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After rallying in the second quarter on the wave of the massive government stimulus, equity markets accelerated in the third quarter as optimism about the pace of economic recovery increased. For the quarter, the S&P500 advanced by 15.6%, its best quarterly return since 1998. Mid and small cap shares did even better with the Russell Mid Cap Index up by 20.6% and the Russell 2000 ahead by 19.3%. As they did during the second quarter, market returns for the larger, better financed companies trailed the more speculative companies. Globally markets were strong as well. The developed markets rose by 19.5%, led by strong results from Europe and Australia. Emerging markets were up by 20.9% led by gains in Brazil. The international returns were helped by a decline in the value of the U.S. dollar during the quarter.

Despite the increased optimism regarding growth during the quarter, yields generally fell during the third quarter with ten-year treasury rates declining from 3.5% to 3.2%. Significantly, the difference in yield between government bonds and corporate credits continued to fall. As a result, returns for both investment-grade and high-yield corporate debt were well above those for treasuries. This narrowing of the yield spread can be traced to better liquidity in the market and a firmer outlook for corporate profits.

Expectations for economic growth improved dramatically as the quarter progressed. As we entered July, consensus forecasts looked for a turn in the U.S. economy sometime in the first part of 2010. Second quarter GDP results, down 1%, while still negative, were well ahead of estimates. This, combined with the successful "cash for clunkers" program, a gradual build-up in spending from the stimulus package, and help from more advanced recoveries, particularly in Asia, has allowed investors to expect a positive GDP as early as the third quarter of 2009. With a better economic backdrop, estimates for corporate profits have accelerated, providing support for the stock market advance.

Equity markets have encountered weakness late in September and into the first few days of October. With the expectation for better growth in both the economy and profits having become part of the market's advance, actual economic reports have become more important to the movement of the indices. Recent news regarding consumer confidence, durable equipment orders, and employment, while generally better, has not supported the more aggressive forecasts for growth. With the market having moved up with little pause since June, these weaker reports have had a negative impact on share prices.

This set-back, both in economic statistics and the market, seems temporary to us. The U.S. recovery is underway and profits and share prices should continue to advance. Historically, the most serious impediment to further gains would be a decision on the part of the Federal Reserve to begin tightening monetary conditions. While there have been recent comments about how and when to remove some of the monetary stimulus, we do not see this as likely until the recovery is more established and employment has begun to improve. Short-term interest rates should remain near zero well into 2010, continuing to encourage investors to move from cash investments to stocks and bonds as we close out 2009.

After a very difficult start to 2009, the bond and stock markets have rallied significantly. This market advance will be more labored as the rally matures, but the fourth quarter is poised to provide us with additional gains.