

# FirstMerit Market Message

A quarterly newsletter for  
FirstMerit Wealth Management Clients

SUMMER 2009



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

## The Recession is Ending

**The waxing and waning of confidence is clearly a major factor impacting the amplitude and duration of economic cycles.**

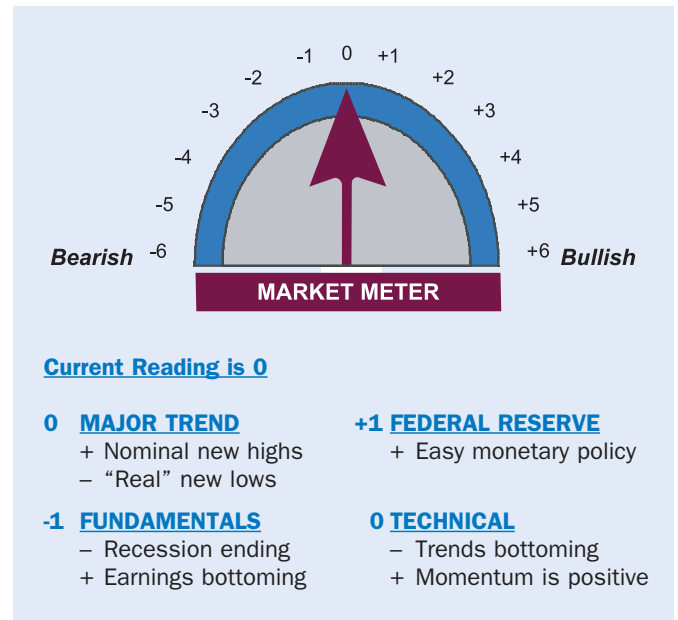
America is a long term growth machine driven by demographics, abundant natural resources and our entrepreneurial spirit, so there are periods when over-optimism and greed take over and bubbles form. Economic sector and financial market bubbles are no more immune to the laws of

nature than soap bubbles, so they always burst.

One aspect of the psychology of crowds is that a strong economy is expected to grow forever and this overconfidence leads to overspending and speculative investing. Unfortunately, resources are not infinite so growth eventually slows. Some consumers and businesses notice that and reduce their spending which slows growth even more. If that leads to a recession, the crowd fears the economy will sink deeper. Inevitably, the crowd is again surprised as data improves to "less bad." Even as the data clearly demonstrates a new expansion is underway, the crowd worries that it's just another unsustainable head fake. Finally, everyone recognizes the economy's strength and the cycle starts anew.

Relating this theory to the current cycle, the debate last year was "slowdown or recession?" and we said "recession." Earlier this year the crowd's fear was "Depression?" and we said "NO!" We now reiterate our forecast of less-bad data into the summer and positive GDP by autumn. **The list of green-shoot data that indicates we are nearing the end of this severe economic decline grows longer by the week** as governments and central banks around the world are implementing unheard-of stimulus and debt guarantee initiatives.

While the key question today is whether this sprouting recovery will be sustainable, the longer term worry is inflation. It is obvious to us that the policy makers would much rather deal



with inflation risks down the road than with deflation risks now. Fed Chair Bernanke addressed this issue in May when he said, "At some point we are going to need to begin to withdraw the policy accommodation. Basically, the exit strategy is that when the time comes, we need to begin to raise interest rates. The question is: will we be able to raise interest rates, given the size of our balance sheet? My answer is, yes."

**Our concern is that history suggests it will be very difficult to perfectly time the stimulus withdrawal.** Too soon could cause a relapse (as in 1936-37 when deficit worries led to tax increases and spending cuts which plunged the economy back into decline). Too late could result in hyperinflation (as in the 1970s when money supply growth was not reined in) or pumping up new asset bubbles (as in the 2000s when interest rates were left at extreme lows allowing the final expansion of the housing bubble).

We continue to believe our thesis of lower consumption and greater aversion to taking on new debt will impact the growth rate of the economy over the coming years. There is simply no other way out from under the crushing debt burdens that were taken on over the past few decades. The looming shadow of this deleveraging by consumers, businesses and the financial sector makes the timing decisions for stimulus removal even more difficult than usual.

continued on back

# FirstMerit Market Message

MARKET METER 0

*The Recession is Ending continued from front*

We do have some sympathy for the concern that taking away the punchbowl “too late” might lead to trillion-dollar budget deficits as far as the eye can see, which raises the specter of a Dollar collapse and hyper-inflation. However, given the economic slack in terms of both plant capacity and labor **we think inflation will remain at low levels for several quarters at least.** We would change our opinion if GDP growth accelerates to 5%+ and stays there, but we think that outcome is highly unlikely.

In the near term, we believe the severity and breadth of the recession created very significant pent-up demand for both consumer and business goods and services. Even if “true” unemployment is 15%, 85% of workers have jobs. Likewise, the vast majority of businesses are not under financial duress. **Our 2009-10 expectation is for the economy to match the stock market and bounce back much more sharply than the crowd expects.**

Most of the “pent-up demand” spending should be satisfied by cash flows. However, sustaining a 3-4% U.S. GDP growth rate for two to three years requires the revival of the credit creation machine as well as the desire of credit-worthy borrowers to use it. We think such **a sustainable expansion is unlikely and therefore we will be watching closely for signs that the crowd is becoming overly optimistic as the economy improves.**

In terms of investment strategy, this outlook means we will stick to our Tactical Asset Allocation plan which causes us to move toward fully invested as the Market Meter improves and to take defensive steps if it reverses.

## For More Information:

- Akron** - Leigh Gerstenberger . . . . .330 384-7104
- Ashtabula** - Ellen Forbus . . . . .440 953-3617
- Canton** - Bob Stark . . . . .330 498-1551
- Cleveland** - Tom Anderson . . . . .216 694-5678
- Columbus** - Curt Ramkissoon . . . . .614 570-7570
- Elyria** - Dan Munro . . . . .440 329-3269
- Medina** - Don Miksch . . . . .330 764-7263
- Mentor** - Karen Manning . . . . .440 953-2179
- Toledo** - Mickey Cooper . . . . .419 720-1521
- Wooster** - Linda Litman . . . . .330 263-3208

## Interpreting the Market Meter at 0

First, entering the third quarter, we are still at below-target equity levels, so we probably can't be characterized as “bullish” yet. We interpret the Market Meter reading from two perspectives: the level (currently 0) and the trend (it has improved from -3 to 0 and our best guess is that it will improve further).

The Market Meter is a critical component of our Tactical Asset Allocation (TAA) plan. So long as it was both negative and trending lower, our plan was to reduce client equity exposure whenever the market staged significant rallies. That resulted in raising additional cash in November and early January.

As usual, the first sign of change for the Meter was the Short Term Technical (STT) input. It rose to neutral in April as it was less weak than the indexes during the severe selloff into early March and showed strong improvement as the rally began. STT gained more strength in the following weeks, pushing it to +1 in early May.

In analyzing developing trends, we had noted for several months that Valuation could improve to neutral when estimates stabilized. We determined that was taking place in May, so it earned an upgrade to 0.

Looking further into current trends, another input that may improve is Economic (currently -1). Our Economic Expansion Checklist now shows 4 of 10 positive signals and continuation of current underlying trends would result in more positive signals and an upgrade. In addition, Technical Trends are on the mend and that indicator may also reach 0 shortly.

The Major Trend's 0 rating remains a longer term concern as the S&P 500 failed to reach a new inflation-adjusted peak at the 2007 nominal new highs and then fell to “lower lows” this year. We are wary of calling this a new secular Bull Market, but the improved Meter suggests the rally could last into the summer and run higher before it ends.

*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.*