The Shape of the Recovery

Much has been made of the eventual shape of the recovery, with letters often used to depict various viewpoints. Possibilities include a “V”-shaped recovery marked by a rapid rebound, a flatter “U” shape, or the more pessimistic “W” and “L” shapes. Some strategists are now pointing to what is called the “square root” recovery based on the mathematical symbol for the square root function. This essentially amounts to a brief period of rapid improvement, followed by flat or slow growth. Regardless of the eventual outcome, investor optimism about the recovery has continued to move the major market indexes to new highs for the year. On the positive side, several areas of the economy are beginning to show improvement. For example, recent data from the housing markets suggests that the worst could be over for housing. The S&P/Case-Shiller index for home prices, a widely used estimate of home prices based on data from 20 cities, rose 1.4% for the three months ended June 30. This was on top of a small increase in May and it was the first time since mid-2006 that the index rose for two consecutive months. However, some analysts think it is too early to call the bottom. They cite a large inventory of unsold homes as well as rising unemployment, which could lead to more foreclosures in the future. On another positive note, a recent survey by the Wall Street Journal of 47 leading economists found that 27 of them believe the recession ended in the second quarter. Of course, this also means that 20 of them think it has extended at least into Q3.

Despite strong rallies in both the stock and bond markets, there is still a sizeable amount of cash that remains uninvested. This includes the cash holdings of mutual funds, hedge funds, and other professional investors. However, the primary source of “cash on the sidelines” resides with individual investors. The question now facing such investors is whether or not the current rally is sustainable and long-term in nature, or more of a reflection of government policies and stimulus programs that might simply have provided markets with a short-term boost that could run out in the second half of the year. Some strategists think that the market is due for a correction, while others argue that the improving economic conditions support their case for a sustained rally.

Many economists often look to the Conference Board’s Leading Economic Index (LEI) for an indication as to the direction of the economy. The LEI is composed of ten factors, the largest two of which are the money supply and average weekly hours of production (in manufacturing). The combination of all ten factors is meant to give an indication of future economic activity. In July, the Conference Board LEI rose 0.6%, its fourth consecutive increase. Over the past six months (ended July), the index is up 3.0%. This compares to a decline of 2.8% for the previous six months. While the direction and magnitude of the changes in the LEI is certainly no guarantee of future results, at least for now it is in positive territory.

<table>
<thead>
<tr>
<th>Market Indices</th>
<th>August Change</th>
<th>Year-to-Date (8/31/09)</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>3.4%</td>
<td>13.0%</td>
</tr>
<tr>
<td>MSCI EAFE</td>
<td>5.2%</td>
<td>21.1%</td>
</tr>
<tr>
<td>Dow Jones Industrial Average</td>
<td>3.5%</td>
<td>8.2%</td>
</tr>
<tr>
<td>Russell 2000</td>
<td>2.8%</td>
<td>14.5%</td>
</tr>
</tbody>
</table>
Where does the Fed go from here?

President Obama recently announced his decision to nominate Ben Bernanke to a second term as chairman of the Federal Reserve. Bernanke, whose first term ends in January 2010, affirmed his desire to remain in the position. While the nomination is subject to the approval of Congress, most analysts expect the confirmation to go smoothly. The challenge for the Fed, regardless of who is running it, will be when and how quickly to remove the stimulus measures enacted to help prop up the financial system. This includes raising the Fed funds rate, which will likely be politically unpopular but necessary to prevent significant inflation. In addition, the Fed will have to unwind its other measures such as buying Treasury securities and mortgage-backed bonds. For example, the Fed recently decided to extend the TALF (Term Asset-Backed Securities Loan Facility) program by three to six months, but to phase out purchases of Treasury bonds by the end of October. Numerous decisions like these, as well as a plan to shrink its large balance sheet, will have to be made over the coming year. The outcome from these choices is likely to have a significant impact on interest rates and inflation and translate directly to action in the stock and bond markets.

1. Wall Street Journal, 9/1/09
2. Wall Street Journal, 8/26/09
3. Wall Street Journal, 8/13/09
4. The Conference Board, 8/20/09

Prepared by: Cameron Lavey
Senior Investment Analyst
Research Department, ING Advisors Network

The views are those of Cameron Lavey, Senior Investment Analyst, Research Department/ING Advisors Network, and should not be construed as investment advice. All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy.

All economic and performance information is historical and not indicative of future results. The market indices discussed are unmanaged. Investors cannot directly invest in unmanaged indices. Please consult your financial advisor for more information.

Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards.

Securities and insurance products are offered by PRIMEVEST Financial Services, Inc., a registered broker/dealer. Member FINRA/SIPC. PRIMEVEST Financial Services is unaffiliated with the financial institution where investment services are offered. Investment products are * Not FDIC/NCUSIF insured *May lose value *Not financial institution guaranteed *Not a deposit * Not insured by any federal government agency.

Harborstone Investments and Insurance Services
6019 Lake Grove SW
Tacoma, WA 98499