FIRSTMERIT
Wealth Management Services

FirstMerit Market Message

A quarterly newsletter for
FirstMerit Wealth Management Clients

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2008: Annus Horribilis!

2009: Annus Mirabilis?

Queen Elizabeth II coined the phrase Annus Horribilis (terrible year) in her appraisal of 1992, the year in which two of her sons' marriages failed and Windsor Castle suffered severe damage in a fire. We can all agree that phrase fits 2008, as the -37.0% return for the S&P 500 in 2008 was its third worst year ever.

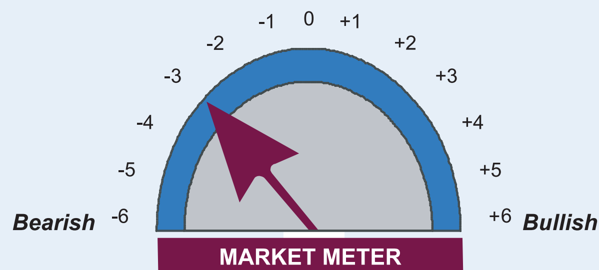
Nearly all asset classes and sectors lost value in 2008. Size didn't matter much, as the Russell Midcap was -41.5% and the Russell 2000 small stock index was -33.8%. Although Value was less dreadful than Growth for the various market cap ranges, the style returns were all in a range of -29% to -44%. U.S. stocks were slightly less terrible than international, as the MSCI EAFE return was -43.4% and MSCI Emerging Markets was down a truly spectacular 53.0%!

It was a difficult year for most sectors of the bond market as well due to the continuous worsening of the credit crunch. Treasury bonds were the beneficiary as investors flocked to their safety, driving yields to their lowest levels since the 1950's. Overall, despite the Fed's aggressive efforts, credit markets remained dysfunctional entering 2009.

After a strong start to the year, commodities also failed to be a good hiding place. Commodity indexes recorded their worst year on record as industrial metals, crude oil and even grains took it on the chin, wiping out six years of gains in the space of months. At its early July peak, the Commodity Research Bureau Index had surged 150%+ since the start of 2002; by year end, that gain was pared to 25%.

All in all, the trillions of dollars lost as both consumer and corporate net worth fell was certainly "horribilis". Unfortunately, it seems unlikely that 2009 will develop into a "mirabilis" (wonderful) year.

In November the NBER (the official arbiters of Recession) finally agreed that a recession started back in December 2007. The U.S. economy's shrinkage has accelerated to -4% or worse for Q4 2008 and Q1 2009. Investors are now banking on a major economic stimulus package from President Obama to minimize the severity of the global economic downturn.



Current Reading is -3

0 MAJOR TREND
+ Nominal new highs
– "Real" new lows

-2 FUNDAMENTALS
– Recession continues
– EPS decline worsens

+1 FEDERAL RESERVE
+ Easy monetary policy

-2 TECHNICAL
– Downtrends in place
– Negative momentum

We are guardedly optimistic that a modest recovery can begin in 2H 2009 driven by existing and new monetary and fiscal stimulus policies. Alas, a strong and sustained economic recovery remains unlikely. 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.

That forces us to conclude that stocks are unlikely to return to the 2007 all-time highs any time soon so we enter the year very cautious on stock markets. At best, we foresee a volatile period of "base building" as the bulls and bears battle for supremacy. Avoiding getting caught up in the emotions ignited by the volatility of a base-building period will be critical in 2009. After the bulls are in charge for a few weeks, it will be tempting to buy late in the hope of regaining losses. Likewise, when prices head down, despair may quickly replace that hope, resulting in selling late. The key to success is to adapt your investment strategy to this environment, utilizing Tactical Asset Allocation or TAA. (See our explanation of this investment approach in this issue's "Investment Management 101" section.)

We continue to strongly emphasize the importance of setting appropriate long term asset allocation targets and to make small range adjustments around those targets, we normally

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2008: Annus Horribilis! 2009: Annus Mirabilis? continued from front

apply the signals of the Market Meter. These are not normal times, so we have expanded the ranges. With upside opportunity capped and downside risk elevated, we remain focused on capital preservation.

Our Tactical Asset Allocation (TAA) plan is to regularly trim a set, small percentage from equities in client accounts when the S&P reaches predetermined levels. The first level was a 15% rebound off the November lows and future trim levels are planned after subsequent 10% increases. The second part of the plan is to buy stocks when the rallies run out of gas and prices near their lows again. It's a classic "Sell Higher, Buy Lower" plan.

Those 10% increments may sound like big moves that aren't normally seen, but remember this is not a normal market environment. It is a base-building period following a harrowing 50% decline and it is not unusual to see 50-60% gains during countertrend Bear Market rallies. And don't kid yourself that 50% up will offset a 50% decline as the tyranny of arithmetic is at work. The S&P 500 plunged 53% from its intraday 2007 high of 1576 to 741 this year (an 835 point loss). That same 53% as a gain from 741 is only 393 points, so it only gets us back to 1134 – still nearly 30% below last year's highs!

The risk of our TAA plan is that a new Bull Market suddenly starts and our clients are not fully invested as stocks recover. Here's the other side of that coin: We know the stock market sold off to cheap levels during the Panic Crash of 2008. We cannot know if there will be another panic that makes it cheaper still during future selloffs. We think the appropriate attitude in such an environment is clear: capital preservation above all, so TAA will be used until the Market Meter indicates a sustainable market advance is probable.

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Investment Management 101

Tactical Asset Allocation

In this section we will review what Tactical Asset Allocation (TAA) is – and what it is not.

First, let's review what it is not. TAA is not Market Timing! You have probably heard bad things about the dangers of Market Timing and you've probably heard some of that from us. We are not advocating Market Timing and we think there is a clear differentiation between TAA (a good idea during range-bound markets) and Market Timing (a bad idea in all types of markets).

We define Market Timing as a speculator's tool. Timers attempt to nimbly jump in and out of stocks, so they are not investors – they are speculators. Going from "long" (fully invested) to "flat" (hedged or in cash) to "short" (betting against stocks) from day to day or week to week is very difficult, because a Market Timer must consistently – and on a very timely basis – outguess their competition as to whether they are buying or selling in the near term.

So here's the deal: Market Timing involves quick moves in/out of your stock portfolio, high turnover, increasing your risk and short term (i.e. fully taxed) gains realized if it's successful!

Tactical Asset Allocation is very different. TAA is an investor's tool. It involves regular moves of adding/trimming a portion of your stock portfolio, low turnover, decreasing your risk and a focus on tax management (harvesting losses and realizing gains taxed at the long term capital gains rate.)

Under our definition, TAA is a process that requires a logical plan and disciplined implementation. Our TAA objective is very straightforward – sell into strength, buy after weakness supporting our focus on capital preservation during these difficult economic times. We will remain below strategic targets until the Market Meter signals the return of a positive backdrop for equity investors.

Until then, your FirstMerit Wealth Team will work closely with you to further explain TAA and how utilizing this approach should help stabilize your account during these turbulent times.

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