

Tipping Point

By Mark Luschini, Chief Investment Strategist

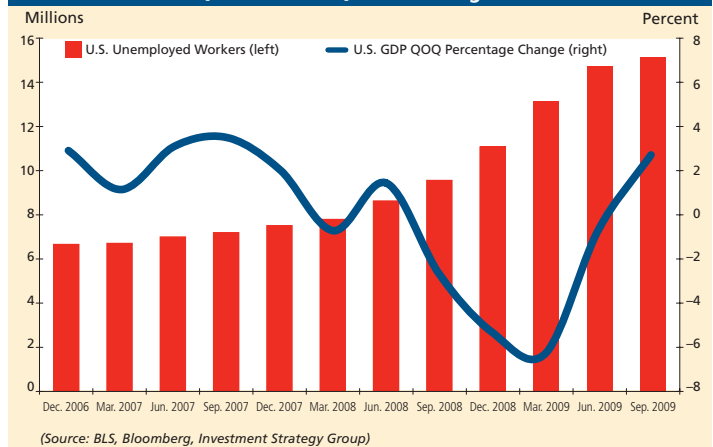


The economic recovery is now almost two quarters old following an abysmal and abnormally long recession. GDP in the U.S. grew at a 2.8 percent annualized pace in the third quarter and the same statistic will show the expansion continued through the fourth quarter. (See Chart A, U.S. GDP Quarter-Over-Quarter Change). Certainly any growth is welcome after a period of economic decline that was unlike anything we have seen in the last quarter century. However, of concern at the moment is the level of unemployment in this country and what is going to be required to restore this level to something approaching the 5 percent rate of just two years ago. An important factor to a sustainable recovery in the labor market is economic growth that is sufficient to absorb those seeking employment back into the workforce.

Some recent signs have been encouraging. Claims for unemployment insurance have been declining steadily and the number of temporary workers being hired has been increasing. Both are often leading indicators of a turnaround for labor, the least of which indicates that the pace of job losses is slowing, leading some to speculate that net job gains may be in the offing sometime in just the next several months. The risk in assessing that forecast is to extrapolate from it that employment will then grow steadily in 2010 if the economy continues to improve. It is generally held that the U.S. economy needs to expand at an annual rate of roughly 3 percent in order to create something on the order of 100,000 to 125,000 jobs a month through an increase in business activity. That number is in parity with the typical churn in job gains and losses and is enough to absorb those coming into the workforce for the first time—college graduates and the like. A 3 percent growth rate is about average for the economy over many years. The situation facing authorities today is not only to pull the right levers to get the economy to establish durable economic growth but also to accelerate the pace of it in order to absorb the millions of Americans who have lost their jobs in the last couple of years as a result of the recession. Stimulus efforts have helped to produce a recovery although it is difficult to decipher how much of it is due to natural forces of pent-up demand and increased albeit weak consumption versus the artificial fiscal and monetary efforts to “do whatever it takes” to reflate activity. The problem, and the reason behind the coordination of a “Jobs Summit” at the White House as well

as the catalyst for calls by some for a second stimulus package, is that a little more than 15 million people are unemployed at the moment and the current pace of the economic expansion is not strong enough to bring that number down with any vigor. The byproduct of a muted recovery is an unemployment rate, which is currently at a 26-year high of 10.2 percent, lingering higher for much longer than anyone is comfortable with, especially the elected officials charged with finding ways of creating jobs for their respective constituents.

Chart A: U.S. GDP Quarter-Over-Quarter Change



One official facing reappointment is Federal Reserve Chairman Ben Bernanke. Congress will have its day to pepper Mr. Bernanke about the role the Federal Reserve is playing in triaging the financial markets and its efforts to resuscitate the economy. In the meantime, however, Mr. Bernanke has been public about the Fed’s position to keep interest rates accommodative and while forecasting growth in the economy next year did say, “Some important headwinds—in particular constrained bank lending and a weak job market—likely will prevent the expansion from being as robust as we would hope.” The aspect of limited access to credit and its impact in the labor market hits right where it matters most—

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small businesses where 70 percent of America's workers are employed. In a survey recently conducted by Toluna Research, two-thirds of small business owners said that they are concerned or extremely concerned about their companies surviving the next two years. Another survey reported that 50 percent of small business decision-makers won't start hiring again for another six months. With loan activity restrictive, small businesses which as a group rely heavily on bank financing, are being tapped out of their source of funding. That constrains the flexibility of these firms causing them to be hyper-cautious about plans to hire. These conditions, combined with statements from the Fed confirm our outlook for a more tepid growth rate than what might have been expected when compared to recoveries from previous recessions. That in turn means the number of those unemployed will remain elevated for some time, putting additional pressure on domestically-oriented businesses that rely on a vibrant consumer to fuel revenues.

The last payrolls report of the year was printed on December 4th and is being scrutinized for indications that the job market is stabilizing and the peak in unemployment has been reached. At this point expectations are for payrolls to decline by 120,000 from the 190,000 drop the previous month. If that holds and the unemployment rate stays steady, market participants will be encouraged that the momentum in the economy right now will carry over to next year. Without economic news that points to GDP growth increasing its clip above its current run rate, however, the Jobs Summit needs to produce ways to boost employment in order to overcome the "headwinds" Mr. Bernanke identified and that which we suspect will likely prevail for some time. ■

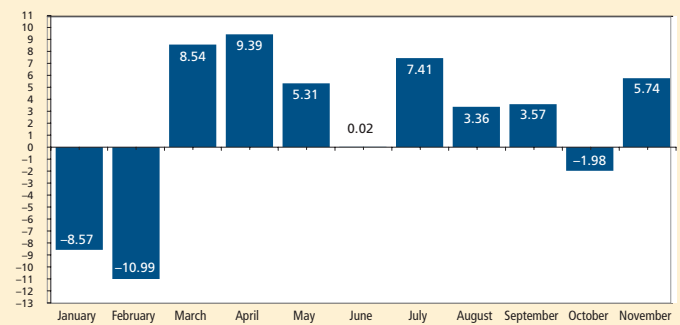


A New Decade— A Brighter Outlook

By Gregory M. Drahuschak, Market Strategist

After starting 2009 with two-straight monthly losses, in the ensuing nine months the S&P 500 posted a gain eight times. The S&P's 5.74 percent gain in November was the index's best performance for the month since 2001 and the 10th best since 1950. (See Chart B, Monthly S&P Percentage Gain or Loss).

Chart B: Monthly S&P 500 Percentage Gain or Loss



(Source: Standard & Poor's and Janney)

The Materials sector was the runaway winner in November, thanks largely to weakness in the U.S. dollar. This same factor, however, did not impact the Energy sector as favorably. All 10 sectors ended the month higher. (See Chart C, S&P 500 Sector Results).

Chart C: S&P 500 Sector Results (%)

Sector	MTD	QTD	YTD
S&P 500	5.74	3.65	21.30
Materials	11.34	5.41	43.21
Health Care	9.01	6.49	14.87
Industrials	8.68	3.61	15.97
Consumer Discretionary	6.73	4.08	33.00
Telecommunication Services	6.38	1.23	-1.86
Information Technology	5.01	4.60	51.46
Financials	4.22	-2.07	16.72
Utilities	4.17	0.83	1.51
Consumer Staples	3.82	4.91	11.94
Energy	2.85	6.09	12.40

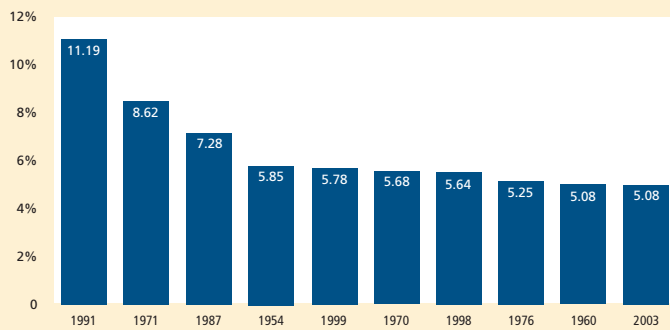
(Source: Standard & Poor's and Janney)

It is difficult to discuss stock market prospects for December without mentioning the month's long-standing role on average as the best month for stocks. In nearly 75 percent of Decembers from 1950 through 2008 the S&P 500 has produced a gain. The overall result for all Decembers is a 1.6 percent gain. When December is an up month for stocks, the S&P posts an average 2.87 percent gain.

This December, however, might get more attention than the typical final month of the year. On December 31st the decade will come to a close at which point there will be numerous retrospective stories on how the market fared through the decade. Barring a major advance this month, the S&P 500 will close out its first losing decade ever.

The S&P 500 faces the daunting task to avoid the first-ever losing decade. It would have to post a precedent-setting December gain of 12.14 percent. The S&P 500 produced a monthly gain in excess of this only once—in January 1987—when it gained 13.46 percent, but the closest it has come in December was an 11.19 percent gain in 1991. (See Chart D, December Gains).

Chart D: December Gains



(Source: Standard & Poor's and Janney)

The market's rebound from the March low has turned investor sentiment much more optimistic. This clearly is evidenced by data compiled by Investors' Intelligence in which bullish sentiment has improved considerably above where it was nine months ago. The renewed optimism is rooted in data from Federal Reserve districts, the Bureau of Labor Statistics and other sources of economic data. The summer's economic "green shoots" have grown, and now investors are looking for the time when the shoots turn to blossoms that eventually bear fruit.

The most important sign of optimism bearing fruit would be a swing in the employment data to showing job growth rather than merely a lesser rate of loss. The December 4 report on non-farm payrolls showing a loss of only 11,000 jobs clearly was a major positive. Nonetheless, we suspect actual job gains are a mid-2010 event, but the market will not wait

to see those numbers. Instead it will do what we believe it has been doing, which is advancing long before positive job data are available.

December has always had tax issues to set aside. Traditionally, the majority of institutional tax selling is complete by the middle of the month. Until then bouts of selling to settle the tax tally could negatively impact the market.

Fiscal policy initiatives in Washington, like healthcare and taxation legislation, could shake the market's growing confidence.

The U.S. dollar has been a major catalyst pushing commodity-based equities higher. While we do not see the dollar staging more than a countertrend rally, any upswing in the U.S. currency will weigh on stocks. Long-term a better value for the dollar would be good, but for the moment even a modest change in direction could prompt a market sell off. Gradually traders will be looking for stocks that have underperformed the S&P 500 on the basis that these stocks could try to catch up with the average. At the end of November, 253 of the 1500 stocks in the Standard & Poor's universe had underperformed the S&P 500 by 30 percent or more. Looking through a list like this requires careful examination since the underperformance could be based on weak fundamentals, but within a list this large there are undoubtedly stocks that simply have been ignored for no good reason. As we move through December, tax selling may further depress some issues. Once that process is out of the way a rebound could be ahead for some of 2009's laggards.

We are impressed by the market's resilience in recent months, particularly the way the market has cast bad news aside. This, however, does not leave us in a holiday-style giddy mood. Good quality stocks have moved higher, but we believe a theme in 2010 will be that quality has not received its due. We think it will at the expense of high beta stocks with less than pristine fundamentals. This is likely to focus market attention on larger capitalization stocks that have the best balance sheets, strongly recurring revenues and amply covered dividends.

Short-term, we would pay attention to the 50-day moving average of the S&P 500. As long as the S&P remains at or above its moving average (approximately 1075 early this month) interim downturns would not alter the market's upward bias. A convincing break of the moving average would only extend the time the market needs to reach its peak for this cycle. ■

2009 Index Performance

2009 Market Data		Prior Close	Last	Change	% Daily	% Yearly	% Jan	% Feb	% Mar	% Apr	% May	% June	% July	% Aug	% Sep	% Oct	% Nov	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter
DJ Industries	.DJIA	10309.92	10344.84	34.92	0.34	17.87	(8.84)	(11.72)	7.73	7.35	4.07	(0.63)	8.58	3.54	2.27	0.00	6.51	(13.30)	11.01	22.47	6.51
S&P 500	SPX	1091.49	1095.63	4.14	0.38	21.30	(8.57)	(10.99)	8.54	9.39	5.31	0.02	7.41	3.36	3.57	(1.98)	5.74	(11.67)	15.22	19.18	3.65
NASDAQ Comp	COMP	2138.44	2144.60	6.16	0.29	35.99	(6.38)	(6.68)	10.94	12.34	3.32	3.42	7.82	1.54	5.64	(3.64)	4.86	(3.07)	20.05	16.87	1.05
SOX Index	SOX	309.82	310.05	0.23	0.07	46.13	(1.84)	(5.11)	13.89	9.63	7.86	(3.01)	14.66	1.47	6.39	(8.95)	4.53	8.14	14.69	17.82	(4.82)
Biotech Index	BTK	885.61	888.15	2.54	0.29	37.24	(1.95)	(6.01)	7.55	(0.69)	1.83	7.47	24.83	6.35	(0.29)	(11.04)	8.17	(0.88)	8.69	27.39	(3.76)
DJ Transports	.TRANS	3922.84	3937.89	15.05	0.38	11.33	(16.16)	(15.73)	7.40	17.14	1.85	1.00	10.68	2.43	3.62	(4.91)	8.98	(24.12)	20.51	21.74	3.63
DJ Utilities	.UTIL	375.71	379.20	3.49	0.93	2.28	(0.29)	(12.37)	1.67	1.47	2.03	4.93	3.26	1.05	1.04	(3.76)	4.45	(11.16)	8.63	5.98	0.52
Volatility Index	VIX	24.85	24.51	(0.34)	(1.37)	(38.73)	12.10	3.37	(4.77)	(17.31)	(20.77)	(8.89)	(1.63)	0.35	(1.54)	19.84	(20.14)	10.35	(40.30)	(6.98)	(4.30)
S&P Midcap 400	MID	683.79	684.77	0.98	0.14	27.21	(7.36)	(9.87)	9.75	13.76	2.56	0.46	8.63	4.22	5.57	(4.61)	3.89	(8.36)	17.21	18.44	(0.90)
S&P 100	.OEX	508.98	510.74	1.76	0.35	18.35	(9.33)	(11.01)	8.37	7.59	5.31	0.49	7.12	3.14	2.87	(1.24)	5.89	(12.56)	13.86	18.87	4.58
Gold ETF	GLD	115.06	115.64	0.58	0.50	33.66	5.54	1.45	(2.54)	(3.33)	10.23	(5.22)	2.38	0.05	5.84	3.72	12.79	4.35	1.00	26.83	16.99
Russell 1000 Index	.RUI	596.26	598.41	2.15	0.36	22.68	(8.29)	(10.67)	8.52	9.95	5.27	0.06	7.49	3.40	3.90	(2.32)	5.63	(11.09)	15.82	19.14	3.18
Russell 2000 Index	.RUT	577.21	579.73	2.52	0.44	16.07	(11.20)	(12.29)	8.67	15.53	2.88	1.34	9.53	2.76	5.63	(6.87)	3.01	(15.36)	20.23	14.06	(4.06)

(Source: Standard & Poor's)

Short Term

By Guy LeBas, Chief Fixed Income Strategist



One of the roles we're constantly tasked with is identifying value within the fixed income universe. Twelve months ago, as the capital markets were in a state of advanced deterioration, that role was almost easier than at any point in history: while the markets were fraught with risk, they were also fraught with opportunity. Today, although both long- and short-term Treasury interest rates are close to their year-ago levels, yields in the agency, mortgage, corporate credit and municipal markets are all far lower. This tightening in spreads between Treasuries and riskier asset classes provided remarkable returns for investors willing to take advantage of year-ago levels, but it also reduced the opportunities available in the debt markets today.

Against this backdrop, not only has identifying value within the debt markets become more challenging, it has also become more important. Our current approach is a conservative one, but there is one major underutilized opportunity that can enhance returns several fold with a modest increase in portfolio risk. Specifically, we suggest extending the ultra short-term (i.e., "cash") portion of portfolios into 1.5 – 2.5 year agencies and CDs in order to capture substantially higher returns. As we anticipate little upside for short-term interest rates in the coming year, this trade can add to income while maintaining limited credit and interest rate risk.

Short-term yields have been very much constrained since the beginning of September. Since that period, the two-year Treasury has only traded above a 1 percent yield on two days, and, in subsequent months, fell below even 0.65 percent. After bouncing off of this 1 percent threshold in late October, yields on the two-year Treasury note have remained very much constrained. Moreover, that trading range is echoed, albeit somewhat more loosely, in the period between the beginning of February and early November. Ultra short-term money market-type yields have meanwhile remained even more compressed, with the three-month Treasury bill having traded below a 0.20 percent yield since April. The bottom line

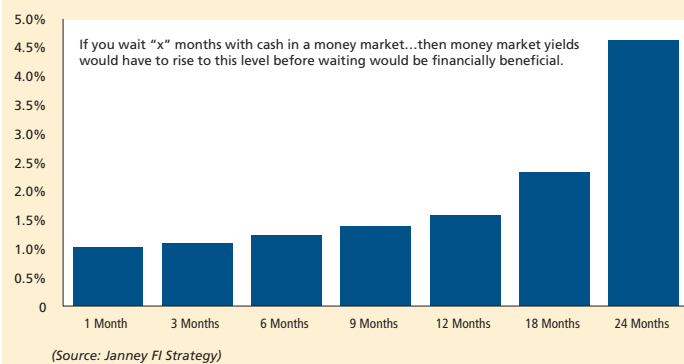
is that, despite talk of shifting Federal Reserve policy and a resulting potential for rising interest rates, the markets are pricing a high probability of stable rates for an extended period, particularly on the short end.

The November FOMC meeting represented a pivotal point in the Fed's plan for monetary policy. With evidence of economic recovery clear in third quarter growth data, Fed policymakers had a clear opportunity to revise or eliminate their expectations of maintaining low interest rates for "an extended period." The fact that the FOMC elected to maintain that language and barely even temper it suggests that monetary policy will remain expansionary well into 2011. Expectations for future inflation meanwhile continue to creep lower, thanks largely to anemic aggregate demand. Low interest rates and limited inflation for a period lasting two years suggests that there's value in terming out the ultra short-term portion of portfolios to the 1.5 – 2.5 year range.

Given that the ultra short-term and cash equivalent portion of portfolios generally has no loss tolerance, our focus on redeploying the fund remains on extremely high credit quality instruments, namely government and agency securities with fixed maturity dates. That narrows the investment focus to four primary asset classes: fixed rate Treasuries, TIPS, agencies and FDIC-insured investments. Fixed rate Treasury yields remain depressed by the liquidity bid and we dislike shorter term TIPS at this juncture, as nearly every instrument shorter than 2013 maturity has been bid up to negative real yields, and volatile CPI results introduce downside risk to nominal returns. That leaves agency debt and FDIC-insured paper, including CDs and TLGP debt (corporate debt insured by the FDIC) as the most attractive options for terming out ultra short-term money. In agency debentures, short maturity callable notes with 1.5 year maturities with short-term calls offer the most attractive limited credit risk income opportunities. For CDs and FDIC-insured debt, extending slightly beyond the 1.5 year mark to the 2 – 2.5 year part of the curve can provide an additional 0.30 percent pickup.

With money market rates at 0.10 percent, and a 2.5 year CD yielding 1 percent, short-term interest rates would have to rise 1.20 percent in the next six months before it would be financially advantageous to hold money market investments over that 2.5 year CD. This concept is often referred to as "the cost of waiting," and despite the absolute low level of interest rates, that cost is extremely high in the present environment. If there's one area of value in the fixed income markets, it's this simple one: pushing out the ultra short-term portion of portfolios into 1.5 – 2.5 year CDs and agencies can provide a significant return advantage without sharply increasing risk. (See Chart E, The Cost of Waiting). ■

Chart E: The Cost of Waiting



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