FULTON FINANCIAL ADVISORS

# CAPITAL MARKETS OUTLOOK

## The Economy ♦ Fixed Income ♦ Equities

**Overview …** The September statement from the Federal Open Market Committee on the economy follows:

> "Economic activity has picked up following its severe downturn. Conditions in financial markets have improved further, and activity in the housing sector has increased. Household spending seems to be stabilizing, but remains constrained by ongoing job losses, sluggish income growth, lower housing wealth, and tight credit. Businesses are still cutting back on fixed investment and staffing, though at a slower pace; they continue to make progress in bringing inventory stocks into better alignment with sales. Although economic activity is likely to remain weak for a time, the Committee anticipates that policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will support a strengthening of economic growth and a gradual return to higher levels of resource utilization in a context of price stability."

The committee **expects that inflation will remain subdued** (emphasis added) for some time. In these circumstances, the **Federal Reserve will continue to employ** a wide range of tools to promote economic recovery and to preserve price stability."

After a record setting rally from the dramatic lows in March, investors believe the economy is healing, but concerns remain about the strength of the economic recovery and what might happen when the government stimulus efforts are withdrawn.

| Performance as of: 09/25/2009 | SEPTEMBER TO DATE | YEAR TO DATE | 12-Month Return |
|---|---|---|---|
| **Strategic Growth Portfolio** | 3.68 | 21.83 | -7.00 |
| **Russell 1000 Growth** | 2.83 | 25.38 | - 7.17 |
| **Strategic Value Portfolio** | 1.50 | 1.08 | -15.96 |
| **Russell 1000 Value** | 2.57 | 13.42 | -14.62 |
| **S&P 500 Index** | 2.45 | 17.79 | -11.28 |
| **MSCI EAFE Index** | 3.16 | 28.14 | - 6.36 |
| **Barclays Cap US Govt/Credit Index** | 0.73 | 4.79 | 9.24 |

### The Economy

- Real GDP fell 1% in the second quarter and the prior quarter was revised down to a decline of over 6% suggesting a glide-path for a rise in the 3rd quarter.
- Due to continuing massive government stimulus we believe GDP will improve in the latter half of 2009
- Moderating declines in consumer spending, housing prices, and business spending along with the recent drop in corporate inventories, especially in automobiles, suggest that the third quarter will be positive.
- Unemployment, more of a lagging indicator, is 9.7%, the highest in 25 years
- We expect an extended period of low inflation (absent a collapsing dollar) due to significant excess and idle economic capacity.
- Core inflation remains within the Federal Reserve's target range of 1-2%.
- The Fed anticipates that economic conditions will warrant exceptionally low Fed Funds at 0 to ¼% for an extended period. Nonetheless, the committee will slow the purchase of $1.45 billion of mortgage and agency debt through the first quarter of 2010 rather than year-end.
- Treasury yield curve has steepened as treasury bill yields declined coincident with the end of FED guarantees on money market funds.

### The FED

- Global central bank intervention, US Government intervention and elimination of the mark to market rule for earnings has alleviated the selling pressure on financial assets.

- The Fed has decided to slow its "quantitative easing" whereby they purchase Mortgage and Government securities in order to smooth the transition for the markets.

**The Bond and Stock Markets**
- We recommend high quality corporate bonds and government guaranteed securities in the 2 to 5 year maturity range. Emphasize high quality municipal bonds, which are attractively priced.
- The stock market will continue to focus on credit issues and anticipate improving corporate profits as the global de-leveraging process continues.
- Should the dollar continue to weaken, this will provide support for large developed international stocks.

**Allocation**
- Consider alternative investment strategies to reduce volatility and provide absolute return.
- Stay with high quality large-caps over small- and mid-cap stocks; favor large- growth over large –value but with less conviction. Continue to diversify using international stocks in portfolios.
- Revisit your overall investment objective to determine if it meets your time horizon, liquidity needs, and risk tolerance.

**Fixed Income Comment**
US Treasuries yields have declined somewhat as investors are seeing signs of an extended period of low rates and inflation. We continue to recommend selective purchases of high quality intermediate maturity corporate bonds, and note that agency bonds are becoming increasingly more attractive.

**Equity Comment**
As we enter the stretch run of 2009, we see an economy that is coming out of a serious recession. However, it remains unclear as to the strength and sustainability of any potential recovery. The stock market has rallied more than 50% from the lows and is 20% over its 200 day moving average. The big debate is whether the economy is keeping pace enough to sustain the stock advance. Let's look at both: If we are to maintain an upward trajectory in the level of economic activity, we will need the consumer to play a bigger part than their estimated 1.0% decrease in spending. Government is hoping to bridge the gap for the economy while consumers repair and rebuild their balance sheets. If successful, the government will step away from their intrusive position just as consumers are ready and able to reassume their position as the main drivers of the economy. The two factors affecting the consumers' ability to assert themselves is their propensity to spend (or save) and their large housing related debt burden. Traditionally, consumer represents 65% of the economy and they save about 8% of their income versus about 70% and 4% today. A return to historic norms would imply pressure on GDP growth. The other factor, consumer debt, is large and exacerbated by declining real estate values. Media reports state about 32% of homes have negative equity and that will rise to 50% by 2011. Moreover, 41% of mortgages conforming to stringent requirements, (otherwise known as conforming loans), will be underwater by 2011 up from 16% in March 2009. In addition a mountain of Alt-A mortgages will have to reset in the next two years. This drag may impede consumer spending compared to prior recoveries. Naturally, a stronger housing market would assist the consumer.

The bottom line is that we see signs of recovery, but we are still in a wait and see approach regarding the consumer. In the meantime, we expect the federal government will do whatever it can to prop up the US economy and promote consumer spending through programs like the "cash for clunkers" program. At the very least, we saw that people were willing to spend given the right set of circumstances, which is a positive sign.

Scott Larison, a contributing writer to Seeking Alpha.com provided these details for a market trading 20% higher than its 200-day average (although there have been rare occasions this deviation has been higher, we note that this is typically an "extreme."):
- During the 2002/2007-bull market, we never hit +20%. ---- 1986 and 1987 saw 19%/20%, but no higher.
- 1982 saw the deviation briefly above 20%. ---- 1975 saw a marginal move above 20%.
- 1943 saw the 20% deviation prove good resistance. ---- 1935 and 1936 though saw the deviation above 20%.
- 1933 saw the S&P 500 59% rich to its 200-day. ---- 1929 saw the 20% deviation again prove good resistance.

In this unusual environment we would suggest that it is prudent to approach your investments with some caution.

## Large Cap Growth Strategy

The portfolio's returns relative to the benchmark lagged somewhat during the quarter mostly due to stock selection in a variety of sectors. However, it continues to outperform on a one-year and multi year basis. The portfolio was repositioned in June to be less defensive by paring back overweights in the consumer staples and health care sectors while adding to economically sensitive sectors such as industrials, energy and materials. Those changes have so far helped our relative performance. On the negative side, our sub sector overexposure to the biotech industry continued to play a major role in our portfolio's underperformance. Although we continue to favor biotech we have cut back somewhat on our relative overexposure. A variety of individual names hurt performance for the quarter. This diverse group includes Intercontinental Exchange, Oracle, Kroger, St Jude and McDonalds. Mirroring the market's aggressive bounce back, the portfolio's higher volatility names again led the charge. Specifically, Apple, Goldman Sachs, Chesapeake Energy and EMC were major contributors to performance.

No major changes were made to the portfolio during the quarter as the rebalancing of the Russell Growth Index in July enhanced the portfolio's relative sector over and underweights. With the market advance approaching 52% in the index since the market low on March 6th, our next moves will most likely be to slightly pare back sectors that have outperformed like energy and add to under performing areas like health care. Selective swaps will be made to individual names as we see fit.

## Sector Comments

**Finance -** Currently we are market neutral on the financial sector. Financials have gained 90% since March on the heels of massive government intervention. As a result, we are selective with our holdings, specifically, investment banking firms, who have record trading revenue from market imbalances, and large diversified banks with strong balance sheets, who benefit from borrowing at low rates and lending or investing at higher rates.

Two obstacles remain: weakness in commercial real estate and the housing sector. Foreclosures and delinquencies have yet to reach their peak as the Fed recently announced they would begin to slow their purchase of mortgage-backed securities. Going forward it should be no surprise that a number of banks will continue to fail, all the more reason to be selective and choose quality financials.

**Energy -** Over the last 3 months there has been little change to the trading range of $66 to $72 for a barrel of oil. Meanwhile, natural gas prices have recovered a bit, but are still at extremely low levels, especially when compared to oil on an energy equivalency basis. The Energy Sector of the S&P 500 Index registered a return of 10.8% through 9/18/09, trailing the overall index return of 18.3%. However, this is rather misleading since the largest companies such as Exxon comprise most of the index. Exxon, Chevron, and Conoco still have negative returns year-to-date. The action has been in the smaller niche companies such as National Oil Varco, Chesapeake, Transocean Offshore and Noble, all of which registered returns in excess of 70% y-t-d.

Looking forward we expect oil prices to shadow the outlook for worldwide economic growth. Natural gas prices have most likely bottomed but will stay low until the current inventory glut is worked off. We are looking for signals to begin rotating into the large company laggards, and taking some profits from the smaller companies with great recent performance. We will continue to over-weight the sector.

**Industrials -** The return for the Industrial Sector through 9/18/09 was 15.9%, slightly behind the 18.3% return of the S&P 500 Index. We have a positive fundamental outlook for the sector due to expected benefits from an improving worldwide economy, as well as the anticipated favorable impact from the infrastructure spending packages.

We are considering a shift from a market-weight to an over-weight position for the sector. We think the global economy will be stronger next year and this will be reflected in this cyclical sector's profitability. Also, from a valuation standpoint, the sector appears a better bargain than other economically sensitive areas. Also, the cheaper dollar is a positive for big exporting companies. We continue to like ITT Corp, Deere, Fluor, Jacobs Engineering and Honeywell.

**Materials -** Currently we are overweight the materials sector as we see many positives. Research indicates that the end of the recession more than likely occurred or is near and materials tend to outperform post recession. Global trade has also begun to stabilize as we look at the recent rebound in the Baltic Exchange Dry Index, which is an indicator of global trade activity. This trend may continue if we see a gradual improvement in the global economy over the second half of the year. Another positive for the sector is the declining dollar, which has helped the majority of commodities continue to surge. If the dollar continues to break through support levels commodities will benefit. Although we see a number of positives within the sector we also are weary of valuations. Currently the sector trades at a P/E on estimated 2010 EPS of 16.7X, above the 14.1X for the overall market. Sub-sectors we like within the sector would be Steel Producers and Diversified Metals & Mining.

**Consumer Staples -** The sector's weight in the indices has declined over the past two quarters as investors have turned to other sectors in anticipation of an economic rebound. The sector is typically viewed as a defensive haven in periods of economic distress. Hypermarket retailers such as Wal-Mart and Costco have taken market share by offering value to cash-strapped consumers. Many branded food, beverage, and household products companies have been hurt by increased consumer tradedown and private-label competition as well as inventory destocking. Earnings reports of multinationals have been lackluster, as price increases have been negated by lower volumes and negative currency effects. Strongest results were reported from Latin American segments. Despite an attractive relative P/E, we remain underweight as the sector's profit margins are coming under pressure from the value-conscience consumer.

**Consumer Discretionary -** The sector is always in the news, whether the developments are related to housing prices, auto sales, consumer spending or advertising. Lately, the major news has been the now expired "cash-for-clunkers" program, the tax credits for new homebuyers and Best Buy raising guidance offering hope for the holidays. Fed Chairman Ben Bernanke stated "even though from a technical perspective the recession is very likely over at this point, it is still going to feel like a weak economy for some time as many people still find their job security and their employment status is not what they wish it was. This is the most important reason investors should not expect a vibrant consumer-led recovery. Real average hourly earnings fell in August from July, which only exacerbates the struggle that consumers currently face. Skittishness amid tight lending conditions is not conducive to growth. We recommend a marketweight as the discretionary sector is one of the first sectors to bottom in a recession and has historically been an early cycle group performing relatively well after a bear market bottom. We favor those companies with strong balance sheets, management and a competitive advantage.

**Technology -** Year to date, the Tech sector is the top performing in the S&P 500 returning 45.20% versus the 500 Index return of 18.30%. Semiconductor Equipment, Components & Internet have been the largest outperforming sub-sectors. That being said, the entire sector will face some headwinds in the coming quarters. The most challenging will be predicting end demand as consumers attempt to repair household balance sheets coming out of the recession. The second is stretched stock valuations. By most measures, the sector is trading above historical norms and outperformance for the remainder of 2009 is unlikely. Although corporate cash levels are increasing due to higher efficiencies and cost cutting, capital spending has net yet rebounded. In the last month alone, component costs for computers, mobile devices and televisions have risen at the manufacturer and retail level. Cross sub-sector mergers and acquisition activity has risen this year and should continue as corporations diversify business lines to achieve greater earnings predictability. We remain market weight the sector versus the growth index.

**Healthcare -** We are underweight relative to the growth index for the following reasons, uncertainty due to government healthcare reform and big pharma companies are patent challenged through 2011. With the Democratic leadership determined to pass a reform bill by year-end, the current debate on healthcare does find a consensus in Washington on the following issues: A requirement that all individuals buy health insurance to broaden the risk pool, which should lower average premium costs; subsidies for poor individuals that cannot afford to buy coverage and tax incentives for small business to offer health insurance; insurance regulations requiring companies to provide coverage to individuals with preexisting conditions at a fair price; also, more emphasis on wellness and preventive care along with incentive payments to providers based on results; finally provide an "Insurance Exchange" for buyers to compare options.

Primary growth drivers are cancer therapeutics, diabetes management and biotechnology. However, the public and Congress are scrutinizing drug prices and seeking cost effective, preventive health care. This should favor generic drugs and provide a pathway for biosimilars. Also, clinical laboratories will benefit due to the focus on preventive care. We recommend investors emphasize their holdings in established companies with consistent earnings growth and drug companies with promising pipelines.