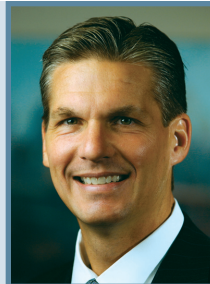


## What's in Your Wallet?

By Mark Luschni, Chief Investment Strategist



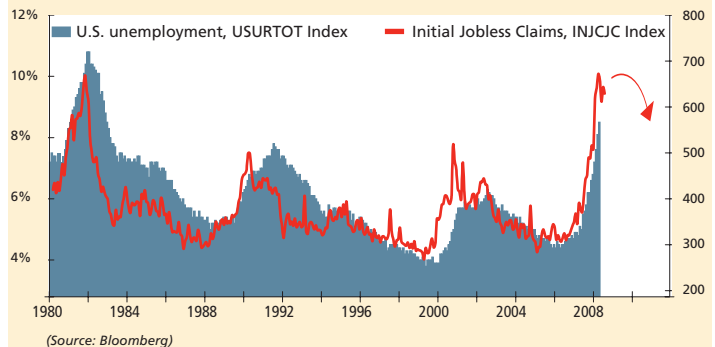
Over many decades the spending behavior of consumers has been an important factor contributing to our country's economy. Historically, consumption represented approximately 63% of Gross Domestic Product (GDP)—a measure of the economy's economic performance. However, that portion reached a record 70% this decade and remains near that level today. Therefore, the consumer sector is dominating the economy. So, if consumers are languishing, the economy should not be expected to do well. At the moment, it seems that consumers face several sizeable financial hurdles that would need to be overcome before spending glides significantly higher—pulling our economy along with it.

The key drivers of disposable income—the amount of income an individual has left after taxes—are the trends in employment and wages. The prospects of the tax cuts enacted in 2003, which are set to expire after 2010, and larger fiscal deficits that pose a threat to future tax rates, will ultimately result in some friction against spending but that issue is less immediate. What is known at this juncture is that the weak business climate has trimmed payrolls by some 5.1 million jobs since the recession began in December 2007. While employment figures will likely show continued job losses for some time to come, recent data on initial unemployment claims have hinted that the pace of the deterioration in the job market is slowing. As illustrated in the accompanying chart (Chart A), that is an important signal because it generally leads the turn in the job market. Interestingly, albeit a tad assumptive for comparisons to this period, the previous three recessions ended within weeks after the number of applications for unemployment benefits started to wane. As a side bar, declining claims for unemployment insurance often coincide with an improving stock market.

Consumer spending is also predicated upon income from wages, which attributes to roughly 60% of household earnings and 40% from Social Security, unemployment insurance and tax refunds. Signs here are mixed. According to the Labor Department, worker compensation rose 0.3% in the first quarter from the last three months of 2008, an improvement but still the smallest quarterly gain since the government began tracking the figure in 1982. The government's fiscal stimulus program, which among other things lowers tax withholding for most workers, is also expected to help in the coming months.

More subtle, but not inconsequential, is the incremental benefit households are realizing through reduced energy costs and lower mortgage rates. Using the Commodity Research Bureau's Index as a proxy for prices paid per capita on commodities ranging from soy, wheat and corn to natural gas and oil, it is estimated that the annualized savings from the peak in prices

Chart A: U.S. Employment Figures



in July 2008 is \$6,000 for a family of four. Additionally, the huge decline in mortgage rates (Chart B) that has prompted a massive amount of refinancing activity is expected to free \$10 billion or more through lower monthly mortgage payments. The savings from these events will help to de-lever the balance sheets of households, setting the stage for consumers to be in better financial position to consume more freely in the years ahead.

Meanwhile, consumer spending declined 0.2% in March from the prior month. At the same time savings rose from 4.0% to 4.2%. Cautious consumers seem to be applying a regular portion of disposable income to savings. This rate could rise further—it averaged 7.5% since 1929—if households try to repair lost wealth. To restore their net worth to mid-2007 levels, households would have to save or gain almost \$13 trillion through the appreciation of asset values.

Spending will probably linger as incomes remain under pressure on a number of fronts. Policymakers fully understand this and plan to compensate by dramatically increasing the government's borrowing and spending.

Ultimately, the path of consumer spending remains uncertain but it is quite possible everything will fall into place. Some combination of cheaper credit, higher stock prices, better job market conditions and improving confidence could reinforce each other. For the first time in many months there are actually some positive attributes to the economic outlook balancing the scales against the remaining downside risks. ■

Chart B: Conventional 30-year Mortgage Rate



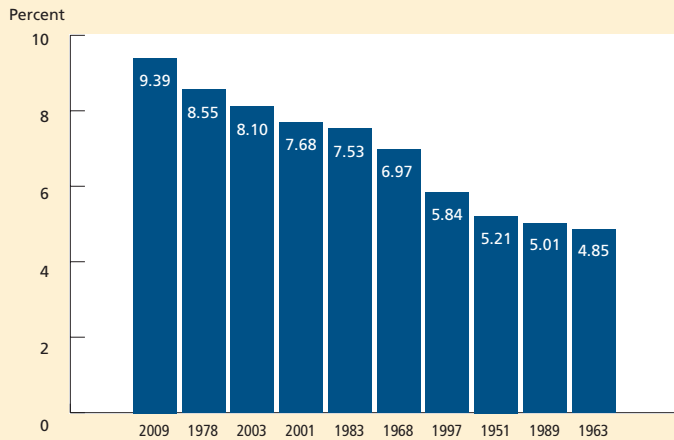


## Winds of Change

By Gregory M. Drachusak, Market Strategist

Last month, we noted that prospects for this April were appealing. In 27 of the 38 previous years in which the S&P 500® posted a March gain, April followed with a gain. This April made it 28 of 39 years with the S&P 500 posting a 9.39 percent gain—the best April result in the last 59 years (Chart C).

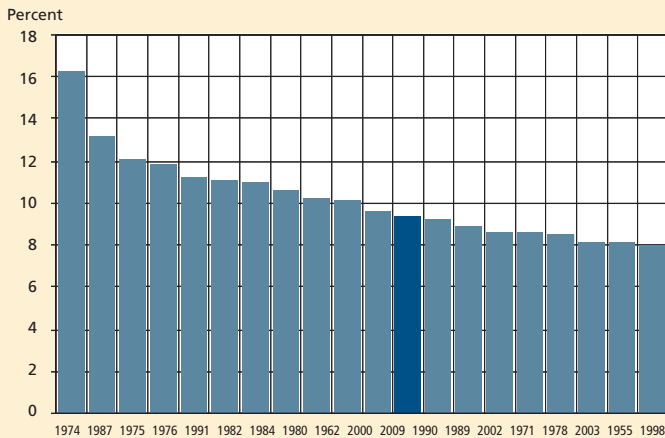
**Chart C: Best Aprils**



(Source: Janney Montgomery Scott)

This April's performance for the S&P 500 was even more impressive when you look at it relative to all 700 months since 1950 (Chart D). In this context, April 2009 was the twelfth best month.

**Chart D: 20 All-Time Best Month Gains**



(Source: Janney Montgomery Scott)

In late March, the market began to embrace the notion that the rate of decline in economic data has slowed, and in some cases stopped. That thinking continued into April as many economic measures fell at a slower pace. A few actually rebounded. Even housing offered hints that the erosion in sales and prices that has extracted a significant toll on consumers and banks was nearing an end.

The most interesting report might have been the most recent release of the Philadelphia Federal Reserve Index (Chart E). After a steady and precipitous decline that started as far back as June 2007, and began accelerating dramatically last September, the Index in recent months has flattened out.

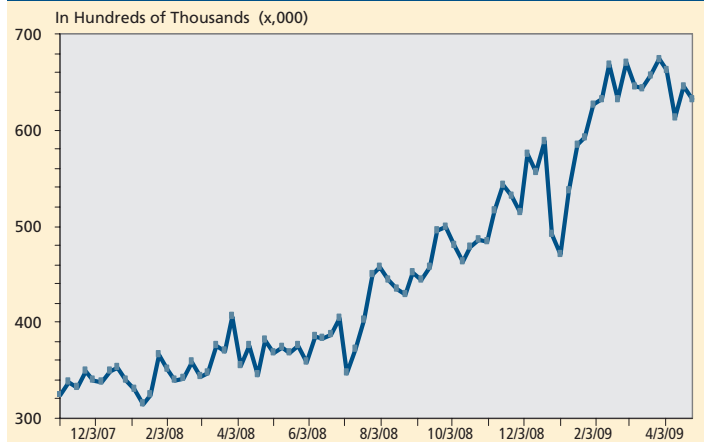
**Chart E: Philadelphia Federal Reserve Index: January 2003–March 2009**



(Source: Philadelphia Federal Reserve)

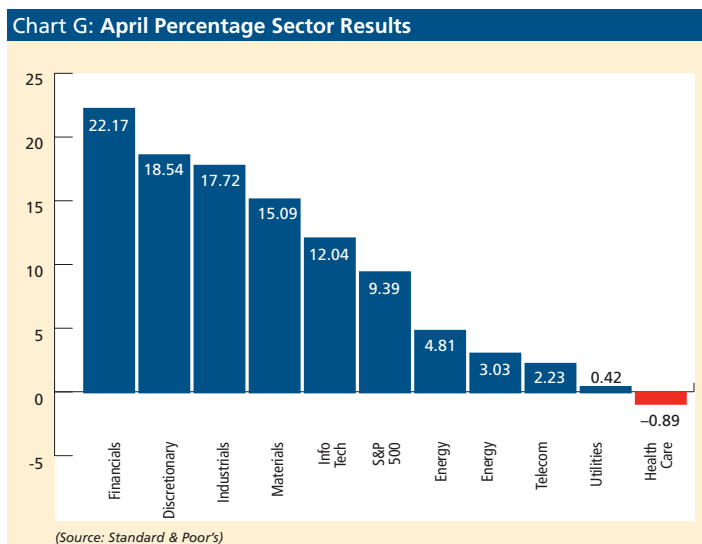
Weekly unemployment claims are suggesting that the worst of the economic decline may be close at hand as the data seem to have peaked (Chart F).

**Chart F: Weekly Initial Unemployment Claims**



(Source: U.S. Department of Labor)

Not surprisingly, the financial sector led in April from the March market low (Chart G). But moderation in economic data allowed many economically sensitive sectors to also do well.



Years ago, famed economist John Kenneth Galbraith made his sentiment about economic and stock market forecasting well known when he said, "We have two classes of forecasters: Those who don't know ... and those who don't know they don't know." We fall into the first category. We know that we do not know with certainty where the market is headed, however, we think there are some hints of possible market movement. The rally from the March low has been vigorous in point and percentage terms, but it has been accomplished only with moderately good market breadth and moderate volume.

The market has largely responded to a lessening degree of negative media coverage rather than improvements in economic data. Earnings for a majority of companies have beaten expectations, but the bar was set so low that leaping over it was not difficult. The market's streak of weekly gains from the March low through the end of April would normally suggest a period of consolidation or an interim correction is due. We think, however, assessing what an appropriate level for the S&P 500 should be, rather than trying to guess its near or intermediate-term path, is more important.

Considering the market's valuation level, possible earnings for the S&P 500 and the market's technical condition, we think the S&P 500 should trade to 1000 at some point this year. We would not rule out 1100 as a possible target if the economy shows actual improvement. In terms of the Dow Industrial Average, this equates to 9000 and 9500. Our expectation, in turn, suggests that if the market does encounter a round of profit taking, buying into the pullback makes sense with an eye on taking profits during the recovery.

A major question for many investors is whether the market already has embarked on a new bull market. On this score, we suspect this is not the start of a new bull market, but rather a potentially significant rally. We would be cautious about being overly exposed to the retailing group due to the move it already has had. In addition, beyond the immediate impact of the stimulus program, consumer spending will be constrained for a potentially extended period.

In sum, the March low was most likely a meaningful bottom for the market and over the coming months, higher-than-present levels are likely. However, without clear evidence of sustainable economic improvement, not merely a slower rate of deterioration, getting beyond the S&P 500 objectives noted earlier could take significantly longer. ■

## 2009 Index Performance

2009 Market Data		Prior Close	Last	Change	% Daily	% Yearly	% Jan	% Feb	% Mar	% Apr	1st Quarter	2nd Quarter
DJ Industries	.DJIA	8185.73	8168.12	(17.61)	(0.22)	(6.93)	(8.84)	(11.72)	7.73	7.35	(13.30)	7.35
S&P 500	SPX	873.64	872.81	(0.83)	(0.10)	(3.37)	(8.57)	(10.99)	8.54	9.39	(11.67)	9.39
NASDAQ Comp	COMP	1711.90	1717.30	5.40	0.32	8.90	(6.38)	(6.68)	10.94	12.34	(3.07)	12.34
SOX Index	SOX	246.67	251.55	4.88	1.98	18.56	(1.84)	(5.11)	13.89	9.63	8.14	9.63
Biotech Index	BTK	653.29	637.03	(16.26)	(2.49)	(1.57)	(1.95)	(6.01)	7.55	(0.69)	(0.88)	(0.69)
DJ Transports	.TRANS	3106.41	3144.15	37.74	1.21	(11.11)	(16.16)	(15.73)	7.40	17.14	(24.12)	17.14
DJ Utilities	.UTIL	334.37	334.20	(0.17)	(0.05)	(9.86)	(0.29)	(12.37)	1.67	1.47	(11.16)	1.47
Volatility Index	VIX	36.08	36.50	0.42	1.16	(8.75)	12.10	3.37	(4.77)	(17.31)	10.35	(17.31)
S&P Midcap 400	MID	561.68	561.14	(0.54)	(0.10)	4.25	(7.36)	(9.87)	9.75	13.76	(8.36)	13.76
S&P 100	.OEX	406.89	406.00	(0.89)	(0.22)	(5.92)	(9.33)	(11.01)	8.37	7.59	(12.56)	7.59
Gold EFT	GLD	88.33	87.27	(1.06)	(1.20)	0.87	5.54	1.45	(2.54)	(3.33)	4.35	(3.33)
Russell 1000 Index	.RUI	477.01	476.84	(0.17)	(0.04)	(2.24)	(8.29)	(10.67)	8.52	9.95	(11.09)	9.95
Russell 2000 Index	.RUT	491.47	487.56	(3.91)	(0.80)	(2.38)	(11.20)	(12.29)	8.67	15.33	(15.36)	15.33

(Source: Standard & Poor's)

## The Inflation Factor & TIPS

By Guy LeBas, Chief Fixed Income Strategist

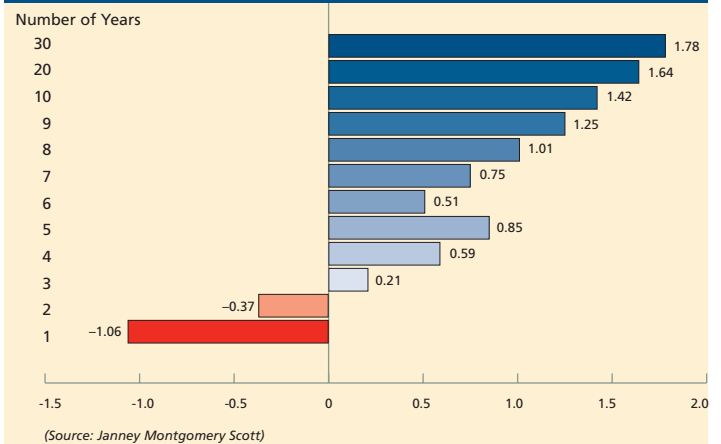


For the second time in just ten months, inflation is becoming a growing concern for the investment community. In mid-2008, rapidly rising oil and commodity prices drove investors' concerns. Today, government spending and Federal Reserve policies are behind the bulk of unease, though we disagree that the Fed's actions are likely to risk significantly higher prices. The concept that money-printing leads to inflation is inherently false if it fails to consider the price environment that gave rise to it in the first place. Encouraging inflation when native conditions are deflationary is not necessarily a road to significantly higher long-term prices. What's more concerning about the inflation outlook is a topic that's largely fallen by the wayside over the course of the last year. Between mid-July 2008, when prices peaked at more than \$145, and April 9, 2008, the cost of a barrel of oil plunged 64%, which is a decline more than twice as severe as that of the S&P 500. Base metals prices trended similarly. While lower commodities costs aren't exactly a driver of higher inflation, the volatility of these prices highlights the potential that future shocks could risk increases in overall price levels. The potential for greater demand from rapidly growing nations, including most notably China and India, for oil and steel, represent a risk that could generate inflation in the intermediate to long term.

Despite these potential commodity pressures, the financial markets have only priced in limited inflation expectations. Arguably the best indicator of inflation expectations is a metric called an "inflation breakeven," the most consistent form of which is calculated by subtracting the yield on a Treasury Inflation-Protected Security (TIPS) from the yield of a maturity-like fixed rate Treasury note or bond. Since TIPS' returns adjust for inflation, this breakeven represents the level of inflation required for the yield on a TIPS to be equal to the yield on a Treasury note. Considering that TIPS and Treasury notes/bonds are of the same credit quality and similar liquidity, the markets should, in theory, price the securities with equal expected yields. While there are some technical factors that can bias TIPS breakevens, these inflation metrics are the most easily available and most consistent indicators of market expectations. As the chart indicates (Chart G), those expectations remain relatively subdued, despite pressures facing price levels. Inflation expectations over the next decade are only approximately 1.4% per year, while over shorter periods, the breakevens are still pricing in expectations of deflation.

Hedging the risks of unexpected inflation in investment portfolios can take a range of forms. The first, and perhaps simplest-to-understand inflation-hedging instrument, is investment in commodities, either directly through funds, or through the futures market. Particularly if, as we believe, future inflation is a commodity-driven phenomenon, this type of strategy will provide a reliable hedge for higher prices. The downside,

Chart H: Inflation Breakevens



however, is that commodities ownership is capital intensive, especially considering they're not an income-producing investment. A second common category of an inflation-hedging investment involves owning the equity of companies whose business is highly correlated with price levels, such as mining companies with significant metals reserves. While such investments are more likely to provide a return on capital even if commodities prices don't rise, they're a less-than-ideal hedge against inflation because non-inflation factors can affect operating performance, and therefore investor returns. The third major category of capital markets inflation hedges is securities whose returns are directly linked to inflation, including commodity-linked CDs and notes, CPI floaters (bonds whose coupons vary according to the consumer price index) and TIPS.

Of these three inflation-linked securities, we view TIPS as the *most* efficient and *most* liquid way to hedge the risk of unexpected future price increases. More specifically, given the liquidity and pure-play nature of TIPS as an inflation hedge, we hold an overweight recommendation on the TIPS sector, and specifically those TIPS in the 7 to 20-year range that have lower index ratios. An interesting fact about TIPS is that, in many cases, it doesn't take increases in inflation for the sector to outperform; increases in the market's inflation expectations are enough to drive TIPS market prices higher. ■

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