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FirstMerit Monthly Commentary
The Market Meter and Tactical Asset Allocation

September 2, 2009

I will begin this month with a brief update on the economy and markets. How's this for brief? The recession is over and a cyclical bull market in stocks is underway. Okay, I won't end that quickly because I have a lot to say about the economy, the Market Meter and our Tactical Asset Allocation plan.

The Great Recession started in December 2007 and has extended at least 19 months through June 2009. The past four quarters were all negative including horrendous -5.4% and -6.4% GDP reports for Q4 08 and Q1 09. Q2 of this year showed "improvement" all the way to a mere -1.0%. THAT IS GOOD NEWS! One of the laws of nature (and economics) is that momentum must slow before it can change direction.

Economic data releases this week continue the trend of "green shoots" momentum shifts we've been seeing since Spring. The Institute for Supply Management business barometer rose to 50.0 in August, which is the dividing line between growth and contraction. It was only 43.4 in July and it also beat expectations of a rise to 48.0. The index, which covers both the service and manufacturing sectors, is often viewed as a bellwether of national trends. Meanwhile, the National Association of Purchasing Management index of business conditions rose to 55.3 from 48.3 in July.

The Case-Shiller index showed home prices rose in June and in addition, new home sales surged +9.6% in July, while mortgage applications rose 7.5% last week. Jobless claims also declined again last week and have now been improving for 5 months. Consumer confidence surveys are bouncing back as well despite a depressing unemployment rate of 9.4%.

I'll insert a client question here: what's the impact of Cash for Clunkers? A program like Cash for Clunkers brings auto buyers into the showrooms, so car sales saw a short term pop from an annualized 9 million sales rate to an 14 million rate. Many economists tied a jump in new durable goods orders to this program's impact on auto assembly lines. I guess the government liked the results, as they are now instituting a much smaller $300 million version to induce consumers to purchase energy-efficient refrigerators, furnaces, etc. I've heard rumors that the next program will be "cash for clunker husbands", so I advise all of you guys to help out with chores around the house!

Seriously, many economists are worried that these programs are "pulling forward" sales from the future which will result in slower growth down the road. We don't agree as we see these sales as part of the "pent up demand" story that generally drives the early stages of economic expansions. Whether pulled forward or backward, the purchases further deplete inventories and at some point, manufacturers have to start manufacturing and importers start importing. Either way, job growth restarts whether it's to produce goods or ship them around the country.

The headline of our early July Market Message was "The Recession is Ending." One major result of the economy basically coming to a standstill for six months was the truly astounding amount of costs that were shed by corporations. They cut capital spending and slashed inventories and employment as they focused on corporate survival. As they

gradually realize orders are getting better, they will have to pick up output and as output picks up, there is a reasonably good chance that employment (despite many permanent job losses) will improve. We expect corporate profit margins will bounce back fairly quickly because of the cost cuts. If we get really lucky, the recovery will become a sustainable expansion.

It's important to note, however, that we are not optimists on the longer-term economic outlook. The de-leveraging impact of the bursting of the credit bubble on consumers, businesses and certainly on the financial sector, is going to have long-lasting results. The demise of the shadow banking system, the downsizing of Fannie and Freddie and tightened bank lending standards mean that it's going to be very difficult to get anything close to the credit generation of the past 15+ years. That means slower GDP growth.

Moving on to the markets, I will be brief: the S&P 500 has now racked up six consecutive positive months. International and smaller domestic stocks have led the rally and corporate bonds are beating US Treasury bonds. This is the normal pattern as we exit a recession. The S&P 500 gained 54% between March and August. It is up 15% year to date and 11.4% this quarter. I received a question from a client who is sitting in cash: "What should I do now?" Our response is unambiguous: if you are well below your strategic target for equities you should work with your portfolio manager to create a plan to get back into stocks. We believe the upside opportunity at this time is significantly greater than the downside risk. It is not too late to participate.

Our methodology for making judgments like that rests on our time-tested asset allocation disciplines. I have recently been questioned about the key to that discipline – our proprietary Market Meter – and how we implement the Meter signals through Tactical Asset Allocation.

Our high-quality-oriented investment philosophy is to participate in rising markets and to protect the value of client accounts during declining markets. The objective of this is to earn above-market returns over time with below-market volatility. In working to achieve this goal for clients, I've successfully used the Market Meter and its predecessor models for over 25 years to drive asset allocation strategy.

As many of you know, the Market Meter has four inputs that have a total of 6 points assigned to them, so the Meter reading can range from -6 to +6. The Inputs are the Major Trend (weighted at 1 point), Fundamentals (which has two sub-inputs, Economy and Valuation each of which is weighted at 1 point, Federal Reserve (1 point) and Technical (with two sub-inputs, Trend Analysis and Short Term Technical each of which is weighted at 1 point). As with physical meters or gauges, both the level and trend of the Meter reading is critical. In other words, our outlook for stocks would generally be more positive if the Market Meter was rising from -2 to +1 than if it was falling from +5 to +3.

Our first input is the Major Trend of stock prices over the long term. This input is designed to keep us from losing sight of the strategic importance of the very long-term upward bias to stock prices. It is a fact that stock prices have risen over the decades as the economy, corporate profits and dividends grew. For our rating of the Major Trend we analyze both nominal prices and constant dollar (or inflation-adjusted) trends from peak to peak and trough to trough on the S&P 500. Nominal prices reached a new high at the 2007 peak versus the prior peak in 2000, but constant dollar prices failed to match that higher high. Then, both versions of the S&P fell to lower lows in 2008 vs. the prior Bear

Market troughs in 2002-03. The saving grace for the Major Trend is that prices remain well above the lower end of the rising price channel in place since the 1940's, so we arrive at a neutral 0 rating. This is actually more significant than it might seem because the Major Trend had been firmly at +1 since early in the secular Bull Market that began in 1982. I will return to this topic when I discuss Tactical Asset Allocation.

Market Meter input number two is Fundamentals which consists of two components, the Economy and Stock Market Valuation. The direction and strength of the economy, inflation, interest rates and earnings are the primary Fundamental drivers for the stock market. Over the years, I have primarily focused on current data and trends rather than basing the Economy rating on trying to predict reversals. Nonetheless, my investment teams always put a lot of effort into determining when an economic expansion or recession may be ending, as recognizing such inflection points on a timely basis can be very important for investment returns. At FirstMerit we have added to the discipline by creating, first, the Recession Checklist (RC) in 2007 and then in early 2009, our Expansion Signals Checklist (ESC). Early returns on these efforts are very positive as the RC results helped drop the Economic input from +1 to 0 in October 2007 and then to -1 in March 2008 when few economists were predicting a recession. We hit the "escape" key this July and returned the Economy rating to 0 due to ESC improvement.

For the Stock Market Valuation input, we compare the S&P 500's price/earnings ratio and dividend yield to historic ranges and to bond yields. Since we utilize forward earnings estimates, we also pay attention to estimate revisions. Our thinking is that regardless of the accuracy of the estimates, market participants base their actions on them so we must consider them as well. We overlay our opinion as to the probability of estimates being low or high because there is a cyclical pattern as to analyst over- and under-optimism. We spent 2007 thinking that estimates would eventually be revised lower and now, with revisions just beginning to turn positive, we expect further positive revisions for 2010. The Valuation input was positive until last fall, then negative until May. The p/e ratio was cheap very briefly at the market lows but we were still seeing significant estimate cuts at that time. Now that revisions are positive, the p/e is back up to a "normal" 14-15x 2010 estimates so we are stuck at a neutral (0) rating for now. Fundamentals thus net out to 0.

What else do you need to know to make informed investment decisions? We believe in the market adages "Don't Fight the Fed" and "Don't Fight the Tape", so we have inputs that represent our opinion for each of them.

For Market Meter input number three, we ask whether the Federal Reserve is on the sidelines or actively working to take away the punchbowl. We are wary of underestimating the power of the Fed, so we give it an important weighting in the Market Meter. The Fed rating went from -1 to neutral in early 2007 (the last of the 2004-06 rate hikes was in May 2006) and we shifted to +1 in September of 2007 when the Fed started cutting rates. The signal was obviously VERY early, but we have seen no reason to downgrade as the FOMC has indicated they intend to hold Fed Funds near zero for the foreseeable future and the "Quantitative Easing" expansion of the Fed's balance sheet remains in place. We do not anticipate the Fed beginning to drain the punchbowl until sometime next year.

The final input to the Market Meter is our analysis of Technical data (the Tape) including price patterns, supply/demand, sentiment, breadth and momentum. The important point

with regard to Technical analysis is that many, many, many investors rely on it. That means it cannot be ignored, even if one thinks it is voodoo. As noted, there are two parts to Technical. For our longer term Trend Analysis, we review weekly and monthly patterns and momentum. As the weekly data improved, we upgraded Trend Analysis from -1 to 0 last month. With improvement in the monthly charts continuing through August (including seeing the S&P 200-day moving average turn upward), we are advancing this input another notch to +1 with our September reading.

The Short Term Technical input reflects our belief that the stock market is driven by sentiment, supply/demand and momentum in the shorter term. The score from this input is often volatile, as it has had more rating changes than any other input (eight in the past three years). Currently supply / demand is positive as flows into equity mutual funds and ETFs have really picked up this year. Sentiment is a contrary indicator, reflecting the reality that most investors chase trends – that is to say, as the markets rise they become more bullish and at market lows the sentiment indicators show despondence. That was surely the case this time around! We are watching for signs of irrational exuberance as the rally continues, but we don't see them yet. Breadth (rising vs. declining stocks and new highs vs. new lows) is a plus as are our technical momentum indicators. With Short Term Technical also +1, the Technical inputs now sum to +2.

Our growing bullishness has been driven by the Market Meter improvement from -3 in March. If you totaled up the points as I went over the Market Meter inputs, you can see it is now at +3 versus the potential range of -6 to +6. Both level and trend are bullish.

I will begin my segue into Tactical Asset Allocation with more detail on the rationale behind the neutral Major Trend rating and how it impacts investment strategies. As we have often stated, we believe the impact of the forced deleveraging of consumers, investors and the financial system will be a drag on global economic growth for years to come. Another worry is the risk that fiscal and monetary stimulus won't be withdrawn on a timely basis which could cause a resurgence of inflation. In a worst-case scenario, that would lead to the debasement of the US Dollar. The reality of deleveraging and fear of hyperinflation are serious headwinds that may cap equity market returns. The situation could be very similar to 1966-1982 when the DJIA went from 1000 in 1966 to 1000 in 1982. Real returns after inflation reflected a very significant loss of purchasing power for buy-and-hold investors.

Now within that 16 year flat stretch there were many cyclical swings and there were definitely periods where different types of companies or sectors of the economy performed very well, so there was significant money to be made. Our concern now is that the peaks in the S&P and in the Dow that were achieved in October 2007 could turn out to be high watermarks for a long time. This perspective that stocks will go up and down, but will not reward a static portfolio for possibly the next three to five years indicates to us that significant asset allocation shifts within portfolios will be required.

We have therefore created a structure and plan for implementing Tactical Asset Allocation (TAA) in client accounts. The basic plan is very straightforward – sell into strength and buy after weakness. It's a basic "Sell Higher, Buy Lower" plan. The goal is to be at or above longer term strategic asset allocation targets for stocks during cyclical Bull Markets and well below those targets in Bear Markets. That may sound like Market Timing but we differentiate TAA as follows: Market Timing is a speculator's tool that requires quick moves in & out of asset classes creating high turnover which increases

risk and causes short term (i.e. fully taxed) gains…if it's successful. Tactical Asset Allocation is very different. It is an investor's tool which uses planned additions or trims of a portion of portfolios. Under our plan, TAA is a lower turnover discipline which aims at decreasing risk and which pays attention to tax management.

Our TAA plan causes us to constantly look out over the next six months to see if current trends are likely to continue. In November of 2008, the market started to rally, but we didn't see signs of a cyclical bull market developing. We set S&P 500 price levels that, if reached, would force us to further increase cash reserves. The first level was hit that month and the next level was hit right at the start of 2009 so we sold a set portion of our equities each time. Then as our Market Meter readings improved this spring and into the summer, we shifted to the other side of Tactical Asset Allocation which calls for adding to equities as the Meter improves or buying after stocks correct.

If you looked at the equity allocation of our Moderate Growth model portfolio at the end of February, it would have held about 53% in Core stocks, 23% in the Explore exchange traded funds and about 24% in cash. Due to our TAA plan, those numbers are now 69% in stocks, 29% in ETFs, and about 2% in cash. To get to there, we added to the Explore ETFs, but primarily it was finding stocks that met our opportunistic characteristics and watching their prices increase.

Bottom line, we think that the key differentiator that we offer to our clients is something that not many investment advisors attempt, and that is to utilize this very disciplined approach. We try to keep it simple and to sell high and buy low, staying invested in equities during cyclical advances and then protecting account values by trimming the portfolio back when we see danger signs. As I stated earlier: We believe the upside opportunity at this time is significantly greater than the downside risk. It is not too late to participate.

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