



Q4 2009

***"In my opinion, the best cure for a balance-sheet recession is self-sustaining economic growth that isn't propped up by the government."* – economist Ed Yardeni, 1/05/10**

We have written many times over the past eighteen months about the massive dislocations in both the domestic and global economy brought on by the huge amount of leverage in the global financial system. The breathtaking volatility in the fall of 2008 was precipitated by the subsequent unwinding of that leverage and the acknowledgement of the systemic risk in the system.

As it often happens after a sustained and precipitous decline in the financial markets, there was a dramatic rebound in 2009. The Dow Jones Industrial Average rose 59.3% from its March 9 low to close the year up +18.8%. The S&P 500 was up +23.5 for 2009. Corporate profits came in stronger than expected due to cost cutting, and positive earnings reports helped to drive the market higher. Economist Ed Yardeni has recently raised his outlook for fourth quarter GDP growth to +6.5% based on inventory rebuilding.

However, more recent economic data has shown a trend of delivering a series of both good and bad news. In November it looked like employment was finally going to show a turnaround to positive job growth following the lead of GDP. The numbers released last week though showed a decline of 85,000 in non-farm payrolls. Paradoxically, this report may be a positive in that it seems to have focused the Administration on the pressing need to create jobs for Americans rather than create uncertainty regarding healthcare reform and energy policy. It is critical to our future growth to invest in R&D to create new jobs in this country. We will also be watching for an expansion of the length of the workweek as a leading indicator for positive job creation.

A key trend to watch in 2010 will be the unwinding of the Fed's huge intervention in the financial markets. According to the Flow of Funds data for the third quarter of 2009, the deleveraging of household and business balance sheets shifted the debt almost entirely to the government side of the ledger. Much of this took place in the Fed's purchase of Treasuries, Agency mortgage-backed securities, and Agency debt. Fannie Mae and Freddie Mac now have unlimited backing by the Treasury, so the downturn in the housing market will continue to be a critical issue for a return to health in the capital markets.

After the big rebound in global equity markets during 2009, we expect the market to remain volatile as private investment returns to the market to replace government stimulus. While bank balance sheets are much improved, there are still losses in both residential and commercial real estate that need to be recognized. We are cautious on bonds given the record inflow to bond mutual funds over the past twelve months. We expect overseas growth to remain stronger than domestic growth due to the headwinds of slow job growth, regulatory and tax uncertainty, and ongoing consumer deleveraging.

Thank you for your continued confidence in us. Crossvault had its tenth anniversary in November, and we have learned a lot after going through two of the worst bear markets since the Great Depression. We were pleased that we ranked in the top 10 managers in our various universes during the three quarters which represented the worst of the crisis. To celebrate our ten year partnership, we would like to focus on what the next ten years will bring for Crossvault and our clients. We will be contacting everyone to set up meetings to review your goals and update your investment objectives for the next decade.

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