

## A Message from the Chief

2<sup>nd</sup> Quarter 2009

**Robert M. Leggett, CFA**  
**Chief Investment Officer**  
robert.leggett@firstmerit.com

Greetings!

2009 began much like 2008 ended – with horrifying economic reports and steep declines in stock prices worldwide. Worries that President Obama's efforts would be no more effective than his predecessor's led to comparisons of the current situation to the 1930's great Depression.

We have often stated our belief that even a severe recession will not deteriorate into a Depression unless continuous and egregious policy errors are committed. After a few false starts, the new administration has consistently reiterated that it will apply all fiscal and monetary stimulus measures necessary to avert a deflationary depression.

While the longer term unintended consequences of this unprecedented effort are unknown, in the near term it tells us we should be watching for signs of economic improvement. In this issue's Economic Outlook, Jeff Doerfler and John Badock introduce our new Expansion Signals Checklist. While it is not yet indicating a recovery is underway, it indicates the worst of the recession may be past.

Jeff Doerfler's Interest Rate Outlook discusses how economic worries and continued credit market tightness resulted in volatility in the bond markets in the first quarter. Continued improvement from the Expansion Signals Checklist would cause us to consider taking on slightly more risk in fixed income portfolios. For now, we maintain our high quality focus.

The Stock Market Outlook written by Mark Shupe uses dialogue from a Peter Sellers movie to make the point that investors (and politicians) need to remember that market cycles go up and down. With the Market Meter inching up from -3 to -2, perhaps an up-cycle is not too far in the future.

As always, feel free to contact anyone on the Investment Management Team with questions or comments about these Investment Strategy reports.

The opinions and information contained in this message have been derived from sources believed to be accurate and reliable, but FirstMerit Bank, N.A. makes no representation as to their timeliness or completeness. This message does not constitute individual investment, legal or tax advice. All opinions are reflective of judgments made on the original date of publication and do not constitute a guarantee of present or future financial market conditions.

### Wealth Management Services

**Akron Office**  
106 S. Main Street, 6<sup>th</sup> Floor  
Akron, OH 44308

**Ashtabula Office**  
4200 Park Avenue  
Ashtabula, OH 44004

**Canton Office**  
4481 Munson St. N.W., Suite 200  
Canton, OH 44718

**Cleveland Office**  
101 West Prospect, Suite 350  
Cleveland, OH 44115

**Columbus Office**  
111 W. Rich Street, Suite 550  
Columbus, OH 43215

**Erie Shores Office**  
105 Court Street  
Elyria, OH 44035

**Mansfield Office**  
100 Park Avenue  
Mansfield, OH 44902

**Medina Office**  
39 Public Square  
Medina, OH 44256

**Mentor Office**  
7800 Reynolds Road  
Mentor, OH 44060

**Toledo Office**  
411 Adams Street  
Toledo, OH 43604

**Wayne County & Western Region**  
135 E. Liberty Street  
Wooster, OH 44691

The economy that officially entered a recession in December 2007 continues to languish. GDP was reported to have fallen 6.3% in the fourth quarter and forecasts are for a further decline of 5% in the first quarter of this year. The Federal Reserve and the current administration continue to aggressively attempt to reflate the economy by increasing liquidity and injecting capital into financial institutions. The government is intent on freeing up the credit markets and spurring economic growth. While no significant near-term positive indications are glaringly evident, we must remain diligent in focusing on a possible recovery scenario.

During 2007 we initiated a Recession Checklist to monitor several key indicators. This process allowed us to maintain an objective view on the trend in the economy and maintain a focused perspective on signs of weakness. Recession not Depression became our consistent economic message in April 2008, when 6 out of 10 indicators signaled we had entered a recession. Eventually, all 10 would confirm that the economy was in a recession. This occurred long before the National Bureau of Economic Research declared in late 2008 that we were in a recession that began in December 2007. The checklist proved a valuable resource in positioning our equity models and portfolios more defensively. The S & P 500 index would lose more than 56%, peak to trough.

With the continued lack of a Depression in our forecast, we must now become watchful for an eventual recovery in the economy. During the first quarter of 2009, we introduced our Economic Expansion Checklist built upon the same principles as the Recession Checklist. We are focusing on a limited number of economic signals that we have listed in the table below. We enhanced this list by backing up the signals with their underlying trends. This will allow us to remain cognizant of indicators that are improving but have not yet passed the designated level to be a clear expansion signal. This should provide more forewarning that an economic expansion has begun. The Checklist, used in conjunction with our existing macroeconomic research, will help develop our Market Message and assist in strategic decisions for our clients' accounts.

The initial Economic Expansion Checklist released in February 2009, showed that 2 out of the 10 indicators signaled expansion, and the underlying trends in the indicators communicated that economic deterioration was still accelerating. The March 2009 version has shown some improvement. While only 3 out of 10 indicators are signaling expansion, the underlying trends show that over half improved or stabilized from the previous month. While it is too early to call for an end to the recession, these indications lend support to our view of an economic recovery beginning later this year.

**Expansion Signals Checklist**

	1980	1981	1982	1991	2001	NOW	Signal Mo.
Real Retail Sales	C	ES	NES	C	C		
Housing Starts	C	ES	L	C	NES		
Industrial Production	C	ES	L	C	C		
Nonfarm Payrolls	L	ES	L	L	L		
Baa/AAA Yield Ratio	C	ES	L	L	L		
Willingness to Lend	C	ES	L	C	C		
ISM Index (PMI)	L	ES	L	L	L	ES	Mar-09
Yield Curve	L	ES	L	L	L	ES	Jun-07
Fed Tightening/Easing Cycle	L	ES	L	L	L	ES	Sep-07
OECD+Non-memb Lead Indicators	L	ES	L	L	L		
Leading Signals	L	5	9	6	6		
Coincident Signal	C	5		4	3		
No Expansion Signal	NES		1		1	7	
Expansion Signal	ES	10				3	

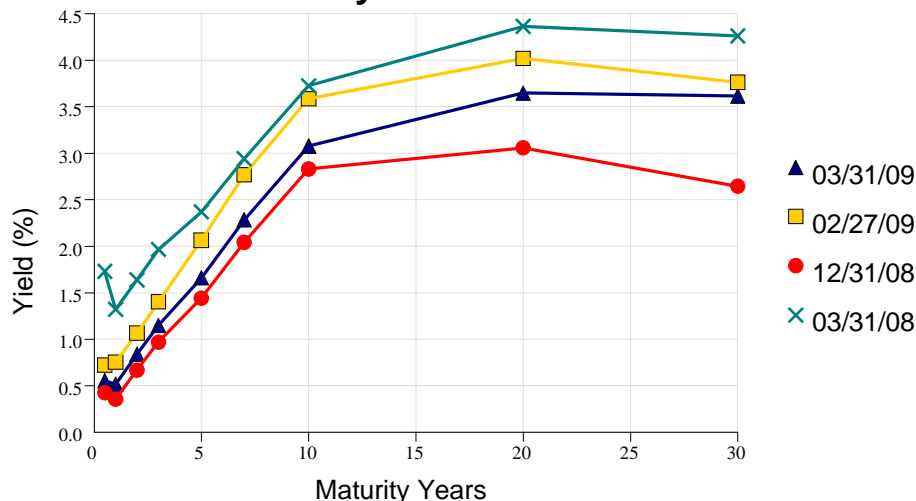
The investment theme for the fixed income markets in the first quarter was the government's effect on all sectors in the bond universe. Just a look at March illustrates the overwhelming influence government had in various types of fixed income. Financial bonds were once again taken to the woodshed as compensation criticism and fear over the stress tests caused spreads to widen once again. Fear of potential inflation drove TIPS (Treasury Inflation Protected Securities) to large gains. Mortgage-backed securities benefited from the Fed's buying program. Riskier asset-backed and commercial mortgage-backed securities gained on the prospects of Federal support. High-yield (junk) paper outperformed with help from a stock market rally driven off government stimulus and bank support plans.

Through the first quarter, fixed income returns were roughly flat (Barclays Aggregate – up 0.12%). Strong performance in agency mortgage-backed securities (MBS up 1.50%) was offset by weakness in Treasuries (-1.32%) and corporates (-1.93%). Agency MBS debt was boosted by the expansion of government buying in the sector while Treasuries were hurt by supply fears. Government agency bonds were flat for the quarter.

Overall, we remain optimistic regarding the government support within the fixed income market. As prospects for economic recovery improve as illustrated by our indicators on the Expansion Checklist, we will need to address the prospects of rising interest rates in our fixed income portfolios. We will need to weigh the potential benefits of gradually increasing risk in the credit sector of our clients' portfolios against potential weakness should rising treasury rates push up all yield curves. The downtrend in inflation should continue to support lower yields in the near-term. Even as the overall volatility in yields should remain muted, growing supply of Treasuries will eventually push yields higher once the economy begins to revive.

We consider the prospect for high-quality mortgage-backed securities favorable. They should continue to outperform Treasuries in a low volatility interest rate environment. Corporate bonds become harder to ignore as spreads (yields over Treasuries) are significant enough to pay for the increased risk. Yield pick-ups in investment-grade rated paper (A-rated) are high enough to produce impressive total returns over the next few years. Durations in bond portfolios will be kept shorter than benchmark in anticipation of higher rates through the year. We will continue to move away from Treasuries in favor of spread product (agencies and selected high quality corporate bonds). Municipals continue to offer attractive yields relative to government bonds, but we will focus solely on high quality insured offerings with high-rated underlying issuers. We have identified specific bond mutual funds to add diversified corporate and mortgage-backed exposure to laddered bond portfolios.

### Treasury Yield Curve



March finished very strong with a 20% rally in the last three weeks as short-sellers unwound and overly strict mark to market accounting finally came under attack by Congress. The first quarter began with oil, gold, freight traffic, and used car prices hitting bottom. The market thus opened the year with the worst January-February ever recorded. Despite March's 8 ½% total return, the S&P 500 returned -11.7% for the quarter, extending the string of negative quarters to six.

Still, other data such as the surprisingly strong retail sales in January and February illustrate the resiliency of the American economic engine. Perhaps our leaders in Washington could learn something from this dialogue from the 1979 Peter Sellers classic: **Being There:**

**The President:** Mr. Gardener, do you agree with Ben, or do you think that we can stimulate growth through temporary incentives? **Chance the Gardener:** As long as the roots are not severed, all is well. And all will be well in the garden. **The President:** In the garden. **Chance the Gardener:** Yes. In the garden, growth has its seasons. First comes spring and summer, but then we have fall and winter. And then we get spring and summer again. **The President:** Spring and summer. **Chance the Gardener:** Yes. **The President:** Hm. Well, Mr. Gardener, I must admit that is one of the most refreshing and optimistic statements I've heard in a very, very long time. I admire your good, solid sense. That's precisely what we lack on Capitol Hill.

Wouldn't it be nice if we had more Gardeners in Washington? These historically depressed valuations in today's stock market mean there are a lot of cheap stocks out there as the dividend yield on the S&P 500 (3.40%) is not much different than the 10 year treasury (2.66%). In absolute terms and relative to the US market, international stocks look even cheaper as their trailing price earnings multiples are well below the 20 year average relative to the US.

Equity valuations and a positively sloping yield curve for bonds are tailwinds for money flowing in to the stock market. Improving new home sales and durable goods orders are giving some sunlight to the short-term economic outlook. But we also expect employment numbers to erode and the economic news reporting in the 2nd quarter to be fear inspiring. As a leading indicator, stocks typically rise months before the end of a recession, and it is likely the US will rebound from the recession first.

Spring is here, and unlike Northeastern Ohio, the seasons of the American economy are of short winters (average 14 month recessions) and long summers (average 45 month expansions). As long as the roots are not severed by continued changes to fiscal policy, our Market Meter will show new signs of life as we go into spring and summer.

**Length of Economic Expansions and Recessions Since 1900**

