

ECONOMIC AND MARKET OUTLOOK FOURTH QUARTER 2009

There is a growing consensus that the recession ended during the second quarter and that the economy is finally on the road to recovery. The recovery is likely to be different than previous experiences. Past recoveries were driven by a strong resurgence in consumer spending. Domestically, consumers comprise 70% of economic activity and an upturn typically propels the economy to a sustainable growth path. The present recovery is driven by inventory restocking, targeted government spending programs such as “Cash for Clunkers”, and some improvement in exports. The durability of the advance, however, will depend importantly on new employment, a restoration of consumer finances, and a timely withdrawal of temporary government supports. There is little evidence of this transition at this time, leaving open the question of the length and intensity of the present recovery.

Momentum in the industrial sector is building for a stronger rebound than generally foreseen. Industrial production climbed 0.8% in August following an increase of 0.1% in July, the first back-to-back gains since late 2007. “Cash for Clunkers” has a lot to do with it, but not all. Automobile output jumped 60% in the two months. Non-auto production was also sturdy with positive readings in July and August after a string of declining monthly production. Business, industrial, and consumer equipment were all positive, indicating an improving trend in a broad area of manufacturing.

The rapid turnaround in the Institute of Supply Management key indicators for Production and New Orders confirms that the bottom in manufacturing output occurred in June and indicates that inventories were too low going into the recovery. Its New Orders index jumped from 49.2 in June to 55.3 in July to 64.9 in August, as manufacturers scrambled to rebuild inventories. The extraordinarily low level of inventories resulting from the long recession means that rebuilding inventories will propel factory output for some time ahead.

Still to be felt is the full weight of the \$870 billion, 2009 stimulus package which has been slow to materialize. Most of the stimulus is expected to kick in by the end of 2009 and will add to the recovery which has already begun. The recovery, however, is narrowly based, limited in extent, and fragile. Inventory rebuilding will level off at some point and its influence on the recovery will wane. In time, targeted government spending programs will have run their course and expire. The surge in car sales from “Cash for Clunkers” is already over. While the Congress announced the program a success, it undoubtedly borrowed sales from future periods, and auto production will decline substantially in coming quarters. Similarly, the improvement in housing is heavily influenced by the \$8000 tax credit for first time home buyers, and low mortgage rates held down by government guarantees of mortgage backed bonds. The vast majority of home purchases in this recovery are backed by FHA and

FHLMC guarantees, and both agencies are in need of new capital. The first time home buyers credit is set to expire in November. It will be extended, of course, but it is an expensive program and will end some time next year. Similarly, government purchases of mortgage instruments will end next year. The point is that heavy doses of government spending will continue to bolster the economy in the medium term. A smooth and timely withdrawal of government spending and guarantees will be necessary for the private sector to grow and create the private sector jobs necessary for a healthy economy.

New employment is the missing ingredient in the current economic upturn. Historically new employment starts to increase after the recovery is firmly established. So far, despite a decline in new employment claims, there is little evidence of any new job growth. The current environment is not conducive to vigorous employment creation. Consumption is likely to remain muted as consumers increase their savings and pay down debt. Corporations, too, are faced with major economic uncertainties surrounding government tax, trade and spending policies. The Administration's control of major corporations representing large segments of the economy creates an atmosphere of distrust and a reluctance to commit to long term expansion. The large cash balances on corporate balance sheets attests to their cautious frame of mind.

A lot has changed in the last three months. The improvement in the economy is visible and sentiment in the financial markets reflects the more optimistic outlook. Credit markets are functioning normally again and both corporate bond and stock issuance have risen. Confidence is very much improved. Over the intermediate term interest rates will remain low and inflation will be quiescent. We believe the period ahead will see further gains in the stock market. Nevertheless serious issues remain to be addressed. Given the history of misjudgments in the management of monetary policy one can be skeptical about the ability of the Federal Reserve to execute a change in its aggressive policies in a timely and effective manner. Furthermore, there is no evidence that the Congress is willing to exercise the fiscal discipline needed to repair the government's spending and budgetary excesses. Large potential tax increases and anti-growth legislative proposals such as "Cap and Trade" create additional uncertainty. These issues are likely to come to the forefront sooner rather than later, and the outcome will determine whether our economy will continue on a non-inflation growth path or otherwise.

Investment Policy Committee
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