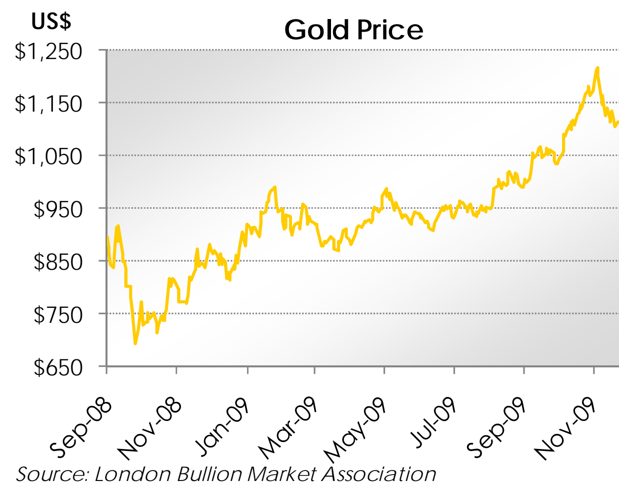
The year about end has been a rollercoaster ride for investors. The equity markets began 2009 with a whimper, as the S&P 500 index fell -24.6% through March 9th. At the same time, Treasury yields fell to historical lows and the dollar reached its highest mark against the euro since early 2006. Then, risk appetite suddenly returned to the marketplace. The S&P 500 reversed course and as of December 15th was **up** 25.6% year to date. Long-term Treasury yields backed up and gold shot through the roof. Though the market recovery was a relief, many investors were caught off guard by the speed and strength of the reversal. The bear market has not been erased, however; despite these gains, the S&P 500 is still almost 30% below its October 2007 high. This month we take a brief look back at the major trends in the markets during the past 11 and-a-half months and what was driving them.

Gold Rush



Source: London Bullion Market Association

The rally in gold was one of the year's biggest stories. Early in 2009, we made our case for holding the commodity (please see our February 2009 research piece "*Weathering the Storm.*") The metal's strength may have surprised investors who viewed gold as purely an inflation hedge – the weak-growth environment prompted more talk of ***de**flation* than ***in**flation*. Instead, it was consistent and prolonged dollar weakness that provided a tailwind for gold. Comments from foreign central banks about the U.S. currency losing its reserve status boosted the appeal of gold as an "alternative currency." Also, since gold is priced in dollars, it remained more attractive in stronger currencies. Year-to-date 2009 through the peak in early December 2009, the price of gold rose nearly 41% in U.S. dollars, but only 23% in British Pounds and 30.5% in Euros. Rebounding growth in emerging market countries and the potential for inflation have also provided support more recently. Though its run has eased in the last several weeks, if we see inflation expectations continue to rise in the year ahead, gold could gain strength once again.

Source: St. Louis Federal Reserve Bank. "Major Currencies" include Euro Area, Canada, Japan, UK, Switzerland, Australia, and Sweden.

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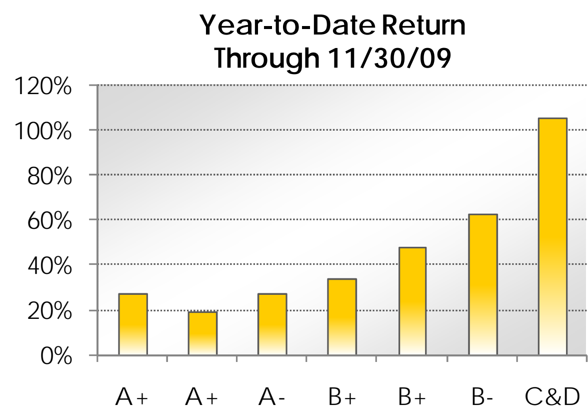
Dismal Dollar

As we just discussed, the U.S. dollar was on the decline throughout most of 2009. The currency made strong gains in the second half of 2008 as a safe haven for risk-averse investors. Then, when investors' appetite for risk suddenly returned in Q1 2009, the dollar reversed as the equity market climbed. Rock-bottom yields on short-term fixed income and cash equivalents provided little incentive for investors to buy dollars. A so-called carry trade was born (please see our November research piece, *"Bet Your Bottom Dollar"*) in which investors borrowed cheap dollars and then sold them to buy higher-yielding assets in other currencies, further depressing the greenback and fueling risk taking. This inverse relationship between equities and the dollar has remained largely in place, showing just a few isolated days when both moved in the same direction. We believe that if we see more sustainable economic strength (i.e. an improved employment picture), and eventually higher interest rates, we could see both a stronger dollar *and* rising equities.

The weak dollar has been beneficial for U.S.-based investors, however; their returns in investments abroad were boosted by a weakening dollar. For example, through December 15th, a U.S.-based investor earned a 34% return from the MSCI Europe index in dollar terms, while a euro-based investor earned only 28%.

Bounce off the Bottom

One way of summing up 2009 is to say it was the opposite of 2008. The '08 strong dollar plummeted in '09. Fixed income spreads that widened in '08 melted in '09. Assets that were crushed in the previous year tended to rise the most in 2009. The Financial sector of the S&P 500 lost -78% of its value from January 2008 through March 9th, 2009, only to bounce up 131% from March 9th through Dec 15th. While these bounces eased some of the pain from 2008, they have not made up for the steep losses. Investors who experienced that -78% decline in Financials would require a 344% gain to fully recover the loss. There is still a long way to go before investors fully recoup.



Source: Merill Lynch Quantitative Strategy MLQS "Quality Indices, 1600 stock universe

Another example of this bounce phenomenon was that lower quality stocks outperformed in 2009 after being severely punished in 2008. Standard & Poor's ranks stocks on a scale of A+ to D based on growth and stability of earnings and dividends over the last 10 fiscal years. Through the end of November, the lowest quality-ranked stocks have outperformed the higher quality stocks by a significant margin, reflecting their bounce off of oversold lows. This low quality rally makes a strong case for owning the index versus an active manager. Most active managers tend to own only higher

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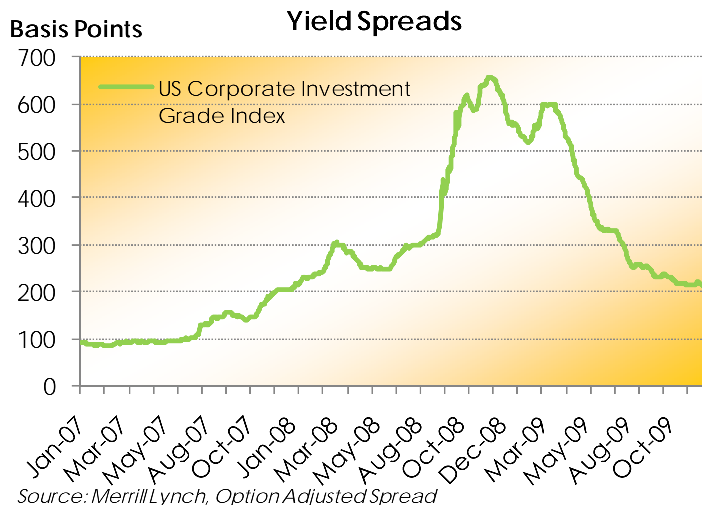
quality stocks, which would have led to them underperforming in this environment. Owning the index ensures that investors participate regardless of how different segments perform.

Narrowing Spreads



As risk aversion spiked in the fall of 2008, spreads on non-Treasury fixed income assets skyrocketed. Investment grade corporate, high yield, and even municipal bonds experienced significantly elevated yields as anything other than Treasury bonds was viewed as highly risky. For many months we cited a narrowing of spreads as one of the things we needed to see happen in order for a sustainable equity rally to take hold. We also believed that if and when this occurred, the flight **away** from safety would hurt Treasurys and benefit risk-bearing fixed income. *This is exactly what occurred throughout 2009.* We discussed this relatively-rare fixed income total return opportunity in our December 2008 research piece, *"Fixed Income Mechanics."*

Fixed Income Returns		
Barclays Index	Year to Date 12/15/09	Full Year 2008
U.S. Aggregate	6.6%	5.2%
U.S. Credit	16.5%	-3.1%
U.S. Corporate High Yield	56.3%	-26.2%
U.S. TIPS	11.8%	-2.4%
Municipal Bond	13.1%	-2.5%
U.S. Treasury	-2.6%	13.7%
U.S. Treasury: 20+ Year	-20.4%	33.7%

Source: Barclays

The biggest "bounce off the bottom" in fixed income occurred in the traditionally-riskier areas of the asset class, such as high yield. Through December 15th, the Barclays Corporate High Yield index gained more than 56%, while even the investment grade corporate U.S. Credit index gained 16.5%. Investors in less-risky fixed income securities also saw nice returns this year. The national Municipal Bond index was up over 13% while Treasury Inflation Protected Securities (TIPS) benefitted from an upward adjustment of inflation expectations.

On the other side of this trade was a flight away from the safety of Treasurys. The broad Treasury index fell -2.6% through December 15th after gaining 13.7% last year. The longer end of the Treasury curve reversed most strongly, with the 20+ Year Treasury index falling more than -20% in the year to date.

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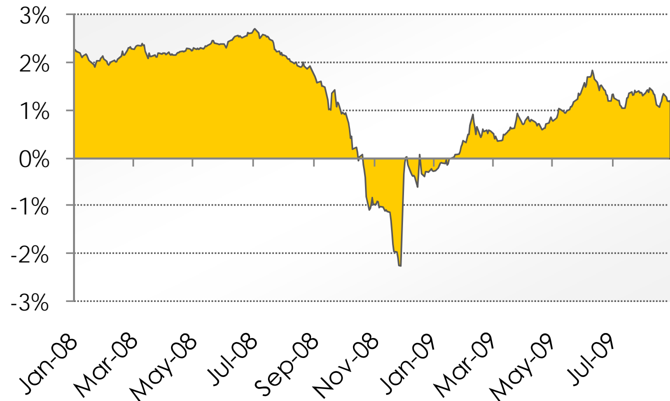
Re-Inflation



Inflation expectations are the difference between the 5-yr nominal and real Treasury yields

As 2009 began, there were few aspects of the economic landscape that indicated inflation. Many investors feared deflation would take hold in light of a deteriorating employment picture and a weak consumer. At the end of November 2008, the TIPS market was pricing in a -2% annual deflation rate over the next five years. While we agreed that the economic picture was grim, we believed that the massive amounts of liquidity and stimulus being pumped into the markets would eventually cause inflation expectations to rise. The chart above shows the difference between the nominal 5-year Treasury yield and the (real) 5-year TIPS yield, which serves as a proxy for inflation expectations. In early 2009 these expectations (re)turned positive, and then rose throughout most of the year. Investors owning TIPS benefited from this adjustment.

Onward and (Hopefully) Upward

As we close out the final few days of 2009, we look out onto a significantly changed landscape from twelve months earlier. In December '08, most investors would not have believed that equity valuations, inflation in emerging markets and a commodities bubble would be on the list of concerns today. We are encouraged by the return to a more "normalized" risk appetite in the markets, which has allowed us to move back into our diversified strategic allocations. We still have a tenuous economic recovery ahead, however; and we continue to focus on risk analysis as well as search for profitable opportunistic investments.

We hope that these publications continue to provoke thoughtful conversations with our readers – we always appreciate your feedback. We wish you a happy and safe remainder of the holiday season, and a great new year!

December 29, 2009

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