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CIO FirstMerit Economic and Markets Commentary
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"It Was The Worst of Times, It Was The Best of Times"

That title may almost ring a bell with you, as it's almost the opening line from Charles Dickens' famous novel *A Tale Of Two Cities*. I just reversed it to fit the pattern of the first half of 2009. In fact, we can pretty much reverse-paraphrase his full opening paragraph as follows:

It was the worst of times, it was the best of times; it was the age of foolishness, it was the age of wisdom; it was the epoch of incredulity, it was the epoch of belief; it was the season of Darkness, it was the season of Light; it was the winter of despair, it was the spring of hope; we had nothing before us, we had everything before us; we were all going the other way, we were all going directly to Heaven.

A key point we made in the midst of the "winter of despair" was that one should not extrapolate the very severe GDP recession of Q4 2008 and Q1 2009 into the remainder of 2009 and certainly not into 2010 – or beyond.

Even then the data wasn't all bad. For instance, Q1 consumption actually rose at a 1.4% pace, spurred in part by strength in real disposable income (+6.0%). The composition of growth, with ongoing weakening in business spending on both labor and capital but with recovery in consumption (however modest it may have been) looked to us like the first stage of a fairly normal pattern that would likely result in positive GDP numbers before the year was over. At past turning points, consumption usually rebounded early, while business fixed investment typically lagged. Data in the "spring of hope" seems to confirm this.

In fact, jumping forward to June data, we see continued indications that the end of the recession is close by. Initial unemployment claims appear to have peaked and employment data is a classic lagging indicator of the economic cycle. U.S. durable goods orders rose +1.8% in May, as did existing home sales which were up +2.4%.

While consumer confidence appears to have found a bottom, with the U of Michigan survey rising in June, other surveys have more mixed readings. We are not home free yet as home prices remain under pressure and new home sales fell again in May. The savings rate is up to 6.9%, indicating that consumers are still worried about facing a nearly 10% unemployment rate. The savings rate has been rising rapidly from virtually zero earlier in 2008 as households adjust to the declines in wealth and to economic uncertainty. We view this as positive news, as stabilization in the saving rate is a prerequisite for a sustainable rebound in consumer spending.

While the worst of the recession is over, the pace and duration of the recovery are the subject of hot debate. We believe the severity and breadth of the recession created very significant pent-up demand for both consumer and business goods and services. Even if "true" unemployment is 15%, 85% of workers have jobs. Likewise, the vast majority of businesses are not under financial duress. Our 2009-10 expectation is for the economy to match the stock market and bounce back much more sharply than the crowd expects.

Longer term, we continue to believe in our thesis that lower consumption and greater aversion to taking on new debt will impact the growth rate of the economy over the coming years. There is simply no other way out from under the crushing debt burdens that were taken on over the past few decades. The looming shadow of this deleveraging by consumers, businesses and the financial sector makes the timing decisions for stimulus removal even more difficult than usual.

But that is a longer term issue and today we are focused on recent events, so I'll move on to a recap of the stock market in the first half.

Even as investors were struggling with the possibility that we were, indeed "going the other way" in January and February, we reiterated that we never lose faith that even during the worst of Bear Markets, stocks will stage some sharp rallies. Candidly, we were certainly starting to wonder when we would see one this time around. The -18.1% return for January-February was the worst ever for the S&P 500 to begin a year. The year-to-date decline went on to reach -26% by early March. That represented a 58% drop from the October 2007 record highs.

The selloff had picked up steam amid fears about the fate of the country's biggest banks and, by the first week of March, the Dow industrials were 13% below their previous low-water mark from late 2008 and were down 25% for the year. When the S&P 500 hit 666 intraday on March 6, it was 910 points below its October 2007 record of 1576, a decline of 58%. As points of reference, the S&P 500 2002 Bear Market low was 768. This was the first trip below 700 since October of 1996.

At that time, we worked to stay on the side of Dickens' "wisdom" and "belief". We believe in our Investment Process which is based on the wisdom of history and the belief that sticking to logical disciplines will result in good investment results over time. Another bit of wisdom was that Bear Market "bottoms" are a process -- not an event. When the March "breakdown" did not accelerate into a high-momentum decline, it reinforced the idea that the stage just might be getting set for a sustainable rally.

If we fast-forward from that point, we can talk about the "spring of hope" that has replaced the season of Darkness. I've been at this a long time and this is truly one of the most amazing sentiment turnarounds I have seen. I like the very-technical characterization our friends at Ned Davis Research use: it's a Monster Rally.

The Dow Jones Industrial Average returned 11.8% for the second quarter, its biggest quarterly jump since 2003. The Standard & Poor's 500 was even stronger with a 15.9% gain, its largest quarterly increase since 1998. A portion of the gain was fueled by the downtrodden Financial stocks which bounced 36% in Q2, but market breadth was very good across most sectors.

For the second half of our "Tale of Two Markets", stocks were clearly driven by the hope that investors have "everything before us" as economically sensitive small caps as represented by the Russell 2000 returned 20.6% for the quarter and the emerging markets ETF was up 35.1%. The higher beta NASDAQ 100 (the largest over the counter stocks and heavily weighted to Technology) is now up a very strong 22% year to date! For large cap stocks, both Growth and Value gained 16% for Q2, but Growth is well ahead for the year with an 11% gain versus Value's 3% decline.

Interestingly, the 2009 "worst of times" lasted two to three months, then the hopes that we were quickly returning to the "best of times" lasted about the same period. That leaves the last month during which economic news has (as expected) stabilized in that "green shoots" or "less bad" zone. This is to be expected. In fact our Expansion Checklist improved to 4 of 10 signals and then decided to rest there for awhile. We are anxious to see more signals switch on, but the data is what it is.

Another reason to stay on the sidelines is that we are entering the potentially volatile early July period when investors compare their expectations against a fresh round of economic and corporate earnings reports. They include tomorrow's release of a report that many analysts expect will show the national unemployment rate creeping closer to 10 percent. Then starts a potentially tough earnings season, when corporations issue results for the second quarter. Many analysts expect another flood of weak reports, with profits down significantly at many companies.

We think any pullbacks caused by short term economic concerns or disappointing earnings will prove to be buying opportunities as we expect further improvement from our Market Meter which is already up from -3 to 0. We are sticking to our Tactical Asset Allocation plan whereby we look to continue to move accounts toward equity target positions. Of course, if the Expansion Checklist stalls out at only 4 of 10 and the Meter gets stuck at 0, we will adjust our strategies accordingly.