have been eight consecutive monthly year-over-year declines. In fact, CPI has not been negative over a 12-month period since August 1955. That is a dramatic drop from the rapid 12-month rate of CPI of 5.6% in July 2008. The 12-month rate of the core Consumer Price Index, which excludes food and energy, rose 1.7% in October and should continue to trend lower.

Additionally, housing prices, which make up about one-third of CPI, continued to decline throughout the year. The housing market has shown some signs of stabilization, primarily a result of low interest rates and the first-time homebuyer tax credit. As we mentioned in the Housing section, we do not expect home prices to start increasing for quite some time. In turn, it takes roughly a full year for actual changes exposed through surveys to be reflected in the CPI data. Therefore, we project that weak housing prices will hold down CPI in the coming months.

Likewise, wholesale prices, as measured by the Producer Price Index (PPI), have been plunging. PPI increased 1.9% during the past 12-month period ending in October. That is a considerably slower pace compared to July 2008, when PPI rose an astounding 9.9% on a year-over-year basis. Core PPI, which excludes the food and energy components,

increased just 0.7% over the past 12-month period in October. It represents the lowest 12-month increase in core PPI since March 2004.

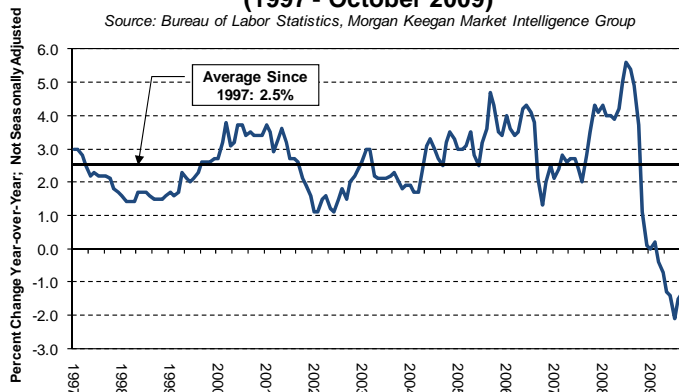
Accordingly, we do not believe that inflation should be a concern through at least the first half of 2010, and possibly into 2011, since home prices are not expected to increase, or even stabilize, for some time.

Crude Oil. Over the course of the past two years, the price of crude oil has been on a roller coaster ride. It ended 2007 at \$95 per barrel, spiked above \$145 in July 2008, but ended 2008 at \$45. This dramatic drop in crude oil prices was a direct result of a rapid decline in consumer demand. Yet, prices rebounded and have nearly doubled during 2009, ending November at roughly \$80 per barrel.

However, as the economy has bottomed and economic recovery has begun, demand appears to have stabilized and should begin to rise next year. Yet, the magnitude of the increase will be proportional to the size of the economic rebound.

Some inflationary pressures have been present throughout 2009, as crude oil steadily increased during the year and gold increased to more than \$1,100/troy ounce. Conversely, after a rebound from record lows in the second half of 2008, the U.S. Dollar has fallen back to those levels. It is our belief that commodity prices have risen primarily on investor expectations that those dollars will have to be removed from the market at some point by the Fed. We would expect commodities to remain at elevated levels during 2010, but ease to pre-recession levels as the economy recovers and the U.S. Dollar strengthens.

**Consumer Price Index
(1997 - October 2009)**



Based on a number of factors, we expect that crude oil prices should rise from current levels, but not at the pace seen in the first half of 2008. Primary among those factors is the return of consumer demand. If crude oil prices rise at a faster rate than the consumer recovers, it may put undue pressure on the consumer and stunt the economic recovery. Furthermore, consumers have searched for more efficient ways to reduce their oil footprint, including purchasing more fuel efficient automobiles. Additionally, government conservation measures continue to be implemented, providing incentives for businesses that become “greener.” Despite these recent short-term measures, a substantial rise in prices would lead to further reductions of global demand and may possibly crimp the ongoing economic recovery.

After a number of years of increases, global demand for crude oil declined sharply in 2008 and 2009 as most global economies fell into sharp recessions. It marked the first time in three decades that global demand fell for two consecutive years. However, that trend is expected to reverse course as these economies begin to recover. As such, global demand for 2010 is expected to increase by 1.25 million barrels a day to 85.4 million barrels a day, according to the Energy Information Administration (EIA).

Crude oil and natural gas producers tightened their capital budgets in 2009, and many projects were put on hold or even outright cancelled. Global production fell by 1.18 million barrels per day in 2009, but is expected to rebound in 2009, according to the EIA. These budgets are expected to be flat versus 2008 levels. And if those projects are brought back online at some point in 2009, it will not happen over-

night. It would take some time to get the necessary personnel in place and production up and running.

A couple of years ago, the reduction in production would have caused prices to soar, since demand was robust and nations were thirsty for oil. The lack of spare capacity, along with other factors, contributed to crude oil prices reaching record highs in 2008. However, there is a vast amount of spare capacity. There is room for additional suppliers to come online without pushing prices materially higher. U.S. oil demand may have already peaked, when domestic consumption reached 21 million barrels/day in 2005. Crude oil consumption in the U.S. is currently under 19 million barrels/day. Furthermore, it is not expected to reach 21 million barrels/day until 2029, according to the EIA, mostly a result of consumers purchasing more efficient cars and government conservation measures. We expect that the biggest driver to crude oil prices will be a continued weakness of the U.S. Dollar.

Lastly, production in the Organization of the Petroleum Exporting Countries (OPEC) has fallen by about 1.7 million barrels/day in 2009. Excess crude oil supplies have risen to nearly 4 million barrels/day in 2009, well above the 1.5 million barrels/day in 2008. Moreover, the EIA expects supply to rise to 4.33 million barrels/day in 2010.⁸

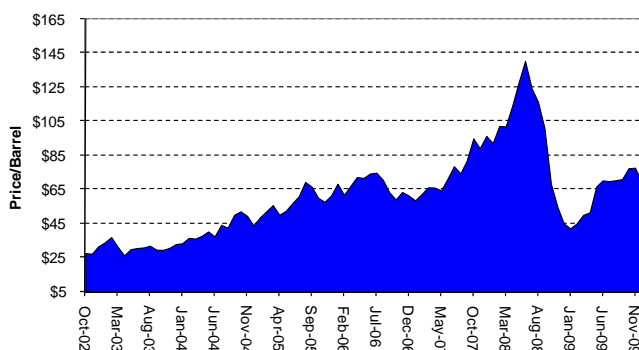
Therefore, we expect crude oil to modestly trend higher, averaging about \$90 per barrel in 2010. If prices spike significantly above \$100 per barrel, it may crimp the global economic recovery.

In the U.S., the average price for regular-grade gasoline at the end of November was \$2.59/gallon, an increase of \$1.00/gallon from the start of the year. That represents an increase of 63.1% in regular-grade gasoline prices through the end of November. Moreover, prices have risen 7.0% since the end of the third quarter. However, they are well off the \$4.03/gallon highs experienced in July 2008.

Typically, lower prices at the pump create positive psychological effects. Consumers’ perceptions of their own buying power would change, causing them to increase their consumer discretionary spending. Yet, the economy remains fragile at this point, despite the blooming recovery. A sudden spike in energy and gasoline prices could certainly

Monthly Crude Oil Prices

Source: Baseline, Morgan Keegan Market Intelligence Group



derail or delay the mending. Although overall demand for crude oil products has certainly diminished during this recession, we maintain our belief that the consumer is not dead and will not completely stop spending. Barring any sudden disruption to supply or an unexpected spike in demand, prices at the pump should remain relatively steady with an upward bias, but well below the historically high levels experienced during the summer 2008. As such, we expect regular-grade gasoline prices to approach \$3.00/gallon during the peak driving season in 2010.

Corporate Earnings. According to First Call/Thomson Financial, the S&P 500 companies should earn \$62.21 per share for the full year 2009 (derived from bottom-up aggregates, with the consensus estimate used for the fourth quarter figure). The consensus forecast for 2010 is \$77.84, which represents year-over-year growth of 25.12%. That growth may be quite high given the uncertainty surrounding the pace of economic recovery from the deep recession. We would expect that corporate executives will continue to keep budgets constrained, cutting loose unprofitable programs to focus on core businesses. Although temporary workers have been added during the final few months of 2009, we do not forecast companies to rapidly add permanent workers for at least the first few months of the year. Many companies acted swiftly and were able to increase profitability by significantly cutting workforce levels and eliminating non-core operations. Consequently, company payrolls are very lean (evidenced by the number of jobs lost since the start of the recession) and businesses are operating at record high productivity levels. These elevated productivity levels will not last long once companies begin to hire permanent employees. However, revenue has not rebounded. As such, corporate payrolls should remain subdued until executives see tangible evidence of an economic recovery.

Nonetheless, we believe that the current consensus for 2010 is biased to the upside throughout the entire year. We anticipate year-over-year growth, but believe it will be more subdued than the overall consensus forecast. Therefore, we are ratcheting down our earnings forecast for the S&P 500 companies to \$70 per share, which would be a 12.5% increase on a year-over-year basis.

Going forward, corporations will need to focus more attention to increasing revenue rather than liquidity. That increase in revenue will come from a rise in consumer demand. However, demand fell off a cliff

during the recession and it will need to improve for revenues to return to pre-recession levels. The consumer will be the driving engine for growth in the economy. Yet, lending has been tight to both consumers and businesses during the past year. It is not just consumers that are having trouble borrowing; many companies are finding it difficult to have easy access to borrowing. As such, consumer lending fell 1.9% in October, the ninth straight month of decline. Since the consumer accounts for more than two-thirds of overall economic growth in the U.S., curtailed lending to consumers would impinge on blossoming economic recovery.

Corporate America and consumers have been slowly cleaning up their respective balance sheets. The Obama Stimulus Plan and government cash injections have helped reduce overall debt positions for corporations. Corporate executives have made their adjustments to control their expenses by reducing the labor force, suspending stock repurchase programs, and eliminating non-core businesses. Additionally, we expect those companies that are flush with cash to start making acquisitions that are more strategic in nature, adding bolt-on companies that are complementary to existing businesses and up and running within a fairly short time. In turn, they should be able to steal industry market share as the economic recovery blossoms. Furthermore, we believe that overall credit markets continue to improve so that company earnings can move higher. Therefore, any hint of revenue growth during 2010 should be a catalyst for an equity rally.

Risks To Our Forecast

The Double-Dip Recession. As we have previously stated, we believe that the recession ended this past summer. However, there is a view circulating that believes that the recovery is unsustainable and expects the economy to return to recession at some point in 2010. The shape of such a scenario would resemble a “W”, and is also referred to as a “double-dip” recession as the section title suggests.

However, there have only been three double-dip recessions since 1854, according to the National Bureau of Economic Research. Those are recoveries that lasted 12 months or less. They were 1913–1914, 1919–1921, and 1980–1982.

Interestingly, each coincided with major tax changes. The Revenue Act of 1913, known as the Underwood-Simmons Act, reinstated the federal income tax; the Emergency Tariff of 1921 was a protectionist tariff on most foreign agricultural products; and Economic Recovery Tax Act (ERTA) of 1981 and the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, which was called "the largest tax increase of that period [1968-2006]".⁹ However, none of those periods had the luxury of stimulus, either fiscal or monetary. We have already discussed the incredible amount of monetary stimulus provided by the Federal Reserve.

Without arguing the merits, the size (or the payment) of the Obama Stimulus Plan, it exists and is being implemented. Roughly \$400 billion, or 51% of the total stimulus plan, is scheduled to be paid out in 2010. This was purposefully designed to be supportive over a long period (not to mention politically convenient to coincide with a mid-year election).

It is also important to note that the economic recovery (validated by the positive third quarter GDP) was accomplished WITHOUT the aid of much of the stimulus. Only \$129 billion, or 16% of the stimulus dollars, had been paid out by October 30th.¹⁰ Therefore, we believe that the chances of a double-dip recession for 2010 are remote.

Artificial Market Support. There are multiple programs that are artificially supporting various markets. Examples include the first-time homebuyer tax credit as well as at least five programs run by the Federal Reserve such as the Commercial Paper Funding Facility (CPFF), Money Market Investor Funding Facility (MMIFF), and the Term Asset-Backed Securities Loan Facility (TALF).

Rather than focus on whether these programs should exist, we will concede that they were necessary given the extraordinary circumstances and that they exist. Nonetheless, it is unknown how these markets would actually function if these programs were not in place currently. Moreover, it is unclear what will occur when these programs end or should they end prematurely (perhaps due to political pressures).

Let's briefly look at one of these programs: TALF, which the Fed introduced in November 2008. A properly functioning market for asset-backed securities (ABS) is crucial for the recovery. The most common among ABS are, of course, mortgage-related but also can be credit card, auto and student loan related. Although unknown to the general public, each of these are directly responsible for the availability of consumer credit. Furthermore, it is a key element for the banking industry, without which banks would have to keep all loans on their balance sheet. Consequently, there would be less credit available for consumers (regardless

Double-Dip Recessions		
Time Period	Recovery (in months)	Tax Act
1913 - 1914	12	Underwood-Simmons Act
1919 - 1921	10	Revenue Act of 1918, Emergency Tariff of 1921
1980 - 1982	12	ERTA 1981, TEFRA 1982

Source: National Bureau of Economic Research

of credit worthiness).

Ultimately, the premature removal of these programs could be catastrophic for the economy. Yet, these programs appear to be firmly in place and not ending soon. Hence, while some are concerned about the "artificialness," the probability of their premature removal is small. If anything, some of these programs may over stimulate portions of the economy.

The Consumer. We expect the consumer to play a large role in the economic recovery, but there are a few issues that could put the recovery at risk.

A material increase in crude prices could be very dangerous to consumers, given the fragile state of the economy. A sudden spike in crude oil prices would cause consumers to spend more of their income on oil-related products, while spending less on other goods and services. Lower spending by consumers could reignite recessionary fears.

Secondly, if the employment situation does not continue to improve and more jobs are not created, consumers may just throw in the towel. A deteriorating employment situation would make consumers cautious and economic growth would be very sluggish. Conversely, those looking for work may miss mortgage or credit card payments, causing their finances to spiral out of control.

Finally, a lack of available credit would have a number of negative effects on consumers. If banks stopped lending to consumers for mortgages, home loans would not be made and it would put additional pressure on the housing market. Additionally, if credit lines were not made available to corporations, budgets would shrink considerably and equipment spending could be cut. More importantly, some companies would not have the available funds to pay everyday expenses, including employee payrolls.

If any of the three scenarios occurs, it would have a lasting negative impact on the economy. It would certainly delay the blossoming economic recovery and could possibly push the economy back into recession. However, we believe the likely scenario is that the U.S. economy continues on its current path, with the consumer as the engine that fuels the recovery.

U.S. Equity Markets

In the "Corporate Earnings" section, we outlined our view that earnings for the S&P 500 companies should increase by 12.5% in 2010, or to \$70 per share. Adding in the roughly 2.2% dividend yield of the S&P 500, we arrive at a simplistic approximate total return estimate of 14.7%. However, we feel that much of this may already be priced into equities. Therefore, the likely return for the S&P 500 Index for 2010 is more realistically in the range of 10% to 12% than the closer 15% that normal earnings growth would suggest.

On a valuation basis, the S&P 500 Index is currently trading at a price-to-earnings (P/E) ratio of 18.6 on a trailing 12-month basis. This is above the 5-year average of 17.7 times the 12-month trailing P/E ratio. However, it is well above the recent low 12-month trailing P/E ratio of 10.2 times, which was achieved at the end of the first quarter 2009. The P/E ratio actually reached a low of 9.9 times the trailing 12-months earnings during the panic months of 2009, when the S&P 500 Index appears to have troughed. The significant expansion to the historical P/E ratio can be attributed to both the expected rise in corporate earnings and the substantial rise in the S&P 500 Index during the final three quarters of 2009.

Given our expectation that the economic recovery

will continue to blossom further, inflationary pressures should remain fairly tame through 2010, and interest rates will remain low for the foreseeable future (at least the first half of 2010), we believe that price-to-earnings multiples should remain above historical averages as additional tangible signs of a recovery are seen by corporations. If we assume no multiple expansion, and apply the current 18.6 times P/E to our \$70 estimate for the S&P 500, we reach a 1,300 year-end forecast for the S&P 500 Index. Likewise, if we assume that multiples contract (most likely due to a faster than expected rise in corporate earnings) and slide back to the long-term historical average of 17.7 times, we would reach a year-end forecast of 1,239 for the S&P 500 Index given our \$70 estimate for the S&P 500 earnings. As such, we expect the recovery to blossom and the markets to rebound further in 2010.

Market Capitalization and Style. From a market capitalization and style perspective, we continue to favor Small and Mid Capitalization (Cap) companies into the new year. With the U.S. economy progressing through the early stages of economic recovery, Small and Mid Cap companies typically have been early-cycle outperformers. Their returns have historically beaten Large Cap companies over the 6-12 month period following the end of a recession. Thus far, Small Cap companies have dramatically outperformed Large Cap companies in 2009, and we expect that to continue through at least the first few months of 2010.

However, we would remind investors that capitalization and style strategies are cyclical by nature and should be approached as such. No strategy is empirically better than the other at all times. Nonetheless, the current environment remains fluid and we anticipate the needle to shift back in favor of Large Cap companies at some point later in the year. The timing of the shift to Large Cap companies will depend on when the U.S. Dollar stabilizes and how quickly the consumer rebounds.

Through our previous discussion on interest rates and the U.S. Dollar, we expect the Fed to unwind its balance sheet accordingly and be prudent with interest rates. This should help the U.S. Dollar to begin to stabilize and modestly strengthen. We also forecast that the U.S. will recover faster than its European counterparts, the old European countries, such as Germany and the U.K, as well as

Japan. As a result of the weaker international recovery forecast, we would focus on Small Cap companies since these firms typically have a higher percentage of revenue derived from domestic operations. The recovery within the developed international economies should catch up to that of the U.S. at some point during the year, and this trend should shift to favor Large Cap companies.

Ultimately, we favor Small and Mid Cap companies heading into the new year. Yet, investors must remain nimble enough to reallocate to Large Cap companies should the U.S. Dollar stabilization not materialize.

U.S. Fixed Income Markets

Bond pricing became erratic during the panic months of the fourth quarter 2008 and first quarter 2009, which we believed was overdone. As a result of the economic uncertainty during those months, credit spreads expanded wildly, but have since contracted to more normalized levels. For example, municipal bonds, which typically trade at roughly 90% of the value U.S. Treasuries, were trading at more than 200% during the panic months. As we moved further away from those panic months of last year, conditions improved. However, it may be a while before we get back to those gluttonous conditions of just a few years ago when credit was freely available.

The feelings of fear and turmoil in markets eventually turned into stabilization and recovery. The yield on the 10-year U.S. Treasury Bond started 2009 at 2.21%, and rose to a high of 3.95% in June as the panic subsided. Remember, of course, that the yield moves opposite the price of bonds. Since the fear

and uncertainty surrounding the credit markets persisted through at least the first quarter, Treasuries were able to post a gain. Although well off 2008's tremendous 12.5% return, the Citigroup 7-10 Year Treasury Index posted a 2.99% increase over the past 12-months (through 11/30/09).

However, other bonds were not so lucky, as the spread over Treasuries widened across the board during the panic months. The credit markets became severely disjointed, and bond spreads widened out to unheard of levels. A number of measures were taken to add liquidity and stability to the markets. Accordingly, spreads finally normalized as we moved into the summer months. As the immediate panic subsided, investors slowly reassessed risk associated with their investments. Bond mutual fund inflows year-to-date have been \$312.8 billion (through 10/31/09), according to the Investment Company Institute. Investors have been flocking to Fixed Income all year, but more specifically towards those with the shortest maturities.

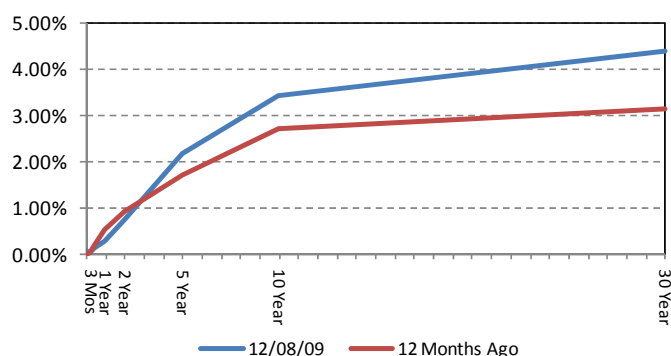
Nevertheless, we would expect that Treasury Bond yields will continue on the path towards normalized levels. As the economic recovery blossoms, the yield on government debt must eventually increase to compete with foreign governments and the returns of equities. Inflationary pressures should not cause the most unease heading into the new year. Rather, the concerns lay on the ability of the Fed to tighten interest rates and repurchase Treasuries in a timely manner.

Thus, it is our belief that Treasury yields will gravitate higher next year from the current levels. Yet, we believe that yields will most likely fall further during the first few months of the year, before steadily moving higher when the Fed begins to tighten. Accordingly, we forecast that the yield on the 10-year Treasury Bond should be in the 4.25-4.50% range by the end of 2010. We anticipate that the increase in yields will move in quick spurts, rather than in gradual increments.

There is a possibility that Treasuries could post a negative year in 2010. Furthermore, we expect that most bonds will not perform well relative to equities in 2010. The exception within Fixed Income may be tax-free municipal bonds, which we believe has a few catalysts behind it going into next year. First, as a result of the Build America Bonds and the current condition of numerous state

U.S. Treasury Yield Curve

Source: Bloomberg, Morgan Keegan Market Intelligence Group



balance sheets, there is a limited supply of new tax-free municipal bonds coming to market. This should push prices for existing issues higher. Secondly, we expect Congress will let the Bush tax cuts to expire, thus making tax-free investments appear more attractive with the resulting higher tax rates. Ultimately, we would underweight exposure to bonds, especially Treasuries, with the lone exception being tax-free municipal bonds.

International Markets

After nearly two full years of a global recession, economic activity is back on the rise. The International Monetary Fund (IMF) estimates that the global economy will grow 3.1% in 2010, a steady recovery from the 1.1% decline experienced in 2009. Yet, it is well off the 5.2% expansion experienced in 2007.⁶ Global growth under 3% is generally accepted as the threshold for a recession.

Most of the developed international markets, such as the Euro zone and the United Kingdom are projecting real GDP recoveries that lag the U.S. recovery, in the +0.3% to +0.9% range. The IMF forecasts Japan's economy to grow 1.7% next year, slightly higher than the 1.5% rate of growth it expects for the U.S.

Although the recovery within the global economy is blossoming, we believe that the U.S. economy is further along the path to recovery than the other developed nations, especially the European counterparts. As such, the upside to the U.S. economic recovery appears to be much higher going forward. Furthermore, we expect the Federal Reserve to stick the landing when it comes to interest rates. This should boost the domestic market and cause the U.S. Dollar to strengthen versus foreign currencies. As such, we would limit developed international exposure, namely the old European countries such as the U.K. and Japan, and focus more domestically.

However, much of the expected global growth will come from the emerging markets (i.e. China, India, Eastern Europe, Russia, Latin America, Middle East, etc.), rather than the developed nations. Although not completely immune to the global recession, emerging markets still are forecast to post economic growth of 1.7% in 2009. Though it is well off the 8.3% jump in 2007 and the 6.0% surge in 2008, the growth drivers remain intact. For the most part, emerging economies should resume the outsized rate of growth that they experienced in 2007 and 2008. The IMF growth estimate for these economies is a 5.1% rise in 2010. The majority of growth is likely to come from China and In-

dia, which are projected to increase 9.0% and 6.4%, respectively, next year. Furthermore, Africa and the Middle East are also estimated to post solid economic growth of about 4.0% in 2010, aided by a rebound in commodity prices.

While emerging markets offer faster growth rates and potential returns, it is important to balance these prospects with the inherent risks that are associated with such markets. For instance, there are issues such as political uncertainty, governmental interference, immature capital markets, liquidity and transparency to name a few. Overall, we believe it is crucial that investors weigh these issues along with risk tolerance when making such investments.

We hope you benefit from our forecast and wish you prosperity in 2010!

Investment Themes for 2010

In addition to our macro level forecast, we have identified four themes that we believe should help guide investments in 2010.

- **Beware of Longer Duration Bond Funds**
- **Don't Fret Inflation**
- **Seek Alternative Energy Sources**
- **Use a Rifle rather than a Shotgun**

Beware of Longer Duration Bond Funds. Last year, one of our themes was "Revisiting Bonds," alluding to the mispricing in the bond market at the time. However, investors have overcompensated and continued to follow the herd into bond funds. Bond mutual fund inflows year-to-date have been \$312.8 billion (through 10/31/09), according to the Investment Company Institute. We think this scenario will end badly for many investors that remain in these funds through 2010.

We expect interest rates to rise next year, which should cause existing bond prices to decline and yields to rise. As bond returns sag in 2010, we would expect investors to "run for the exits," pushing bond prices down even further, especially for those funds holding longer duration U.S. Treasuries. While this will also affect individual bonds, those bondholders have the luxury of holding their bond to maturity and receiving the return of the par value of the bond.

Don't Fret Inflation. As previously mentioned in the Inflation section, we do not believe that inflation will be a near-term concern for investors heading into next year. Although we expect rates to start increasing during the second half of the year, inflationary pressures should remain restrained. The Fed's target range for inflation, as measured by core CPI, is in the range of a 1 – 2% increase on a year-over-year basis. The 12-month rate of the core Consumer Price Index, which excludes food and energy, rose 1.7% in October, and is expected to decelerate in 2010. Further declines to core CPI should keep interest rates from moving significantly higher during the year.

Moreover, housing prices make up about one-third of overall CPI and have continued to fall throughout the year. Given the overhang of vacant homes and the elevated level of foreclosed homes for sale, housing prices should trend lower. On a year-over-

year basis, the number of home foreclosure listings increased 18.9% in October, according to Realty Trac Inc. Prices may begin to stabilize as we advance through the year, but the downward pressures from bargain hunters should keep prices from rising. Thus, it should keep the housing component of CPI in check. Additionally, unemployment is expected to keep rising during the first half of the year, which should keep downward pressure on wages. Consequently, businesses have had to keep wages and prices low to maintain competitive positions. As such, fears of a double-dip recession should continue throughout the first half of the year.

However, we would expect there to be some degree of inflation throughout the year. We expect the year to bring a healthy type of inflation, and not the rampant, double-digit hyperinflationary environment of the 1970s. As interest rates begin to rise and the U.S. Dollar strengthens versus foreign currencies, corporations will be able to start raising prices. Businesses should start hiring permanent employees and consumer spending should rebound. As such, we would anticipate moderate inflation to appear towards the end of 2010. However, overall inflation should remain contained throughout the year.

The primary risks to rampant inflation would be a substantial rise to crude oil and gasoline prices, along with a sudden increase in home values. A sudden rise to crude oil and gasoline prices would crimp the consumer and possibly send the economy back into recession. Although rising home prices would be good for consumer spending and the overall economy in the short-term, it may cause it to overheat and drive prices too high and too fast. Finally, the Fed may wait on the sidelines too long before pulling stimulus and raising interest rates. This delayed action could put the Fed behind the curve on the fight to keep inflation in check. Conversely, if the Fed steps in too early and takes back stimulus when the consumer is not fully healed, it could slam the brakes on the recovery and send the economy back into a recession.

It is important to note that stocks are generally the best performing asset class in an inflationary environment.

Seek Alternative Energy Sources. The last few

Investment Themes continued

years prove that Americans' thirst for crude oil can be reduced if provided an alternative. It appears that U.S. crude oil demand peaked in 2007, when average daily consumption totaled 20.6 million barrels of oil per day, according to the EIA. That figure has fallen over the past couple years as the economy slipped into a recession. As such, the search for alternative sources of energy continues. We believe that lithium and natural gas could be a couple of solutions to significantly reduce the demand for crude oil products in the U.S.

The most common use of lithium is in lithium-ion batteries, which can be found in laptops and cell phones, as well as hybrid and electric cars. The shift to an electric car that utilizes lithium-ion batteries as the substitute for gasoline could be the solution for automobiles. However, it would greatly increase the demand for lithium. The heightened demand should certainly benefit the countries with the greatest lithium deposits, like Chile and Bolivia. According to the U.S. Geological Services, Chile has total reserves of 3,000,000 tons of lithium while Bolivia has a reserve base of 5,400,000.¹¹ For comparison, the total lithium reserves in the U.S. amount to 760,000 tons. As of 2008, Chile was already the largest producer of lithium products. It accounted for 43.8% of the world's production last year. Although Bolivia may be a qualified lithium producer down the road, it has yet to produce any lithium due to a number of political issues. Consequently, we favor Chile over Bolivia because the country has already built the necessary infrastructure, and there is an efficient production process already in place. Furthermore, lithium demand should increase substantially as the shift toward more efficient cars continues.

Natural gas may become the preferred source of energy down the road. It is a cleaner burning fuel compared to crude oil and coal, and there is an abundant supply within the U.S. that can be extracted relatively easily. Despite a nearly 60% decline in the number of working drilling rigs from September 2008 to July 2009, there has been an excess of natural gas production. Combine that with warmer-than-normal temperatures across the country, and natural gas inventories were at above-average levels throughout 2009. Thus, heightened inventories and slackening consumer demand has pushed prices lower. However, the depressed

natural gas prices have made it a more favorable source of energy within the industrial sector, including electric power generating companies. According to the EIA, production is forecast to decline 3.1% in 2010, in the wake of a significant drop in the number of working drilling rigs. We believe that a return to normal weather and the blossoming economic recovery should drive natural gas demand higher in 2010. Consequently, natural gas prices should increase as well.

Use a Rifle rather than a Shotgun. Although the U.S. economy is not officially out of a recession, we believe that it ended sometime late during the second or early in the third quarter this year. The economic data has been fairly positive so far this year, but it has been inconsistent at times. Consequently, there are a number of cross-currents present in the markets today.

While a particular sector may look attractive on the surface, you may have to dig a little deeper to find the specific industry that is actually favorable. We do not feel that there is an overriding sector or market style within equities that is more favorable compared to another. While a sector or style may not appear favorable on the surface, specific industries or sub-sector may look attractive. As the market rallied in 2009, investors had the luxury of taking a shotgun approach – shooting broadly at a general sector or style (i.e. growth or value). However, we believe that overall equity returns will be muted. Therefore, we believe investors will need to be more specific when searching for areas to invest in 2010. In other words, they will need to aim with a rifle rather than a shotgun. They must be able to navigate within a given sector or industry, rather than just investing in a broad asset class.

Since overall equity returns will likely be muted, total return strategies will reemerge. We have repeatedly stressed to investors that dividends are an important component of return. On a fundamental basis, they reflect a sound balance sheet and a solid business model. According to Ibbotson Associates, stocks have returned about 10% per year on average since the 1920s. However, more than 40% of that total return has come in the form of reinvested dividends. On the other hand, we regularly remind folks that dividends are not the “end all, be all” component either. As we have witnessed during the credit

Investment Themes continued

crunch, dividends can be cut to preserve capital and shore up the balance sheet of a firm. Thus, it is an important component of return but not one that outweighs all other determinant factors when selecting investments.

As of December 14, 2009, the yield of the S&P Telecommunications sector was 5.4%. However, the sector has not participated in the current equity rally for the most part. Going forward, the Telecom sector offers above-average dividend yield, which may help it outperform the overall equity market in a low-return environment in 2010.

Additionally, the conditions within the Information Technology sector remain favorable at this time. More specifically, the trends within the hardware-related companies are positive. Corporations, especially small to midsize businesses, have delayed IT spending for three-plus years. This has created a significant amount of pent-up demand, which should become evident as the economic recovery blossoms. Yet, we believe that spending on these upgrades may be lumpy and could spill into 2011. However, the catalysts within the computer hardware industry remain quite favorable.

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Definitions:

S&P 500 Telecommunication Index – It is used to represent the Telecommunication sector, which contains companies that provide communications services primarily through a fixed-line, cellular, wireless, high bandwidth and/or fiber optic cable network.

S&P 500 Information Technology Index – It is used to represent the Information Technology sector. The Information Technology sector includes hardware manufactures and distributors, software developers, and companies that provide information technology consulting services, including data processing.

Citigroup 7-10 Year Treasury Index – A market value-weighted index of public obligations of the U.S. Treasury with maturities of 7 -10 years.