

A Message from the Chief

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Greetings!

The message of this quarter's Investment Strategy write-ups is much more positive than those of the past several quarters. That is largely due to improved readings from both the Expansion Signals Checklist and the Market Meter.

We introduced the Expansion Signals Checklist earlier this year. It consists of 10 economic and interest rate indicators that typically improve as GDP expansions get underway. Only 3 of 10 were switched on in April, but Jeff Doerfler notes in the Economic Outlook that we are now at 6 of 10. This means the recession is almost certainly ending. In fact, we think the suddenness and depth of the recession will be mirrored in a recovery that will be sharper than most people expect. The next debate will be over the sustainability of the expansion and we are less optimistic on that front.

In the Interest Rate Outlook, Jeff Doerfler points out that the Federal Reserve Board has given no indications they will reverse their easy monetary policies anytime soon. Coupled with signs of economic expansion, this led to strong returns from the corporate bond sector in Q2 which we expect to continue. Despite state budget woes, we see minimal default risk for municipal bonds. Given their relatively high yields we continue to favor high quality tax-free bonds.

In the Stock Market Outlook, Jeff Onuska reviews the high volatility of the first half. As should be expected, hopes for an economic recovery resulted in Q2 market rally leadership from cyclical and higher beta areas such as Emerging Markets and Technology stocks. As the Market Meter continued to improve, our tactical Asset Allocation plan caused us to reinvest a large position of the cash reserves we had been holding in client accounts.

As always, feel free to contact anyone on your Wealth Management Services team with questions or comments about this Investment Strategy report.

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The economy has begun to show signs of life which financial commentators call “green shoots.” This is illustrated in the current status of our Expansion Signals Checklist which now has 6 of the 10 indicators signaling expansion. The U.S. and global economies are bottoming, but the uncertainty over the shape of the inevitable recovery needs to be considered. While current odds and consensus favor a sub-par recovery, the potential for a sharper near-term rebound in the economy must be considered.

It is evident that the economy is past the depths of the recession. Job declines are lessening, housing deterioration has subsided, and inventory slashing is slowing. The Fed responses to the recession have had time to take effect and will soon become more evident in the economic indicators. In the corporate sector we are witnessing improving manufacturing numbers and rising factory orders. In the important consumer arena, we have seen pending home sales rise for three consecutive months. Consumer sentiment improved for four consecutive months. Retail sales have turned positive. Massive fiscal stimulus is still working into the system. There have been 681 initiatives announced over the last 23 months. In the 2nd quarter stimulus payouts increased \$41.2 billion.

We must be cognizant of the potential for a quick recovery to run into an eventual roadblock from the difficult credit environment. On the corporate side, when manufacturers are gearing up to meet orders, will the banks be willing to make the necessary loans? Non-residential construction is weakening and seems to have further to decline as credit will continue to be difficult to obtain. Consumer debt levels, while beginning to decline, have a long way to fall to unwind the extreme over-leveraging of the last decade. It will be impossible to sustain a growing economy without the full participation of consumers and income growth may be held down if corporations continue to implement wage cuts.

So how will this recovery play out? A near-term upside surprise could occur as the snap back from some horrific economic trends may occur sooner than most predict. The manufacturing picture this fall will look quite different than it does now as the low level of inventories will be a catalyst for a quick rebound and exports potentially provide a tailwind for growth. Since productivity continued to increase in the depths of the recession in 2008, companies are ahead of the curve in cutting costs. This should aid in a corporate earnings rebound as the economy recovers. Our longer term concerns stem from the impact of deleveraging at all levels of the economy. This keeps us from becoming too exuberant as the expansion begins. We will watch our Expansion and Recession checklists closely in the next quarter for any signs of a double-dip recession or disappointing recovery...or proof that a sustainable recovery is underway.

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	ES	Apr-09
Baa/AAA Yield Ratio	C	ES	L	L	L		Jun-09
Willingness to Lend	C	ES	L	C	C		Jun-09
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	6	4
Expansion Signal	ES	10				4	6

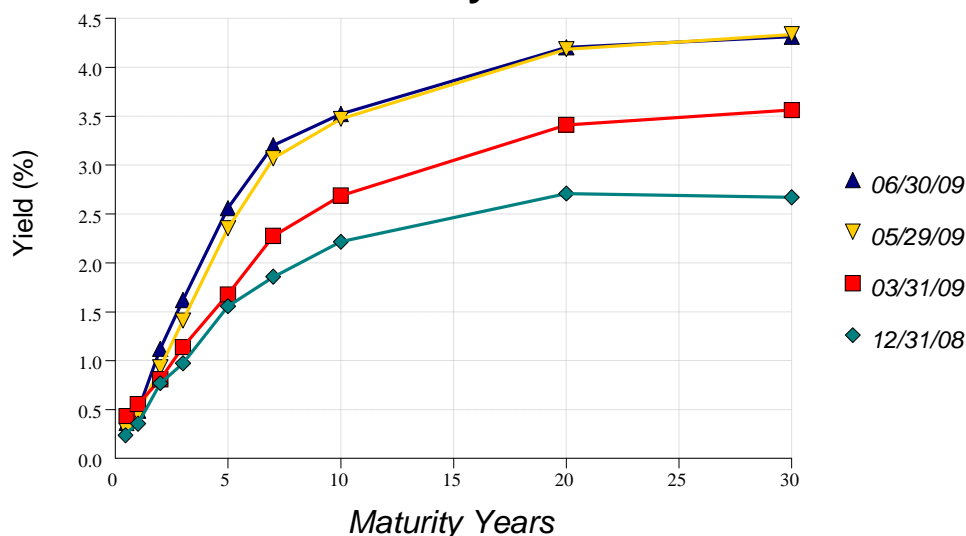
Bond market performance was mixed in the 2nd quarter as prospects for improvement in corporate credit played against the massive amount of government leverage used to stimulate lending and boost the consumer. The Fed continues to maintain a loose monetary stance by keeping rates near zero and purchasing massive amounts of fixed income securities (called quantitative easing). The committee has pointed to some signs of a bottoming of the economy, but maintains that a contraction is still underway and “substantial resource slack” will keep inflation under control in the near-term.

The improving credit picture drove investment-grade corporate bonds to strong performance over the quarter, gaining over 10%. Meanwhile, Treasury yields moved back up in the intermediate and long-ends of the curve. The Treasury sector as a whole lost over 3% with long Treasuries losing over 9%. Agency paper benefited from slightly higher coupons and a modest tightening of spreads to remain flat.

With much focus being shifted to state budget problems, the municipal sector performance was poor through the quarter. We continue to believe ultimate default risk in the sector is minimal. Our portfolios consistently emphasize general obligation and essential revenue bonds that carry extremely low default risk. The weakness in yields from the recent underperformance will continue to provide opportunities to capture attractive yields on a net-tax basis.

Our forecast for a continued near-term economic recovery will be supportive of further tightening in credit spreads. Corporate performance will continue to benefit despite the possible pressure from an upwardly moving yield curve. We must remain very selective in the corporate sector as the rebound has lifted all Financial bonds, when some may not be ultimately worthy of tighter spreads (yields closer to Treasury levels). In many cases, we will be open to using diversified mutual funds to capture continued corporate outperformance, while lessening the potential downside risk from a problem on an individual issuer level. Treasuries will be hurt by the prospect of further increases in government debt and potential inflation pressure as the Fed maintains its easy money stance into 2010.

Treasury Yield Curve



What goes up, must come down...and then up again? This scenario played out in the 2nd quarter of 2009 as the equity and bond markets staged dramatic rebounds from their extreme lows. As the chart below indicates the March to June bounce represented a 39.9% increase from the previous lows. So is this the beginning of "green shoots" or "dream shoots?"

The MSCI Emerging Markets Index led the way with a 29.62% return for the first half of 2009. Other notables included the NASDAQ Composite with a 16.36% return, and the S&P 500 nudged into positive territory, up 1.78%. Conversely, last years safe bet, the Barclays Long-Term Treasury Bond Index, sank -12.25%. The technology sector returns topped the S&P 500 sectors, averaging 24.1%. Materials finished the first half with a 12.3% return. The stellar performance of both groups gives rise to the prospects of better second half economic activity.

As we know, the stock market is a leading economic indicator. But this is just one the sign posts that we study to determine the overall direction of the economy. There are 10 indicators that we are currently tracking at FirstMerit. Six of the indicators have turned positive and more are on the verge of giving positive signals that the economy might be expanding. As we approach 2nd quarter earnings season, we are hopeful that the worst of the market declines are behind us. But market bottoms are a process, not an event as volatility has returned.

We continue to favor a tactical asset allocation approach to managing portfolios. We have taken advantage of the markets strength to add to equity positions and reduce low yielding money market holdings. The Market Meter has improved to a "+1" rating reinforcing our equity strategy.

Sports fans in Northeast Ohio are familiar with the adage, "It ain't over till it's over!" So we are not officially calling for an end to the worst recession since the '80s, but we are increasingly optimistic that the lows are in for the market. Please contact your Client Advisor or Portfolio Manager to discuss your current asset allocation and the opportunities that will come with an improving economic forecast.

3rd Biggest Bounce in Last 100 yrs			
Begin	End	Trading Days	Return
3/31/1938	11/9/1938	153.00	59.8%
11/13/1929	4/17/1930	106.00	48.0%
3/9/2009	6/12/2009	67.00	39.9%
10/5/1931	11/9/1931	23.00	35.0%
6/2/1931	7/3/1931	23.00	27.6%
4/11/1939	9/12/1939	107.00	26.0%
1/5/1932	3/8/1932	43.00	24.7%
11/20/2008	1/6/2009	30.00	24.2%
12/16/1930	2/24/1931	46.00	23.4%
6/10/1940	11/7/1940	105.00	23.2%

Courtesy ISI Group