

## A Message from the Chief

1<sup>st</sup> Quarter 2009

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Greetings!

Most investors saw the value of their accounts decline in 2008 as the sharp panicky selloff in both stock and bond markets in September-October was one of the worst any of us have experienced. We know that makes it difficult to continue to believe in the value of your long term investment plans. Nonetheless, this is a very good time to review that plan, take a deep breath, rebalance as required and then continue to stick to your plan. As we have stated many times, we are confident that the current severe recession is not morphing into a depression. If history is any guide that means the financial markets will eventually start discounting a recovery.

In this issue's Economic Outlook we review 2008, a year that saw the economy go from bad to worse. There is little reason for optimism in the near term, but we are hopeful that signs of improvement will show up by mid year. We include a chart that demonstrates the astounding growth of consumer credit over the past 40 years. Our de-leveraging theme calls for a reversal of that trend which will dampen -- but not prevent -- economic growth going forward.

In our Interest Rate Outlook, Jeff Doerfler notes that the credit crunch caused many sectors of the bond market to record negative returns. On the other hand, US Treasuries had strong returns as the flight to quality forced their interest rates to low levels not seen for decades. While we expect rates to remain low in 2009, we anticipate a contraction in spreads for corporate bonds as the economy demonstrates that it has bottomed. Municipal bonds remain quite attractive.

The stock market had a terrible fourth quarter and finished with some of the largest losses ever seen for a calendar year as shown on the table we include with Michael Kormos' writeup. He notes that there was truly nowhere to hide in global equity markets, but also states that it is the nature of the media to accentuate the trend. The stock market discounts the future and we expect to start seeing improved conditions later this year. For now, however, we remain focused on capital preservation.

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

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The economic story for 2008 can be summed up as “from bad to worse.” Last January, there was still hope that the subprime problem would be contained and that a recession could be avoided. The near-meltdown of the financial system caused by the March failure of a large investment banking firm, Bear Stearns, caused the credit crunch to deepen and investor sentiment to darken. By April, our Recession Checklist worsened from only 2 up to 6 (of 10) indicators signaling recession.

The consumer was clearly in poor shape with high debt, declining housing values, rising energy costs and employment worries causing a sharp decline in consumer sentiment. The attached chart demonstrates the impact of massive credit expansion by consumers over the past several decades. Consumer (Household) debt as a percentage of US GDP first exceeded 60% in the 1980’s, expanded past 70% by 2000 and then skyrocketed to over 100% last year! This ratio is already falling and will likely fall a lot more over the next several years as the Boomers retire and learn the wisdom of their parents’ generation: a paid-off mortgage is the key to a comfortable retirement.

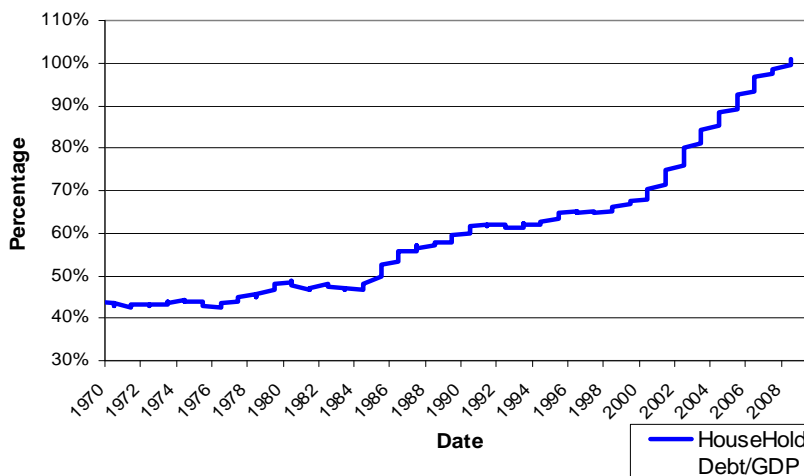
Still, corporate balance sheets (ex the financial sector) were in good shape, the Fed was cutting interest rates and tax rebates were on the way. That combination allowed investors to maintain hope that the recession would be mild until September when the Paulsen Panic scared Congress, investors, businesses and consumers into paralysis. By that time, Credit Markets were barely functioning and then the on-again, off-again TARP episode put the economy into a deep freeze. Our Recession Checklist quickly moved to a perfect 10 (not that we wanted to see that occur) and the government confirmed that we are indeed in a recession.

A consumer-lead recession like this one coupled with dysfunctional credit markets is very serious for two reasons: (1) consumer spending accounts for 2/3 of GDP and (2) economic growth has become more and more dependent on borrowing and leverage. The lack of confidence among investors, lenders and consumers is palpable, so the key to economic recovery in 2009 is clear: guarded optimism about the Obama Administration’s stimulus plan must blossom into confidence that the economy is moving onto the right track.

Alternatively, if the stimulus plan dissolves into partisan bickering or does not show immediate positive signs, the economy could go from “worse to worst.” We continue to believe that “worst case” would be a long recession that requires so much stimulus that we later find ourselves risking stagflation (rising inflation and a slowly-growing economy.)

The bottom line is that our most probable scenario has the economy stabilizing by summer and showing clear signs of improvement by autumn. With interest rates very low, the Fed printing press running full speed, inflation non-existent, and pent-up demand due to six months of severe recession it appears sufficient catalysts should be in place for recovery to begin later this year.

**Household Debt/GDP**



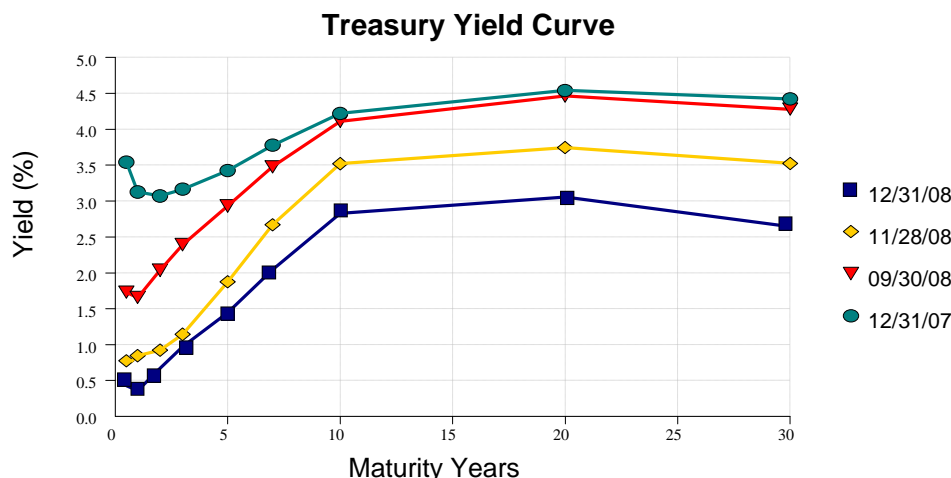
Source: Bloomberg

The credit crunch in 2008 had an effect on every sector in the fixed income market outside of Treasuries. Despite the aggressive easing throughout the second half of the year, many sectors produced negative returns. Anything related to credit suffered especially further down the credit rating scale. The Treasury market was the beneficiary of all the fear in the markets as investors flocked to the safety of government bonds at any cost, driving yields to their lowest levels since the 1950's. Government agency bonds performed relatively poorly until the implicit guarantee of their bonds became an explicit one during the summer. High quality government agency mortgage-backed securities suffered through a difficult period until the Treasury released its plan to buy \$500B in these securities.

The Barclays Aggregate index (formerly the Lehman Aggregate) posted a 5.24% return for 2008 spurred by strong Treasury performance and lower exposure to the weakness in corporate bonds. The Treasury sector as a whole gained 13.7% with the 20+ Year sector returning over 33%. Despite a decent recovery in the last 2 months, corporates posted negative returns with Financial bonds falling 8.4%. A-rated bonds fell 5% and BBB-rated (the lowest investment-grade level) declined 8.9%.

From current extreme low yield levels, the big question is whether they go much lower. Treasury yields on the short end have little room to fall further. The overwhelming buying in 2008 has driven Treasuries into bubble territory. However, with the Fed signaling their intent to maintain the Funds rate near zero, there is limited near-term downside in short Treasuries. Yields will start moving back up due to a re-emergence of inflationary pressures as the Fed easing cycle continues and treasury supply increases. The near-term risk of significantly higher yields, however, is somewhat low as the flight to safety will continue until there is clear evidence of improvement in the credit markets. Corporate bonds should begin to benefit from a contraction in spreads (the difference between corporate yields and Treasury yields). Corporate bond prices fell too far in 2008 and reflected unprecedented potential default levels in the market. Corporate bonds should also be buoyed by anticipation of a renewed appetite for risk in 2009 supported by prospects for government support of beleaguered core industries other than autos. The success of the Treasury Liquidity Guarantee Program should aid Financials.

Durations in bond portfolios will be kept shorter than benchmark in anticipation of higher rates through the year. We will move away from Treasuries in favor of spread product (agencies and selected high quality corporate bonds). We will continue to build up our mortgage-backed weightings in accounts benchmarked to the Barclays Aggregate index. Laddered bond portfolios will continue to be extended in the intermediate to long end of the yield curve. 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. Mutual funds will be used to selectively to gain exposure to specific sectors while offering better diversification than individual issues.



Happy New Year! As we look forward, we cannot ignore the fact that most investors would add “Good Bye and Good Riddance to 2008” to their well wishings for 2009. In order to gauge the economic climate for the beginning of this year, we certainly must take inventory on the dismal markets of the previous one.

Some last minute hope was fostered by the Santa Claus rally. However, the S&P 500 finished at -37% which accounted for the third worst year in its history. For those of you keeping score at home, only 1937 and 1931 eclipsed that dismal number with returns of -38.6% and -47.1% respectively. To provide a bit of perspective concerning the other markets, the Dow Jones Industrials finished at -33.8% and the more tech-heavy NASDAQ limped across the finish line at -40.5%.

Such poor results in the markets mentioned above beg the question: “Where was the safe place for investors to hide?” The answer, unfortunately, in regards to equities was: “Nowhere.” The EAFE index, which measures Europe, Australasia, and the Far East came in at -43.4%. If Emerging Markets had been kind to you in recent years, you were blind-sided by last year’s return of -53%! If a “Flight to quality” was on your radar screen, you soon discovered your wings were tiring. With events like money market funds “Breaking the Buck,” fixed income and even cash positions were considered somewhat perilous.

We were constantly bombarded with the label “unprecedented times” because of bailouts,

(Bear Stearns, Freddie Mac, Fannie Mae, AIG, banks, autos) collapses, (IndyMac, Lehman, WaMu, Wachovia, among others) and the Fed’s aggressive interest rate cuts.

Curiously, the National Bureau of Economic Research announced in November that the country was in a recession. The average citizen made the same discovery months earlier.

More could certainly be said regarding the financial news of last year and most of it would be negative (refer to chart for historical perspective). Although severe slumps in housing and retail combined with rising unemployment and a credit crunch don’t instill immediate confidence, there are indeed reasons to be cautious yet genuinely optimistic.

The stimulus of drastically reduced energy prices, a new administration poised to enact swift and lofty policies, and the sheer fact that we’ve weathered the storm thus far provide much needed optimism. Remember that bad news sells and the media’s main profit is through advertisements, which explains why we have become conditioned to the doom and gloom.

We feel comfortable that the move away from a correlation of 1 (which makes individual equities move in lockstep with the overall market) bodes well for our current Tactical Asset Allocation strategy. We are not attempting to read a crystal ball but rather to interpret current conditions. Our cautious strategy is driven by a Market Meter reading of -3 which keeps us focused on capital preservation.

Magnitude & Duration of Bear Markets				
Date Beginning	Close Beginning	Date End	Magnitude	Duration
9/16/1929	31.86	7/8/1932	-86.2%	704
3/10/1937	18.68	4/28/1942	-60.0%	1,284
10/9/2007	1,565.15	11/20/2008	-51.9%	283
3/24/2000	1,527.46	10/9/2002	-49.1%	637
1/19/1906	75.45	11/15/1907	-48.5%	459
1/11/1973	120.24	10/3/1974	-48.2%	436
6/17/1901	57.33	11/9/1903	-46.1%	602
11/3/1919	119.62	12/21/1920	-44.2%	283
11/21/1916	110.15	12/19/1917	-40.1%	268
11/29/1968	108.37	5/26/1970	-36.1%	369
8/25/1987	336.77	12/4/1987	-33.5%	71
5/29/1946	19.25	6/13/1949	-29.6%	761
11/19/1909	73.64	7/30/1914	-29.0%	1,178
12/11/1961	72.39	6/26/1962	-27.7%	136
11/28/1980	140.52	8/12/1982	-27.1%	430
2/9/1966	94.06	10/7/1966	-22.2%	167
8/2/1956	49.75	10/22/1957	-21.6%	307
7/16/1990	368.95	10/11/1990	-19.9%	62
9/21/1976	107.83	3/6/1978	-19.4%	366
8/3/1959	60.71	10/25/1960	-13.9%	311

Courtesy ISI Group