

Investment Outlook

January 2010

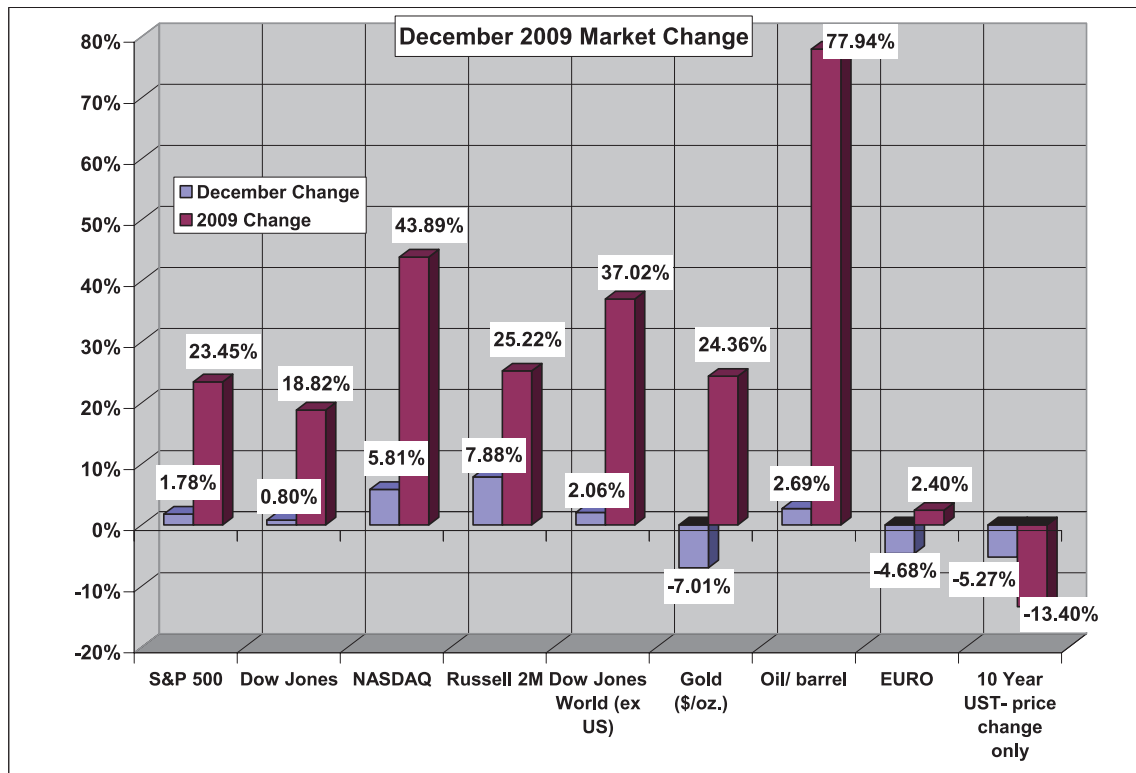
Paths to prosperity



December Markets A Santa Sighting...

Happy New Year, and welcome to a new decade. In the following pages we'll review 2009 and discuss our outlook for 2010, but first some comments on market action in December.

In market parlance, a "Santa Claus rally" describes equity markets that rally through the holidays and year-end trading. Given that definition, Santa came to visit this year as markets were able to withstand some selling on the final two days of the year to still close with gains for the month as shown below.



2009 closed with all of the major equity indices in black for the month and held onto their remarkable gains for the year, with the S&P 500 turning in its best performance since 2003. With its smaller exposure to financial companies and concentration of growth oriented firms the NASDAQ led equities with gains of 4.8% and 44% for the month and year respectively. Even the beleaguered dollar got a nod from St. Nick to rally at year end, as evidenced by the declines in both the Euro and gold.

Investors' improved appetite for risk and confidence in improving economic conditions is evident in the recovery in oil prices with a gain of 78% from the late 2008 level, as well as the decline in value of Treasury debt. The latter is the result of prices being bid up at the end of 2008 as investors sought safety at any price, only to decline sharply as cash was desired to reinvest in growth assets and markets demanded higher returns.

Regardless, it was a good month to close out a tumultuous but rewarding year.

Commentary ***Out with the old...***

When we published our Investment Committee consensus view for 2009 last January we foresaw a year that would be marked by:

- Negative GDP growth,
- Improved credit markets anchored by tightened spreads and a steep Treasury yield curve,
- No meaningful core inflation risk,
- A "bearish" equity market prone to retest lows after gaining any meaningful highs.

Instability in the housing market was the most noted economic risk cited for 2009, followed by low consumer confidence, sluggish recovery in employment and expanded Treasury borrowing. The Committee noted that the risks to the outlook were "to the upside" meaning conditions might prove to be better than forecast.

Equity opportunities were seen in large domestic growth companies as well as "selected emerging countries". High-quality corporate debt was the fixed income investment of choice, followed by municipal bonds.

In reconciling fact to forecast at year end it seems that the Committee got most of its outlook for 2009 right. The recovery in GDP during the second half of the 2009 will prove to be insufficient to overcome the weakness earlier in the year. The resulting economic weakness has kept inflationary pressures "contained" as well. In the meantime, support by various central banks and governmental programs have returned calm to the credit markets that had been substantially distorted by a record "flight to quality" that bid up Treasury prices and pushed yields to record lows (yields fall when bond prices rise).

The Fed's desire to support the economy has kept short rates at virtually zero while market forces have demanded increased yields on longer dated bonds. The result has been an extremely "steep" curve, as measured by the record gap between yields on bonds due in 10 years minus the yield for those due in two; accompanied by the loss in value of longer-dated Treasury bonds, as noted on the earlier chart. In the meantime corporate and municipal bonds rallied significantly as investors raced to "re-embrace" risk.

The same chart denotes the stellar gains in the growth-oriented NASDAQ, as well

as international equities, which have led markets in their recovery from the March lows; something also anticipated in the Committee's outlook. The market's tendency to "...frustrate the most investors with the least effort..." was proved true again in 2009 when the sentiment turned bullish in the Spring and the ensuing rally proved resilient to any desire to "retest the lows". Consequently the virtues of asset allocation, and weakness of market timing, were evident as the persistent rally, and lack of any meaningful correction, restored value to existing holdings but made reinvestment grudgingly difficult.

Regardless, with all of our asset classes closing 2009 in the black we're more than pleased to exchange the resulting gain in asset value for the overly pessimistic view of the markets that we held twelve months ago.

...and in with the new.

For 2010 the Investment Committee sees continued growth, but at a moderate and perhaps uneven pace, resulting in positive GDP for the year. Unemployment levels are expected to remain elevated which will continue to pressure households resulting in sluggish demand for goods and services and difficulties for mortgages and real estate. Clues to the strength of the first post-recession year will come from:

- Stabilized employment markets marked by weekly Initial Claims falling below 400,000 and a lengthening work week,
- Continued healing in credit markets evidenced by the return of private-securitization of mortgages and similar assets,
- Reports from the Service sector of our economy that mark continued strength, i.e. ISM reports significantly over 50,
- Speed of recovery in the housing market measured by changes in the inventory and price levels.

Committee members unanimously anticipate stocks to close 2010 at higher levels than they opened, although the pace of growth will be more modest than 2009. Corporate earnings growth will be required to propel stock market gains and justify the record valuation levels, which will also leave the market vulnerable to any meaningful disappointments.

Higher interest rates are also expected this year, although there is some disagreement about whether short term rates will increase before longer term ones. The Committee believes the upward pressure on rates will come from market forces as the Federal Reserve is not expected to make any meaningful changes in its policies until well into 2010, at the earliest. Indeed, it is the anticipated prolonged policy of low rates and "easy money" that many Committee members credit as driving stock prices higher.

Real estate concerns continue to dominate Committee members' fears, although this year the angst is focused on commercial properties. The combination punch of declining values and the resulting pressure on bank earnings and capital has been cited as providing a meaningful drag on bank lending and the pace economic expansion.

Risks to the forecasted recovery may come from:

- External pressures on the dollar which forces the Federal Reserve Bank to change policies earlier than desired,
- Political risks emanating from excessive borrowing and fiscal deficits by developed nations, as well as physical violence from unfriendly venues,
- Discouragement among investors and business leaders related to lack of clarity on pending federal and state budget and related business policies.

Portfolio recommendations include utilizing existing cash to true up asset allocations. Bond holdings should be increased where the income is needed, but only when the asset can be held to its stated maturity, given the Committees' expectation of higher long term rates during the year. In the meantime stock dividends continue to rival yields from many investment grade bonds while offering a better opportunity for appreciation.

As our economy stabilizes and starts to expand in 2010 the Committee again sees a potential risk in its forecast from the possibility that the recovery may prove more robust than widely anticipated. This would be recognized as a "happy problem". The indicators cited earlier should provide early clues to the pace of the recovery and opportunity to adjust accordingly.

Outlook and Strategy ***Data dependent...***

January may prove to be an "interesting" month as investors stay prepared to protect last year's gains while seeking confirmation that the current prices of both stocks and bonds are warranted by unfolding reports. Equity markets are positive for the early days of January in spite of ambiguous economic reports and pending corporate earnings announcements scheduled to commence in next week. In the meantime Treasury yields continue to move higher which will pressure bond prices and may dampen economic growth.

With markets presently behaving as envisioned in our outlook the present strategy is to continue to seek corroboration or, in the absence of any evaluate the evidence that may challenge it, and respond accordingly. New Years is a traditional time to confirm expectations or resolve to make changes in many areas of our lives, including investments. Consequently, this is an opportune time to review one's investment objective and resulting asset allocation to ensure they remain appropriate to present needs and long term expectations. To the extent that revisions are needed the current markets provide an excellent opportunity to make the necessary changes.

Investors with questions on these or related matters are always welcome to call.

<i>S&P 500:</i>	<i>1,141.68</i>	<i>Mark Fingerlin</i>
<i>10 Year U.S. Treasury Yield:</i>	<i>3.82%</i>	<i>January 7, 2010</i>

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