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Quarterly Economic Report

MTB INVESTMENT ADVISORS

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Appropriately, the two faces of the Roman god Janus appeared in January: economic data were favorable, while stocks ended the month in negative territory.

ECONOMIC REPORT

December 2009 brought an end to the decade, the year, and the quarter. It was a historic period; much has been written, and will be written, of the events that highlighted the era. Our *Quarterly Economic Report* highlights the final quarter with an outlook for the beginning of 2010.

Since our Report is published after the Commerce Department announces its GDP estimate, we have the opportunity to report on the economy and capital markets for January – the month named after Janus, the Roman god facing in opposite directions. Appropriately, economic data were favorable, while stocks ended the month in negative territory. On January 29th, the Commerce Department reported fourth quarter 2009 GDP grew 5.7% (inflation-adjusted rate), the best rate of growth in six years. Equity investors were not impressed, as the S&P 500 ended the month down 3.6%.

Businesses invested more in equipment and software. Exports rose, and the important consumer sector showed a 2% increase in spending. However, caution is advised in projecting the fourth quarter rate of growth into the future. Without the inventory change, growth was 2.3%. While this positive growth provides further evidence the Great Recession has ended, the rate is subdued.

In addition to inventory rebuilding, government stimulus programs, such as “Cash for Clunkers” and tax credits for qualified homebuyers, contributed to growth. Gains from restocking will not be long lasting unless consumers spend and consume. The inventory-to-sales ratio spiked to 1.5 times at mid-year, but fell to about 1.3 times by the final quarter. This means that sales were increasing faster than inventory, which brings about an increase in orders and production rates.

QUARTER HIGHLIGHT: Fourth quarter 2009 GDP growth was 5.7%, but without the inventory change, growth was 2.3%. While this positive growth provides further evidence the Great Recession has ended, the rate is subdued.

The S&P/Case Shiller Home Price Index (20-City Composite) indicated that prices were down 7.3% year-over-year during the quarter. Although this is not a favorable number, it represents a nice comeback from the 18% drop at the beginning of the year. The working down of housing inventories that we noted above has contributed to the firming of prices.

Oil prices (West Texas crude) have been volatile, trading in the \$71 to \$80 (per barrel) range. Gasoline prices (at the pump) are beginning to show increases, but remain under the \$3.00 level of last January. According to the Lundberg Survey (January 25, 2010), the national average price at the pump for self-service, regular gas was \$2.72 a gallon. The Lundberg Report also indicated that prices are likely to remain near this level through early 2010.

The Labor Department reported unemployment for January at 9.7%. A sub-report in the employment data is the U-6. This data includes part-time workers who want full-time jobs, and those who have given up looking for work. This rate is 16.5% (near the highest level since records started in 1994). The U.S. lost 20,000 jobs in January. As we have noted in prior reports, unemployment is a lagging indicator and will remain weak as the economy recovers. Businesses will use temporary workers and over-time hours for existing employees before hiring new workers. This will continue until businesses feel more confident about any recovery.

Our outlook continues to call for a tepid “U” shape economic recovery. Although private consumption has been resilient during the recession, high unemployment and a weak housing market have kept consumers on the sidelines. In addition, consumer de-leveraging

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While we do not expect a second large stimulus program from Congress, 2010 is an election year, and infrastructure spending will take place. Unemployment will remain high, but once employers feel the economy has turned, they will hire.

ECONOMIC REPORT continued

and a higher personal savings rate are likely to continue. Business spending is expected to recover in 2010. McGraw-Hill estimates an increase of 11% as capacity utilization increases and banks step up lending.

STOCK MARKET The fourth quarter was another favorable period for stocks. The S&P 500 ended the year up 65% from the low of March. Volatility (daily change of plus-or-minus one percent in the major indices) continues. During the final quarter, consumer discretionary stocks and the information technology sector were stellar performers. The S&P MidCap Index (those companies with market capitalization between \$1.5 billion and \$6 billion) gained 6% in the fourth quarter – this index was up 37% for the year.

Equity Total Return Performance		
	Fourth Quarter (Ending 12/31/09)	Full Year 2009
S&P 500	6.04%	26.46%
DJIA	8.10%	22.68%
NASDAQ	8.21%	46.73%

Source: Factset

Equity gains of greater than 20% (the S&P 500) in one year are not the norm; however, we have experienced these returns in eight calendar years over the past two decades. Although we do not expect gains of this magnitude in 2010, our forecast for slow economic growth in a low inflationary environment does bode well for stocks. Our stock market analysis and outlook continues to call for S&P 500 earnings per share of \$78 in 2010 and a six percent increase to \$83 in 2011. Applying a market multiple of 14.5 times our 2011 earnings estimate, the widely followed S&P 500 Index could reach 1204 by year-end 2010 – an increase of 8% for the year. Of course, there will be volatility with backing and filling, and we continue to stress

selectivity, diversification, and quality in our portfolio representation.

FIXED-INCOME MARKET Treasury prices declined in December, wrapping up a difficult year. While the Federal Reserve kept short rates near zero all year, intermediate and long Treasuries were pressured by unrelenting supply and the fear that inflation would accompany stronger economic growth. Given these dynamics, the yield curve steepened to record levels.

While Treasuries were the fixed-income market's poorest performer in 2009, corporate bonds were outperformers. High-yield corporates advanced over 50% in 2009, while leveraged loans were up only slightly less. Investment grade corporates gained over 18%, as they rebounded from depressed 2008 levels on the promise of stronger economic growth and less systemic risk.

Treasuries, agencies and mortgage-backed securities (MBS) were the object of massive support in the form of buying by the Federal Reserve. This "quantitative easing" was part of an effort to keep rates low and spur business activity. The Treasury buy-backs ended in the fourth quarter, while the agency and MBS purchases are slated to end in the first quarter of 2010. Given the massive support of the government, agency MBS advanced five percent.

The investment-grade fixed-income sector that outperformed all others in 2009 was the municipal bond sector. Like the corporate bond market, municipals were sold down substantially in 2008, a victim of broker/dealer, insurance, and credit woes. However, municipals rebounded strongly in 2009 gaining over 12%. The return on 5-year municipals was 7.40%. The introduction of taxable "Build America Bonds" also helped reduce the supply of tax-exempt issuance.

We began 2009 with an overweight to the corporate sector and remain overweight as we

plan for 2010. On the other hand, the Treasury sector, pressured by growing supply, inflation fears, absence of Fed buying, a fragile dollar, and the whims of foreign buyers, remains our least favorite sector. In December we moved to a 95% duration posture, anticipating a breakout of the range that has held the Treasury market for much of 2009. In addition to supply, the end of quantitative easing will likely pressure Treasuries, agencies and MBS. We also expect far less from the municipal market in 2010, as municipal finances remain under pressure, and "taxable equivalents" reveal few bargains in tax exempts.

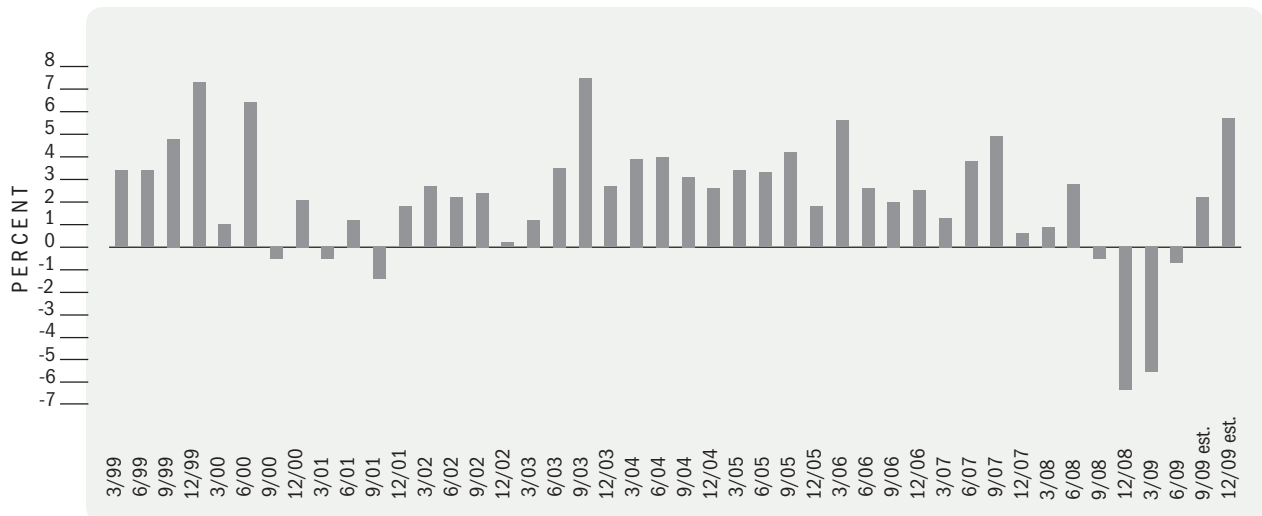
OUTLOOK The recession has ended and 2010 is expected to bring positive (but slow) economic growth. This will be a challenging year with the end of selected stimulus programs, excess capacity in many industries, and little pent-up consumer demand. We look for business capital investment to recover and continued lending from still available TARP funds. While we do not expect a second large stimulus program from Congress, 2010 is an election year, and infrastructure spending will take place. Unemployment will remain high, but once employers feel the economy has turned, they will hire. In the meantime, wage increases will be subdued and overall inflation should remain benign over the near term. Housing has benefited from the tax credit noted in our comments above. This has been extended through April 2010. The Federal government has removed the ceiling on federal backstops for Fannie Mae and Freddie Mac, suggesting a continuation of support to the housing markets. There is light at the end of the tunnel. Selected global economies are also beginning to experience growth. Global growth and a weaker dollar should aid U.S. exporters and the U.S. economy.

ECONOMIC STATISTICS

Economic Indicators December 31, 2009	2008 Actual	2009 MTBIA Estimate	2010 MTBIA Estimate
GDP (Change, Y/Y)	1.30%	0.10%	2.5%
CPI (Change, Y/Y)	3.80%	1.00%	1.00%
Housing Starts (Million Units)	0.90	0.60	0.75
Federal Funds Rate (December Target Rate)	0 - 0.25%	0 - 0.25%	0.25 - 0.50%
Profits (S&P 500 EPS)	\$58.00	\$70.00	\$78.00
Capacity Utilization	78.00%	71.50%	73.50
Unemployment Rate (Dec.)	7.2%	10.0%	9.5%

Source: MTBIA, Bureau of Labor Statistics

GROSS DOMESTIC PRODUCT (QUARTERLY)



Source: Bloomberg

YEAR-TO-DATE 2010 PERFORMANCE

Market Index Summary:
(Period Ending: January 31, 2010)
For Selected Indices

Index	Change 12/31/09 – 1/31/10
S&P 500	-3.6%*
S&P Mid-Cap	-3.2%*
Russell 2000	-3.7%*
Tokyo Nikkei 300	-3.3%*
France CAC 40	-4.1%*
Hong Kong Hang Seng	-8.0%*
MSCI EAFE Index	-4.4%*
Barclays Capital Aggregate Bond Index	1.5%**

* Represents price change for the period, as reported by Factset (1/31/2010).

** Total return as reported by Barclays Capital.



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