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## Quarterly Economic Update 1Q 2010

The quarter in brief. The stock market continued to confound skeptics by moving higher by over 5 percent for the quarter. Economic growth surprised on the upside, inflation remained low, consumer spending moved higher and corporate profits trounced expectations. U.S. economic strength relative to the rest of the world pushed the dollar higher in the first quarter. Congress passed healthcare reform without a public option and now sets its sights on financial reform.



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many items could be to blame, the lack of credit availability may play a part. Public companies can borrow by issuing bonds in the market where most small businesses rely on local financial institutions for their financing needs. The credit markets are flowing and spreads are near pre-crisis levels. Local credit is still tight. Since small businesses produce roughly half of the private sector GDP, it is hard to envision a sustained recovery without their participation.

The economy. It was reported that the economy grew at a revised 5.6 percent for Q4 2009 and there are signs that the economy is in good shape.

Leading economic indicators expanded at their fastest rate in more than

three decades during the first quarter. Though consumer confidence was mixed, consumer spending improved for much of the quarter, increasing by 0.4 percent in January and 0.3 percent in February.

Inflation remains a worry in the long term, but there was little evidence of price pressure in the quarter. The Consumer Price Index went up 0.2 percent in January and was flat for February. The Bureau of Labor Statistics estimated that we had seen 2.1 percent inflation over the 12 months ending February 2010.

The business environment was stronger for much of the quarter. The Institute of Supply Management (ISM) Manufacturing Index ended the quarter at 59.6 percent, the strongest since July of 2004 and the eighth straight month of expansion (any level above 50 percent is considered expansionary). Durable goods orders increased for three straight months and retail sales advanced throughout the quarter.

Corporate earnings reports for Q4 2009 beat expectations, and for the first time in almost a year received help from top-line sales growth. With 70 percent of the companies exceeding revenue estimates, earnings grew nearly 30 percent. However, small business confidence and capital spending remain low. The National Federation of Independent Business Optimism Index declined to 86.8, a level not seen since November 2008 when the economy was on the brink of collapse. Though

The economy did add 162,000 new jobs in March, but the unemployment rate remained at 9.7 percent each month in the

quarter. The possibility of a jobless recovery – when economic activity rebounds but payrolls do

not – is real and continues to be the primary focus of policy makers and market participants alike.

The markets. Equities remained on an upward path during the first quarter of 2010. The market corrected in January and February as sovereign debt problems rattled investors. By the end of March, however, equities resumed their trend higher with the S&P 500 finishing the quarter up 5.38 percent, and other major indices following suit.

*“We are in the middle of the most unloved market rally in recent memory.” - Mark Stevens*

Major Indices	1Q 2010	4Q 2009	Y-T-D
DJIA	+4.82	+7.37	+4.82
NASDAQ	+5.68	+6.91	+5.68
S&P 500	+5.38	+5.49	+5.38
MSCI EAFE	+0.85	+1.80	+0.85
MSCI Emerg Mkts	+2.45	+8.25	+2.45

*Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.*

The looming debt crisis in Portugal, Ireland, Greece, and Spain sparked widespread worry about a new credit crunch that could spread throughout Europe. However, as the quarter ended, the European Union indicated a bailout was forthcoming, putting investors at ease at least for now. Nonetheless, developed foreign markets were able to finish the quarter in positive territory as evidenced by the MSCI EAFE up 0.85 percent. Emerging market equities maintained their positive momentum (+2.45 percent) but passed off leadership to U.S. equities in Q1.

With only a few temporary setbacks, the stock market continued to move higher (+75 percent) since touching its low in March 2009. In spite of this rally, many investors still shun the equity market. Recent surveys by the American Association of Individual Investors show near record-high allocations to bonds despite historically low interest rates. Inflows to bonds exceeded stock inflows by almost a 10 to 1 margin. Does this represent a source of funds ready to plow back into the market, or have the last 10 years discouraged an entire class of investors from ever investing in equities again? We will see.

The U.S. Dollar Index reversed trend gaining 1.7 percent in Q4. However, this didn't keep commodities from moving higher with most commodities gaining 10 to 20 percent for the quarter. In fact, only two widely traded commodities went negative during the fourth quarter: coal (-4.64 percent) and cattle (-0.39 percent).

**Outlook.** The market has proven many skeptics wrong. This time last year the market had priced in virtual Armageddon. We were able to sidestep absolute collapse and the market has snapped back to reflect that. When the decline is steep, so is the rebound.

The market is moving higher in spite of political turmoil not seen in years. With health care reform now real, and financial regulation reform, energy reform, and tax reform all in the offing, many remain skeptical about the future of American prosperity. Though the threat of destructive government policies will remain a long-term concern, it has done little to derail the current recovery. Lesson learned: Long-term political issues are not good indicators of short-term market performance.

We are in the middle of the most unloved market rally in recent memory. Every time positive news is reported, a new objection pops up in its place. ISM manufacturing data is strong and productivity growth has been good. But high uncertainty and low capacity utilization is limiting

investment. Consumption has improved but it has grown faster than personal incomes indicating households are eating into their savings. Real estate prices have firmed but the availability of supply of existing homes is back to 8.5 months. Public companies are gaining access to credit again but bank lending is still contracting. March's gain in employment was positive but nearly 40 percent were temporary Census workers and unemployment remains high at 9.7 percent. The list goes on.

All in, the economic recovery is "real," just not "real good." As long as economic signals remain mixed and long-term government policy action continues to be a cloud over future economic growth, it is hard to see the economy maintaining the 5.6 percent growth seen in the fourth quarter. Though the economy is not "real good" it probably is "good enough."

The upshot is that with all of this uncertainty, the Fed is likely to keep rates near zero for an extended period of time. We are still in the early stages of the current economic cycle and most cycles last four to five years. Earnings power is still strong and revenue is improving. Rates are low and alternatives to equities (primarily bonds and cash) are not overly attractive.

Our market outlook remains somewhat cautious in light of significant equity gains over the past year. While many end markets are beginning to show improvement, current equity valuations appear to have discounted much of the positive news. That is not to say the market can't move higher. It just means that it is less likely that a return to normalcy will be the driving force behind future advances. Many feel that the "easy" money has been made and a continuation of positive economic trends and further improvement in corporate earnings will be needed. We got it in the first quarter and we'll need more of it to push this market higher.