WEEKLY MARKET REVIEW

Week ended January 8th

Ten for 2010

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With 2010 now underway, it's time for the traditional economist's rite of listing prognostications for the New Year. So, out of respect for tradition, here are our top ten predictions for the global economy and financial markets:

1. A Continuation of Economic Growth
   The U.S. economy is likely to continue to accelerate though, given the excesses that remain in the system, breakout growth remains out of reach. A return to job growth should stimulate personal consumption, and industrial production should pick up as businesses fill the yawning gap between improved final demand and depressed inventory levels. Growth caused by an inventory bounce is often viewed as a one-time affair, but in fact restocking is likely to set off a cycle of renewed production, leading to further job creation, leading to further improvements in final demand, leading to more production—and on and on.

2. Fed Keeps Short Term Rates Low for the Long Term
   The Federal Reserve is likely to keep interest rates low for the long term, with any interest rate hikes coming with ample warning for the financial markets. Inflationary pressures remain at bay at least through 2010 as wage growth remains modest and businesses work below capacity. The Fed will complete its purchases of mortgage-backed securities in the first quarter, but will stand ready to take action should mortgage rates widen significantly.

3. Rising Treasury Rates
   While the Fed is scaling back its quantitative easing policies, will the private sector buy the mountain of new Treasury issuance at the low yields the Fed accepted? Supply is the enemy of price. Treasury rates will head higher in the U.S. A spike in Treasury yield, however, should prove self-limiting; 10-year rates approaching 5% will discourage borrowing, weaken commercial and residential real estate markets, and limit small business expansion, all of which could catalyze the return of quantitative easing.

Dr. Jerry Webman is Chief Economist for OppenheimerFunds, Inc. In this capacity, Dr. Webman provides strategic viewpoints on the overall financial and economic markets to investment management and the financial advisor and investor communities.

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.

Dr. Webman holds a B.A. in political science, with honors, from the University of Chicago, where he graduated Phi Beta Kappa, and a Ph.D. in political science from Yale University. He is also a Chartered Financial Analyst.

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4. **Credit Risk over Interest Rate Risk**
   Rising Treasury rates are bad news for interest rate risk but good news for credit risk. Spreads will continue to tighten in senior bank loans, high yield corporate bonds and lower-rated municipal bonds as investors gain confidence in the economy and reach for yield.

5. **Dollar Support…But Not Against All Currencies**
   As U.S. growth leads that of other developed economies, the dollar is likely to rally against the yen and the euro, providing support to the export-driven economies of Japan and the Eurozone. Emerging market central banks will tighten in tandem with, or even before, the U.S. Federal Reserve Board, providing support for emerging market currencies, especially as China tightens policy (see #8).

6. **Cyclical Stock Rally in U.S. Has Legs, but Fades By The End of the Year**
   The cyclical bull rally in the S&P 500 Index is likely to continue through the first half of 2010, but the rally may lose steam in the second half of the year, as concerns about long-term growth prospects and mounting public debt unnerve investors. For the year, U.S. equities should post modest gains. The biggest winners will be companies that can finance themselves internally and out-earn the improving expectations for the index averages.

7. **Emerging Market Equities Pullback**
   High-flying emerging market equities may pull back as valuations become extended. The prerequisites for investor over-exuberance are evident—global interest rates are low, there is a yawning gap in growth potential between the emerging and the developed world, pegged exchange rates are creating imbalances, and market volatility is modest. Any pullback will likely represent a longer term buying opportunity.

8. **China Reduces Highly Stimulative Credit and Currency Policies**
   As growth accelerates and inflation threatens, China will scale back credit for public investment projects. Officials will likely allow gradual currency appreciation to resume. A stronger yuan will support domestic consumption and ease foreign trade imbalances. It could also allow other emerging market currencies to continue appreciating against the U.S. dollar.

9. **Federal Regulatory Reform Progresses**
   With the inglorious conclusion of the federal healthcare debate, Congressional attention will return to re-regulation of financial markets and institutions. Expect restrictions on derivatives, increased capital requirements and stricter regulation of home mortgage lending. Although Senate Banking Committee Chairman Chris Dodd's resignation provides a layer of political insulation, continued uncertainty inhibits financing while the Washington legislative machine cranks on.

10. **I Pray Not, but….**
    Political instability in regions that house radical activists raises the probability of significantly disruptive geopolitical events. As a result, security concerns need to continue to play a role in our future planning—including financial planning.

Turning our attention from the future to the immediate past, last week we saw stocks begin the year with decent gains, though an important employment report was less than spectacular.

Employment data disappoints

Non-farm payrolls fell by 85,000 in December, signaling that businesses are still cautious about hiring. The unemployment rate was unchanged at 10.0%. The report contained few bright spots, with the government shedding 21,000 jobs, the manufacturing sector cutting 27,000 and construction employment falling by 53,000. Professional and business services, however, added 50,000 jobs. Many of these were temporary positions, which are often a precursor to full-time hiring. Additionally, November's payroll numbers were revised higher, to a gain of 4,000—the first positive result in nearly two years.

I am particularly concerned about the household employment data that continues to paint a distressing structural picture of long-term unemployment, underemployment, and a decline in labor force participation. In order to be optimistic about the next stage of the business cycle I would like to see previously discouraged workers rejoin the workforce and find employment. We're not there yet.

Separately, **initial claims** for unemployment benefits were nearly flat, rising 1,000 to 434,000 in the week ended January 2. The smoother four-week

moving average continued to decline, however, hitting 450,250—its lowest level since September 2008.

Ultimately, the December payrolls report does not change our view that employment growth is likely to turn positive in the first quarter of 2010. Businesses have been trying to do more with less, and have succeeded to a large extent. Given the anticipated economic growth in the U.S. and overseas, however, new hiring and industrial production will most likely need to rise in order to meet final demand.

Manufacturing continues to outstrip services

The Institute for Supply Management's (ISM) **Manufacturing Index** rose to 55.9 in December from 53.6 in November, indicating solid expansion in the sector, which has so far led the economy out of recession. New orders were strong at 65.5, a sign of continued manufacturing growth in the months ahead. Data on delivery times and inventories show that manufacturers have their hands full keeping up with rising demand, which bodes well for future hiring activity, despite December's disappointing decline.

The much larger services sector continues to lag manufacturing, but is once again in growth territory. The ISM's **Non-manufacturing Index** rose a modest 1.4 points to 50.1 in December, just over the 50-point threshold between expansion and contraction. Unfortunately, new orders, while slightly up, registered their slowest increase in four months.

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