WEEKLY MARKET REVIEW

Week ended December 11th

Focus Increasingly Turns to Exit Strategies

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Economic news was fairly scant last week and the broad equity indices were essentially flat. As the end of 2009 approaches, the markets are increasingly turning their attention to the challenges of 2010—especially to questions surrounding the federal government's "exit strategy" from its various economic and financial rescue programs.

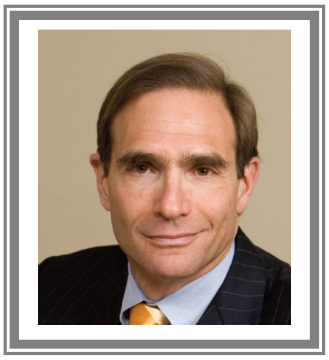
In late 2008 and early 2009, we saw a raft of initiatives, such as the Troubled Asset Relief Program (TARP), aimed at fixing the biggest, broadest problems facing the financial system. Later, we saw a number of programs designed to aid specific industries or sectors, including the "Cash for Clunkers" auto subsidy, and the first-time homebuyers' tax credit. As the financial crises began to recede, the federal government sought to help the business cycle get going again in order to create jobs and foster growth. Most recently, there's been talk of additional stimulus measures, including the possibility of redirecting unused TARP funds toward job creation and small business aid.

With a recovery underway, however, the Fed's exit strategy is taking on more immediacy. As growth returns and hiring resumes, the government will begin the task of unwinding many of the very costly measures it has put in place to shore up the economy and financial system. Though hiking rates will eventually be on the Fed's to-do list, it will also continue to scale back its quantitative easing program (i.e., printing money), and raising interest rates on bank reserves in an attempt to keep inflationary pressures at bay by preventing too much money from entering into circulation.

Minding the (budget) gap

The government will likely also have to start dealing with what is expected to be a roughly $1.5 trillion budget deficit—a subject that will be the focus of President Obama's State of the Union address early next year. Some market observers have questioned whether the U.S. could face a credit rating downgrade, as deeply indebted Greece did last week (Standard & Poor's also lowered its outlook for Spain).

Despite the size of our deficit, the U.S. is not in immediate danger of a credit rating downgrade although the country will face difficult decisions in the years ahead. Greece on the other hand has a much less dynamic



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For over 20 years, Dr. Webman has been involved in the investment and economic markets—as a researcher, a financial advisor and a portfolio manager.

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economy than the U.S., it doesn't control its own monetary policy, and it has a responsibility as an E.U. member to get its fiscal house in order. The U.S. has more flexibility. If it can't grow strongly enough to ease the deficit, it could inflate its way out of debt or devalue the dollar. There is no free lunch here though. A devalued currency, while providing support for the U.S. manufacturing base as exports become more competitive, brings a lower standard of living for the holders of the currency. Debtors, including American citizens holding U.S. Treasuries, will get every dollar they lent to the federal government back—but there's no telling what those dollars will buy when we get them back.

Much will depend on the U.S. growth rate. If it's too weak in 2010 and 2011, the country's debt-to-gross domestic product (GDP) ratio could be problematically high. The likely outcomes include a combination of higher taxes, scaled-back government-funded services and entitlement plans, and higher interest rates. Investors may wish to remain cautious on interest rate risk, including that of U.S. Treasuries and Treasury Inflation Protected Securities (TIPS).

Initial claims spike amid broad downtrend

Breaking a five-week string of declines, **initial claims** for unemployment benefits rose 17,000 to 474,000 in the week ended December 5. Seasonal factors may have played a role in the rise. In any event, jobless claims remain in a months-old overall downtrend. The four-week moving average dropped from 482,500 to 474,000.

That said, getting past peak unemployment in early 2010 won't do much for the 15 million under-employed Americans. Once businesses restock inventories and consumer backlogs ease, economic growth is likely to be milder than the robust recoveries of the past—probably 2–3%—due to deleveraging and pressures on the U.S. consumer. Add in a growing population, and, though we're likely at least to see a resumption of positive job growth in early 2010, full employment remains a distant prospect for quite some time.

Improving employment prospects are already having a positive effect on **consumer sentiment** and are likely to continue to do so. The Reuters/University of Michigan Consumer Sentiment Index rose to 73.4 in December from 67.4 in November. Consumers' views of current conditions improved more than for future expectations.

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Trade deficit narrows

The U.S. **trade deficit** narrowed to $32.9 billion in October from $36.5 billion the previous month, driven in part by the weak dollar, which lent support to exports. Exports, which grew 2.6% versus a 0.4% rise in imports, also benefitted from better overseas demand, a reflection of the global recovery. The U.S. also imported less petroleum in October than in September. Overall, the narrower trade deficit is accretive to fourth quarter GDP.

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