

The Economy and the Markets

The economy finished 2009 in improved health, and attention is now turning to the year ahead. Big questions loom: Will the recovery run out of gas? Is the inflation shoe about to drop? When will we start generating jobs?

Further improvements won't come easy. The hiring environment remains poor. Businesses hesitate to add jobs in the face of uncertainty over taxes, health care and the economy. Consumers have reset their habits, paying down debt and cutting spending. Less consumer debt improves the economy in the long run, but thrifty consumers offer less support for the recovery now.

With demand lagging throughout the economy, there's not much to fuel inflation. High unemployment adds up to little or no wage pressure. Personal consumption is down. The economy is operating at about 70 percent of capacity, well below the 80 percent average. Conditions would have to change significantly for inflation to get a strong foothold, and the Federal Reserve is unlikely to move off its low interest rate position until the recovery is clearly established.

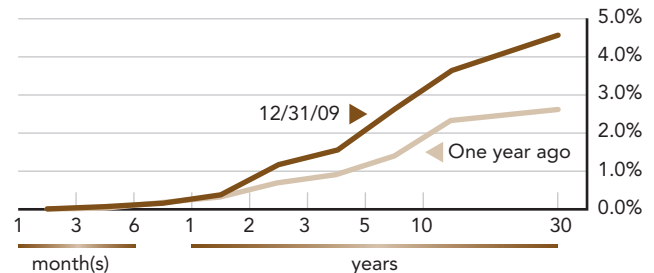
The economy is in far better place than it was six to nine months ago, but has plenty of room for improvement. The consensus expects 2010 economic growth to be modest, somewhere in the range of 2-4 percent.

Equities

Equities continued to move upward in the fourth quarter, finishing the year with solid double digit gains. The Standard & Poor's 500 Index was up 6.0 percent for the quarter, and 26.5 percent for the year. Foreign markets performed even better, with the MSCI EAFE Index gaining 32.5 percent in 2009.

Better-than-expected earnings drove equity market gains. Increases in 2009 came primarily from cost cutting, as corporations retrenched quickly, trimming payrolls to bring company economics in line with the environment. In 2010 the market will expect companies to start showing positive top line revenue growth.

Treasury Yield Curve



The Treasury yield curve steepened in the fourth quarter, with spreads (the difference in yields) between two-year and 30-year Treasuries reaching record levels. The yield curve indicates investors anticipate both a strong recovery and tighter Fed policies in the future.

Institutional investors led the return to equities. Large numbers of once-burned individual investors remain on the sidelines, keeping assets safely tucked in low-yielding money market accounts.

While equities outperformed early 2009 expectations, the market remains significantly down from previous highs. The S&P 500 Index at year-end remained -20.3 percent from year-end 2007, and -24.2 percent from its 2007 peak.

Fixed Income

Fixed income markets continued to offer low yields in shorter durations, and better returns in the mid and longer parts of the yield curve. Fixed income investors who are optimistic about a smooth recovery can snap up the higher yields at the 10-year end of the curve. Those who are more cautious on inflation can stay with intermediate duration bonds.

Companies continue to sit on cash reserves they built during the economic crisis. New debt issuance is light at the moment, but companies are likely to soon begin taking advantage of low interest rates by issuing bonds in the 10- to 30-year range.

Merger and acquisition activity, which came to almost a complete halt in 2009, is likely to return to the scene in 2010.

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Real estate

While 2009 found banks dealing with bad residential mortgage loans, 2010 is likely to find them coping with bad commercial real estate loans. Commercial real estate is under considerable stress, with highly-leveraged properties in serious trouble. Banks will have little choice but to start foreclosing on and disposing of non-performing loans.

The national banks bore the brunt of the residential mortgage defaults, but regional banks will feel the pain of commercial loan problems. Commercial real estate typically plays a larger role in regional bank loan portfolios.

In residential housing, low mortgage interest rates and special tax breaks have helped bring back lower and mid-priced sectors of the market. The jumbo market (\$700,000-\$800,000 and up) continues to struggle from lack of financing. It may be awhile before this part of the market recovers.

Outlook

Employment will be the key to how the economy fares in the year ahead. Consumers account for two-thirds of economic activity and continued high unemployment rates would pose a big roadblock to a sustained recovery.

Government deficits and taxes will be a key economic topic in 2010 with attention focused on paying the stimulus back. Deficits eventually have to be paid for, either through spending cuts or higher taxes. Since 2010 is an election year, the discussion will likely be loud and heated. It's difficult to know whether the issue will affect the markets, which may have already factored it into current pricing.

While we look for the economy and markets to improve in the year ahead, we remain cautionary in our expectations.

The S&P 500 Dividend-Adjusted Index is market-value weighted based on 500 common stocks, which are traded on the NYSE, AMEX and Nasdaq. The weightings make each company's influence on the performance of this index directly proportional to that company's market value.

The MSCI EAFE Index measures international equity performance. It comprises 21 MSCI country indices, representing the developed markets outside of North America: Europe, Australasia and the FarEast.

You cannot invest directly in an index.

Past performance is not indicative of future results.

Investment risks associated with international investing, in addition to other risks, may include currency fluctuations, political, social and economic instability and differences in accounting standards when investing in foreign markets.

Investment risks associated with investing in real estate, in addition to other risks, include rental income fluctuation, depreciation, property tax value changes, and differences in real estate market values.

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