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ECONOMIC AND MARKET OUTLOOK **January-March 2010**

“If the people fear the government there is tyranny, if the government fears the people there is freedom.” -Thomas Jefferson

The U.S. Economy

The end of the year is usually a time for reflection, and 2009 is no exception. However, the end of 2009 also marks the end of a decade, one that many investors would like to forget. It started with a stock market bubble that would eventually burst, and finished in the pit of what is already being dubbed as “The Great Recession.”

The S&P 500 Index is still 24% below what it was 10-years ago, while the NASDAQ Composite is down 44% from its December 31, 1999 close. Manufacturing jobs in the U.S. fell by 32.6% over the last decade, though manufacturing output fell just 2.3%. Between the mid-1960s and the year 2000, the level of manufacturing jobs in the U.S. was more or less steady, falling in recessions, but rebounding in recoveries.

That changed after the 2001 recession. There was no rebound in manufacturing jobs during the ensuing economic recovery. A large part of that was due to globalization, increased foreign trade and less expensive labor costs overseas. Advances in technology, as evidenced by the relatively small decline in manufacturing output, also allowed companies to do more with fewer workers.

By late 2007, the second asset bubble of the decade burst. This time it was the housing sector, brought on by inappropriate and unfair mortgage lending (ironically, it was the housing sector that helped us out of the 2001 recession). Mortgage lenders were aggressively pushing subprime loans to people by fraudulently overestimating the value of homes or overstating borrower’s income.

As a result, housing prices, which had been rising in an atypical and unsustainable way, and mortgage defaults, began a self-reinforcing downward spiral. The next domino to fall was the bankruptcies of the suspect lenders who pushed the bad loans.

The large negative wealth effect created by the sharp drop in home and stock prices slashed household net worth, causing consumer spending to nose dive. At the same time, rising loan defaults weakened the balance sheets of major banks, forcing them to tighten lending standards. This dampened consumer credit flows, squeezing consumer spending even more. Lower demand means declining output, rising unemployment, and rising bankruptcies and foreclosures.

So, the U.S. economy began 2009 in freefall, losing nearly 700,000 jobs per month in the first quarter of 2009 alone. Roughly eight million jobs have been lost since the recession began in December of 2007. If payrolls rose by 200,000 per month, it would take nearly three and a half years to regenerate that many jobs. Consider too, that from the start of the recession to that time, it is estimated that growth in the working-age population will have generated the need for nearly another eight million jobs!

Unemployment

Clearly, the 10% -plus level of unemployment is a major obstacle to economic recovery. In fact, it is perhaps *the* major obstacle. The last time unemployment was this high was in the early 1980s after a quadrupling of oil prices helped drive the world economy into recession. A recovery later in the decade brought some relief, and by the end of the 1980s, unemployment in the U.S. was half what it was at its peak. Europe, though, was not so fortunate. Unemployment there remained stubbornly and unusually high, even as economic growth resumed.

Europe's problems 25-years ago were based on several factors: monetary policies that were too tight; unemployed workers disinclined to search for new jobs; and companies that shied away from hiring new employees in response to government policies. On all three fronts, there's a sense of similar problems in the U.S. now.

Unlike Europe in the 1980s, it's not the government-imposed cost of firing workers that's keeping companies from hiring. It's the uncertain cost of hiring them as President Obama presses plans to reform health care and stem global warming through new mandates on business.

Perhaps the most disturbing parallel between 1980s Europe and the U.S. today is the rise in long-term unemployment. The longer people are out of work, the harder it is for them to find a job and the more embedded unemployment becomes.

By most accounts, the rate of job losses continued to moderate in the fourth quarter. Weekly jobless claims are trending lower, which a good sign, although not yet at a level that would be consistent with overall job growth. But for the economy to be "on the mend" we need to see an unemployment rate firmly below 8%. We need clear proof that jobs have been created in a sustainable period of 3 months.

Substantially stronger job growth, on the order of 300,000 or more per month, would be a big help. That could be achieved with a couple of years of 5% to 6% GDP growth. That's why, as long as inflation and inflation expectations remain low, the Fed should be willing to leave interest rates alone.

Fiscal Stimulus and Bank Bailouts

The fiscal stimulus and the bank bailout have been costly, and have clearly been unpopular with the American public. The Troubled Asset Relief Program (TARP) was not carried out to its original intent (to buy troubled assets). Instead, funds were used largely to recapitalize the banking system. It wasn't exactly fair, but from an economic point of view TARP, along with the Fed's efforts to promote liquidity, has stabilized, at least for now, the financial system.

And while the trillion dollar fiscal stimulus may continue to add to the level of real GDP in early 2010, the effects of the spending on the economy are nowhere near what was expected or promised. On top of that, it would seem that the maximum impact on GDP growth is already behind us, and as it fades away in 2010, it will effectively act like a drag on economic growth.

The idea behind fiscal stimulus is to provide *temporary* support, while the private sector begins to recover. Yet, we know that recessions that are caused by financial crises tend to be more severe, longer lasting, and with more lengthy recoveries. Hopefully, the underlying economy will be improving as the fiscal stimulus is pared away. But there are so many hurdles.

The Bush tax cuts expire at the end of 2010. A tax increase in a fragile economic recovery is never a good thing. Taxing away a person's ability to fulfill his own wants and then providing him with things he may not care about, makes him worse off in any environment. This process condescendingly supposes that individuals cannot decide for themselves what they need.

On top of that, taxing is not done in a uniform manner. Progressive income taxes, double corporate taxes, and estate taxes all disproportionately take from the people that make, create, invest, and speculate to the betterment of all.

Summary

The end of year is also time for looking ahead, hopefully with some degree of optimism. But looking ahead, the economy faces a number of serious challenges, making it more and more difficult to put a positive spin on things.

In the midst of the intense focus on the recession, what caused it, and government's efforts to combat it, a far more important question is being ignored. Can the American political economy come up with honest-to-goodness long-term growth? Year in and year out growth that expands capital, that reduces unemployment and underemployment to stable and low levels, that significantly improves real incomes of most Americans, that raises living standards, and that accompanies a solid increase in asset values?

Is socializing health-care going to do it? Subsidizing mortgages or bailing out privileged companies like GM or GMAC at taxpayer's expense? Regulating and controlling energy markets? Printing money and funding more welfare programs, or throwing more money at education? More taxes, more subsidies, and more regulations?

From a purely mathematical point of view, the numbers don't seem to add up. The federal budget deficit for 2009 was \$1.42 trillion and a similar deficit is expected for 2010. The cause of the near total collapse of the financial system was too much debt. The solution it seems, is even more debt, piled on to the original debt. Unfortunately, there's no free lunch, and these kinds of aggressive policy actions to prevent a depression, have to be clean up.

Yes, U.S. corporate profits improved in the third quarter of 2009, but this was largely a consequence of cost containment rather than growth. Companies responded to the financial problems of late 2008 by cutting jobs and capital spending. Until corporate profits can be sustained through increased consumption of the products these companies produce, the unemployment rate is going to remain high.

Underlying demand should see moderate growth in the early part of the year, hopefully picking up over time, but growth is not likely to be strong enough to push the unemployment rate down by much.

Inflation is expected to remain relatively low early in 2010, but as usual, oil prices will remain an important wildcard in the outlook for both consumer spending growth and inflation. The Fed is unlikely to start raising short-term interest rates until 2011.

Negative cycles of mutual reinforcement played a major part in the downturn. For example, job losses led to weaker consumer spending, which led to more job losses, and so on. Those negative cycles appear to have ended for the most part, but we've not yet reached a point where positive cycles have taken over. That should come over time. It's how recoveries build. A little bit of good news should lead to a little more consumer spending and a little more business investment.

While the government has borrowed a lot more in recent quarters, consumer debt has actually contracted. That may leave people in a better financial position, but the transition is painful. The economy cannot expand without credit growth – no loan growth, no economic growth. Tight credit will remain a restraint in the near term.

One major positive in 2009 was the bottoming and improvement in the global economy. The fear was that the rest of the world would tank as the U.S. demand for foreign goods dried up. However, clearly the world economy is in better shape and more flexible than was commonly thought.

Portfolios

Despite the U.S. stock market's surge, we really don't think the domestic economy has improved much, certainly not enough to justify the substantial rise in stock prices. For that reason, we are behaving cautiously with both bond and stock allocations and have even raised our cash allocation somewhat. As an alternative to money markets or CDs, we have had higher than customary allocations to bonds since November 2008 but feel compelled to continue a "wait and see" approach to the first quarter of 2010.

Until we see a few things clearly pointing to growth and stability in the U.S., we will be increasing our stock exposure to foreign stock markets; specifically to high growth countries like China, Brazil and India, and to the energy sector, and the metals and mining sectors.

When analyzing what 2010 may look like for the bond market nothing looms bigger than interest rates. But bond prices are also affected by supply and demand, just like all securities. Our government cannot issue an endless supply of bonds and expect investors to buy them up at lower and lower yields, especially when investors, foreign central banks in this case, aren't sure they will ever be fully repaid for the US bonds they already own.

With central bank interest rates sitting near zero they only have one direction to go, and it's just a matter of when. As rates rise, bond prices fall. Historically, however, corporate bonds offer more protection against rate hikes than government bonds.

In the coming months, we look to reduce conventional Treasuries in favor of inflation protected Treasuries due to expected rising inflation, and to investment grade corporate bonds. Treasuries are expected to be in less demand as the global economy improves, fear subsides, and as the U.S. issues massive amounts of Treasury debt. We will also continue to add to corporate high yield (junk) bonds, as rates would have to go up substantially in order to really hurt these yields.

U.S. Market Index Results
As of 12/31/09

<u>INDEX</u>	<u>Y-T-D Return</u>
S&P 500 Index	23.5%
Dow Jones Industrial Average	18.8%
NYSE Composite	24.8%
NASDAQ Composite	43.9%
Russell 2000	25.2%
Barclays U.S. Aggregate Bond	5.93%

WFA NOTES

According to current federal guidelines, Roth IRA conversions are only available to taxpayers with adjusted gross incomes of less than \$100,000. That limit is being repealed in January, for most Americans. Below is an informative article from the New York Times that explains the rules in an understandable way.

Please note, however, that Wisconsin residents will miss out on the new Roth conversion opportunity for now.

Wisconsin residents who have already done a Roth conversion and exceed the income requirements could face several *state income tax* penalties. They include:

- A 3.3% early distribution penalty for the amount converted for taxpayers younger than 59.5 years old.
- Any amount that is rolled into a Roth IRA may be treated as a contribution and subjected to a \$5,000 annual maximum. If the amount exceeds that limit, it may be subject to a 2% penalty.
- For 2010 conversions, the amount withdrawn from a traditional IRA will be taxable in Wisconsin for the year, even though federal law allows income to be spread over 2011 and 2012.

- The state Department of Revenue has said previously that it will propose updating state tax code to adopt the federal changes. Those proposals have not yet been made, and would require legislative action, which will not occur until January, at the earliest.

This means that a Wisconsin resident doing a conversion in early 2010 would face uncertainty as to the state tax treatment of the transaction. No real surprise there.

Deciding Whether a Roth Is Right

By Deborah L. Jacobs; *New York Times*
October 14, 2009

Starting in 2010, anyone can convert a traditional Individual Retirement Account to a Roth I.R.A. That's great news for people who previously were shut out of a Roth because their adjusted gross income was more than \$100,000.

Especially if you want to leave retirement assets to family or friends, a Roth conversion is one of the simplest, best planning tools available. You avoid the requirement to take yearly minimum distributions starting at age 70 1/2, and that can leave more for beneficiaries if you don't use the money yourself. And subject to certain restrictions, no tax is assessed when the money is withdrawn, so income can compound tax-free.

But this technique has a hefty price tag. You owe income tax on the amount you convert, which can be the entire account balance or part of it. And some people worry about what might happen years from now if Congress eliminates the Roth.

One possibility is that those who have already converted will have their gains untaxed, said Christopher R. Hoyt, a professor at University of Missouri-Kansas City School of Law. Another is that only the investment earnings — not the amount converted — will then be taxable.

For now, many lawyers and financial advisers have put that thought aside and are strongly recommending Roth conversions to clients who can afford to pay the income tax. Yet this advice can be hard medicine to take, for it goes against the conventional wisdom that one shouldn't pay a penny of tax sooner than necessary, and the idea of writing large checks to the Internal Revenue Service for an uncertain future benefit makes many clients queasy.

The strategy also requires substantial paperwork and monitoring to avoid pitfalls and get the best results. Here are some guidelines that I.R.A. experts have devised to get clients over the obstacles:

HEDGE INVESTMENT BETS

Ed Slott, a certified public accountant in Rockville Centre, N.Y., said he planned to convert his entire traditional I.R.A. on Jan. 4 — the first business day of 2010 — to start the tax-free earnings growing. Assuming the assets increase in value after that, the income tax cost of converting will turn out to be a bargain.

But if investments tank, the tax code offers “a money-back guarantee,” Mr. Slott said. You can reverse the transaction — a process called recharacterization. You’re allowed this do-over any time until Oct. 15 of the year after you do the conversion. So converting early in 2010 gives you almost two full years to decide whether you’re pleased with your strategy.

SET UP MULTIPLE ROTH I.R.A.’S

For each I.R.A. or asset class that you convert, open a separate account, said Barry C. Picker, an accountant and financial planner with Picker, Weinberg & Auerbach in Brooklyn. This makes it easier to monitor performance (for instance, of growth stocks, value funds or bonds) and recharacterize if necessary.

Another approach is to simply convert portions of your I.R.A. at various times throughout the year (say, 20 percent in January and another slice in April), Mr. Picker said. The goal is to compensate for market fluctuations, just as you might by laddering a bond portfolio with different maturities.

You can consolidate accounts one by one as the window to undo each conversion closes. After you have recharacterized, you are not permitted to do another conversion with the same assets until the next year or 30 days after the conversion was undone — whichever is longer.

TIME THE TAX

For conversions done in 2010, the law gives you a choice of when to pay the tax. One possibility is to count the amount converted as 2010 income and pay a lump sum. The other option is to divide the income equally in the following two years, in which case you must use installments — half with your 2011 income tax return and the remainder with the 2012 one, at the rates in effect for each of those years. You have until you file your 2010 tax return to decide, so if you request an extension you can wait until Oct. 15, 2011, said Michael J. Jones, a lawyer and C.P.A. with Thompson Jones in Monterey, Calif. By then it may be clear whether tax rates are going up. If they are, it might be better to pay the tax in a lump sum before they do.

But whether you request an extension or not, remember that your tax is still due on April 15, 2011, and if you pay it late there is a penalty. In addition, you need to have made quarterly estimated tax payments during 2010 (it’s sufficient that they total 110 percent of your tax bill for the previous year). If you have made all these payments for 2010 and decide at the last minute to spread the income over the subsequent two years instead, you can get a refund.

FACTOR IN PERSONAL CIRCUMSTANCES

Someone who now lives in a state with an income tax, like New York, but plans to retire to a state without one, like Florida, might want to postpone the tax until the year after moving, said Robert S. Keebler, an accountant with Virchow, Krause & Company in Green Bay, Wis. People who are collecting Social Security — or plan to start in 2011 or 2012 — should ask tax advisers whether extra income from the conversion in a given year would cause Social Security benefits to be taxable.

Remember that if you are older than 70 1/2 and want to do a conversion in 2010, you must take your required minimum distribution first, and this could also affect your tax bracket.

START THE FIVE-YEAR CLOCK

If you withdraw investment income from any Roth within five years of setting up your first Roth I.R.A. (either by conversion or through annual contributions), you need to pay income tax on that withdrawal. So even if you're not gung-ho on the idea of a conversion, if you don't already have a Roth, convert a small sum now to start the "marinating period," said Natalie B. Choate, a lawyer with Nutter McClennen & Fish in Boston. That way, if you want to convert more funds later, at least part of the five-year period will have passed.

Note that even once you meet the five-year requirement, you may still have to pay tax on account income plus a 10 percent penalty if you take the money out before you are 59 1/2 (subject to certain exceptions).

DO THE PAPERWORK

Money in I.R.A.'s cannot be distributed by a will. Instead, it goes to the people you name on the beneficiary designation forms that you fill out when you open the accounts or later amend. You need a separate form for each account. So you will need to do this paperwork for each Roth I.R.A. that you set up, and repeat the process if you merge the accounts once the recharacterization period is over, Ms. Choate said.

COVER EVERY CONTINGENCY

What if you die after the conversion but before the time to undo it has expired? Under the federal regulations on I.R.A.'s, the next steps fall to your executor — the individual or institution that takes charge of your estate after you die. You can express your wishes in a codicil or amendment to your will, which must be signed with the same formalities as the will itself.

If the I.R.A. and the rest of your estate are payable to the same person, this precaution probably is not necessary, Ms. Choate said. But it's prudent if, for example, you leave most of your estate to your spouse, and a Roth I.R.A. to your children of a previous marriage. That could create a sticky situation, especially if your executor is your spouse.

If the I.R.A. remains a Roth, your estate will have to pay the income tax on the conversion, and less money will go to your spouse, Ms. Choate said. In contrast, an executor who undoes the conversion puts more money in your spouse's pocket. Your will can let everyone know where the chips should fall.