



A CONTINUATION OF THE MARKET RALLY THAT BEGAN THIS MARCH

Through the end of September, investors saw the continuation of the monster rally in the markets that began on March 9th. As of September 30th, the S&P 500 was up almost 60% from its lows. As is typical with a bear market bottom, small-caps and the emerging markets outperformed with the MSCI EAFE Index up 73% and the S&P Small-cap 600 up 75% from their respective lows on March 9th. The outperformance was also present within the third quarter with the S&P 500 up 15% and the MSCI EAFE Index and S&P Small-cap 600 Index up 19% and 18%, respectively.

Within the S&P 500, the financials sector continued to offer the best performance (a continuation of the reversion to the mean trade from highly oversold positions) and was up over 25%. In our last commentary published in July, we indicated that cyclical sectors should outperform secular growth areas. This was the case with financials and the other cyclical sectors (industrials, materials, consumer discretionary and information technology) adding to index performance with consumer staples, health care, utilities and telecommunications being relative underperformers. The latter sectors are universally viewed as “safe zones” and were the stars of 2008 and early 2009. They became overcrowded trades for many market participants. As investor’s went farther out on the risk spectrum (as leading economic indicators showed further signs of recovery), these historically defensive sectors saw money flow out to the beaten-up cyclicals. This flow continued through the third quarter and likely will be the case through year-end 2009 and into the beginning of 2010. We had explained in prior quarterly commentary that such market action is typical at or near a bear market bottom. The market has followed a playbook dating back through multiple recessions to the late 1920’s.

Ranked Returns

- S&P 500 Sectors

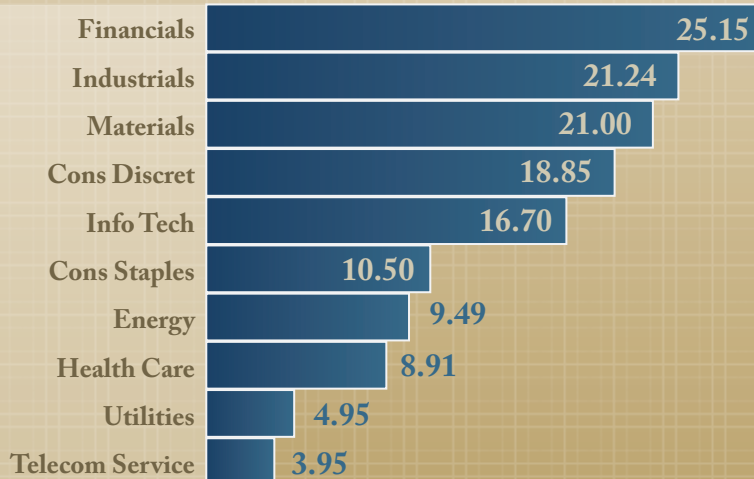
Return: 14.98

Start Date

6/30/09

End Date

9/30/09



This market playbook includes the recovery of leading economic indicators (4-week average jobless claims, commodity prices, money supply, manufacturing and durable goods orders, etc.) Of note, unemployment typically worsens through the beginning stages of a recovery and is a lagging indicator. Similarly, consumer confidence is usually linked to employment and is not a good indicator of what lies economically ahead. We at CitizensTrust remained focused on leading indicators which allow us to focus both our asset allocation and sector selection on the future and not the present or the past.

Of note, the energy sector (up 9.5%) also underperformed with crude oil flat at around \$70/barrel in the third quarter and natural gas still in the grips of a problematic supply-demand imbalance (too much natural gas in supply) heading into the winter heating season. We expect energy to outperform going forward as the global economy continues to heat up and domestic industrial demand begins to recover. We also expect the U.S. dollar to remain weak relative to other currencies supporting commodity prices including oil and gold. Low interest rates are funding a “carry-trade” where money is borrowed from the U.S. and used to loan at higher rates abroad or to invest in commodities like gold.

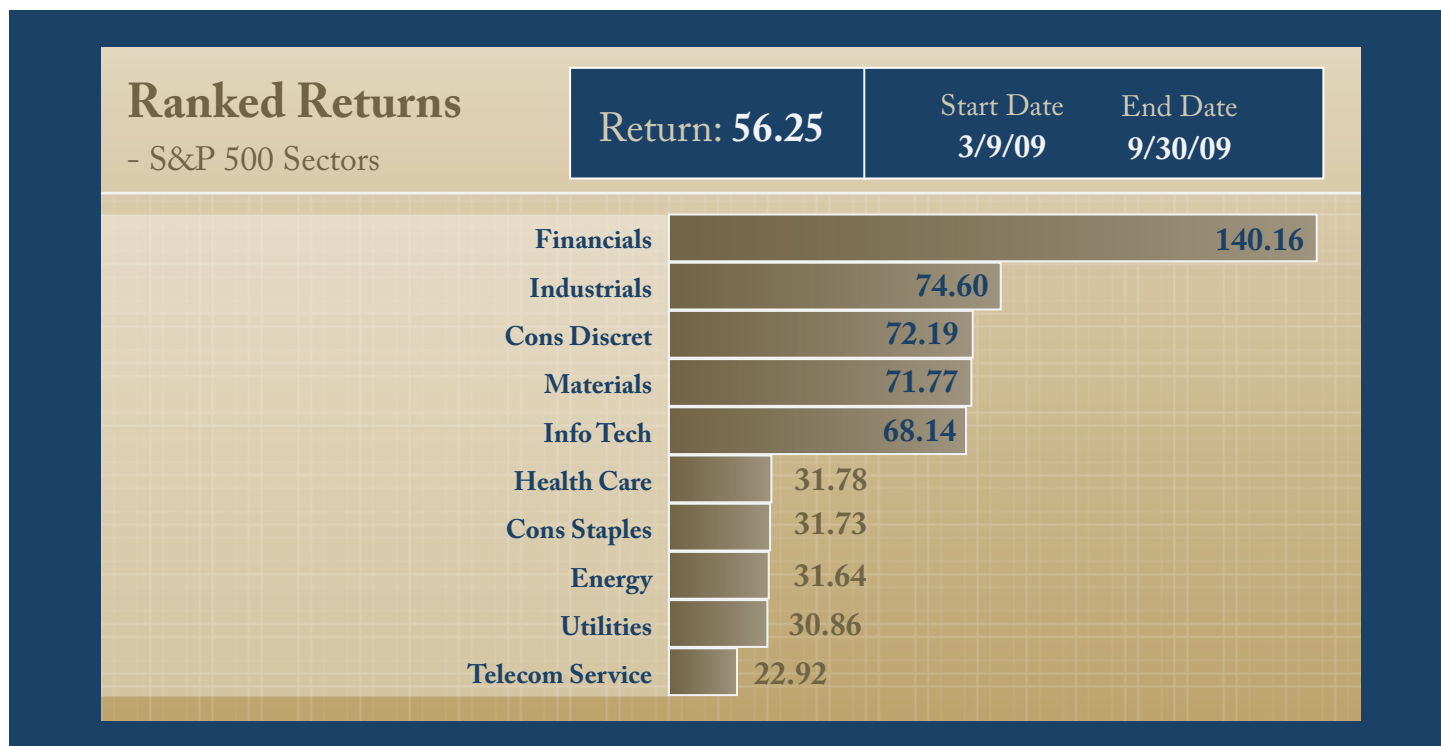
In the bond market, ten-year treasury yields declined slightly from 3.53% at the start of the third quarter to 3.31% on September 30th as worry ensued about the true strength of the global recovery and whether expectations had gotten more positive than reality given weak employment and consumer confidence. Corporate and high-yield bond spreads continued to narrow through the third quarter and have achieved normalized levels. Their trends continue to indicate a bottoming of the global economy and support a positive market environment. We continue to favor high quality corporate, agency and municipal bonds (based on tax situation) but have moved to more intermediate maturities (longer duration) given the steepness of the yield curve. For municipal bonds, we remain credit-quality-conscious, emphasizing bonds with stable revenue sources such as schools, water, sewers and roads. With federal tax rates poised to increase beginning in 2011, and further state income-tax rate hikes likely, municipals should comprise a healthy portion of high-net-worth investors’ portfolios.

With the recent raising of interest rates in countries like Norway and Australia, there is consistent worry amongst investors as to when the major developed economies in North America and Europe will begin to raise rates and, thus, eliminate stimulus. We do not feel that such increases will take place in the US until at least the unemployment rate peaks which will not likely be until mid-2010 at the earliest and/or inflation becomes an issue. The European Union’s decision on rates is driven by views on inflation. To date, given slack factory utilization and no wage pressures, inflation is not a problem. At some point, this will not be the case given the excessive issuance of debt by the US and other developed nations to relieve economic pressures. We will continue to watch for signs that inflation is becoming an issue.

ENTERING THE SECOND STAGE OF THE MARKET RALLY – LOW-QUALITY TRADE ENDS AND STOCK-PICKING BEGINS TO MATTER

As with most market recoveries post a recession, low-quality stocks tend to rally the most given their dramatic falls in the downturn – a regression to the mean effect. Most market participants can remember that this was the case with the recovery after the technology bubble burst earlier this decade and has been the case in the current market run. From the bottom of the market on March 9th to September 30th, the financials sector of the S&P 500 has rallied over 140% versus the 60% rise in the overall index! We have all witnessed the dramatic percentage rises of the stocks of companies such as Citibank, Bank of America and AIG. Of note, these companies still have many “issues” to resolve and were simply considered too big to fail by the federal government. Other financial stocks

face the negative effects of a commercial real estate unwinding. The rise in the financials' stock prices from the bottom of the market is not considered "fundamental" by many analysts.



Source: Bloomberg.

At this stage of the market cycle, we believe we have entered a period where the market's gains will be more subdued and where stock-picking (high quality companies in strengthening industries) matters. Given our fiduciary duty to our clients, we have never been and never will be an investor in low-quality companies on either the equity or debt sides. Rather, our focus has always been and continues to be on choosing the stocks and bonds of companies that are fundamentally sound and expected to improve over our period of share ownership. While we will tend to surrender relative performance in the short periods when this low-quality trade occurs, we are comfortable waiting for the "fundamentals" to take hold again.

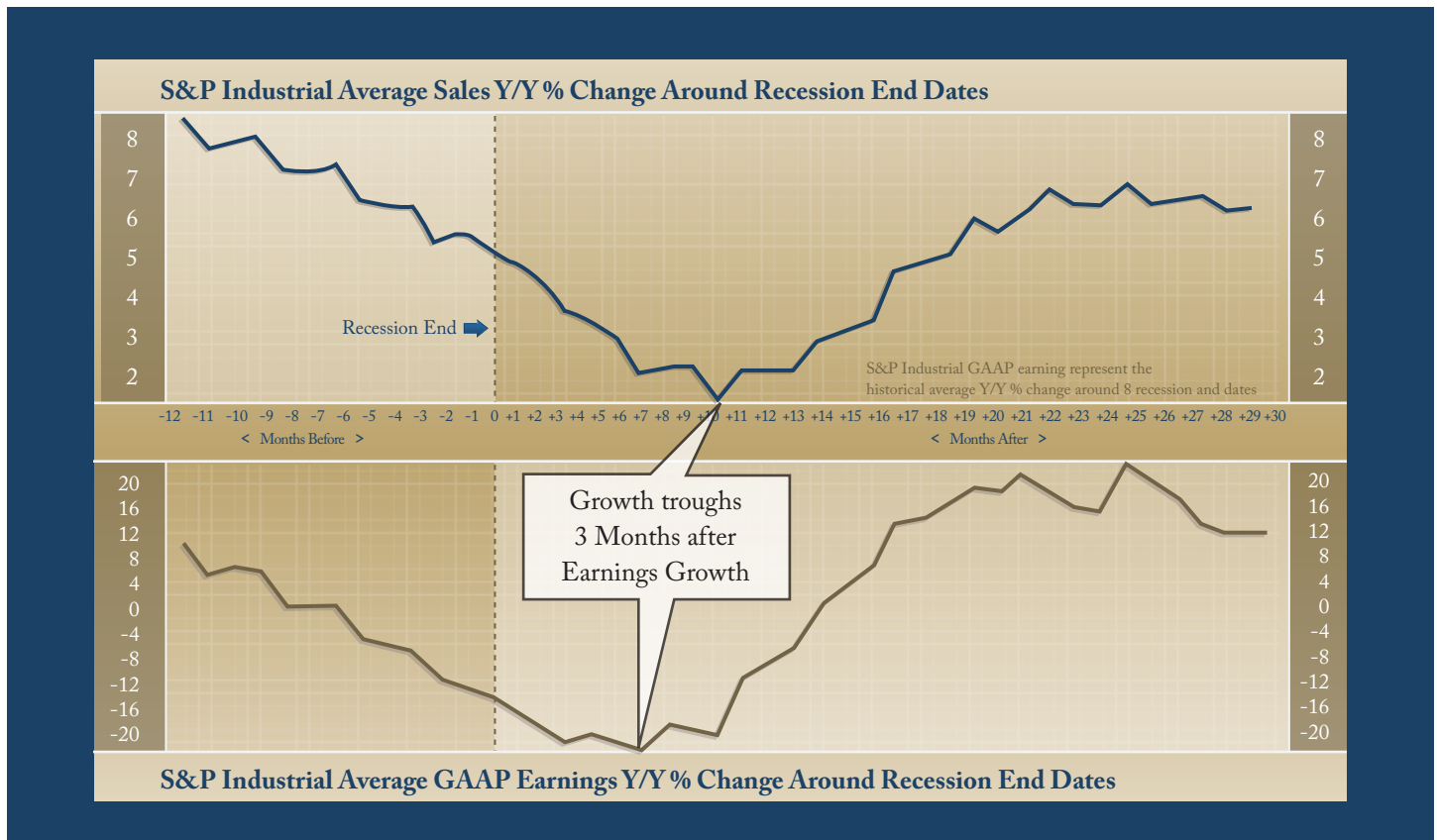
Therefore, we remain positive on the market and reiterate our belief (as seen in our last commentary) that we are in a cyclical bull run within a longer-term secular bear market. In such markets, being tactical and focused on leading indicators to judge the business cycle is crucial. While we will not likely see the same massive upside we have enjoyed over the last 6 months, we believe that the market environment for stocks will be positive to early 2010 (with corrections every now and then). If we look at history, there has been 18 such cyclical bull runs in longer-term secular bear markets since 1923. The mean percentage gain from the bottom of these 18 instances has been 64.3% with an average duration of the run being 508 days (Ned Davis Research). The mid-1970's market (similar to current conditions) had a 75.7% run. From the low on March 9th to September 30th, the market has risen 56.3%. While much of this cyclical run has already been realized, we believe the market still has room for some appreciation before the cyclical bull run is over and the bear market trend resumes.

SALES GROWTH UPTREND – A KEY TO MARKET OUTPERFORMANCE

To remain positive in 2010, we need an environment conducive to market appreciation. Investors have given a lot of credit to companies which have cut costs and lowered inventory levels through the downturn. These companies

have, by and large, exceeded earnings expectations although year-over-year sales growth for many companies has still proven to be elusive. Such activity is typical in a recovery out of a recession. However, for the market to advance (and even to maintain gains), sales growth has to resume and turn into an uptrend.

As the chart below shows, sales growth tends to bottom about 3 months after the same occurs for earnings growth. Therefore, we should begin to see the onset of sales growth in the third and fourth quarter reports of many companies. We continue to favor investing in US companies with substantial international sales that can take advantage of the low US dollar to price aggressively versus foreign competitors. Many of these companies are already showing a sales uptrend given many of those international countries purchasing their goods are in their own long-term secular bull markets (including BRIC – Brazil, Russia, India and China). This foreign growth combined with low global inventories and a positive seasonal bias around the holidays bodes well for the markets going forward.



Source: Ned Davis Research.

As always, we will continue to keep our eyes on leading economic indicators as well as potential issues as they arise. Some of the issues we are watching include the eventual removal of fiscal and monetary stimulus globally, the end of the global inventory rebuild, intensifying problems with commercial real estate, and additional forced deleveraging by countries such as Dubai. As always, we are proactive investors and will constantly reexamine our economic, asset class, and sector views with every new applicable data point.



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