



# MARKET REPORT

THIRD QUARTER 2011

## THE ECONOMY

*Rising concerns about the capabilities of Governmental policy makers increases the uncertainty around global economic growth. Despite the increasing pessimism and fear, U.S. economic data does not suggest an imminent recession.*

Global economic growth, which was anemic to begin with, slowed further during the third quarter, raising concerns that the world's developed economies are headed back into a recession. Just a few short months ago, investors were optimistic for a rebound in global growth by year-end. However, the temporary shocks to the world's economic system earlier in the year, including the turmoil in the Middle East and the Japanese earthquake, began to slow the recovery in economic activity. Then, the deterioration of the sovereign debt situation in Greece and other Euro zone countries heightened the risk that an economic slowdown could turn into a global financial crisis.

Rising concerns about the ability of foreign policy makers to handle the sovereign debt crisis in Europe makes any prediction about global economic growth very uncertain. Add in the fact that the fate of the global economy is dependent upon decisive action by Government officials in Europe and the U.S. and it becomes clear why there is such volatility in the global markets. Clearly some of the key sources of growth are beginning to show signs of weakness. Economic activity in the emerging markets has softened which has reduced exports from the developed world. China's exports are also slowing as a result of the problems in Europe.

In the past few months both the Federal Reserve and the International Monetary Fund brought the increasing risks around the world into clearer focus by voicing their concern about weaker-than-expected growth. By the end of September, a growing number of economists were increasing the probability of a global recession. The Economic Cycle Research Institute (ECRI) went so far as to declare that a recession was unavoidable. Such commentaries have negatively impacted business and consumer confidence. As a result of this lower outlook for growth, several key commodities have dropped considerably. For the quarter, the price of oil declined 18% to \$79 a barrel, and copper plummeted 27%. Copper is a key metal that reflects not only global industrial activity, but also Chinese demand.

In the U.S., with unemployment above 9% for over a year now, personal spending began to slow during the quarter and incomes declined for the first time in almost two years. Despite the increasing pessimism and fear, U.S. economic data does not suggest an imminent recession. The Jobless Claims report in the U.S. has been improving, and GDP growth for the second quarter was up 1.3%. Capital Equipment spending growth in the U.S. remains strong and according to the Conference Board, the Leading Economic Index (LEI) rose 0.3% in August. In September the University of Michigan Consumer Sentiment Index also improved slightly. So, while consumer spending trends and manufacturing activity are not robust, they do not seem to indicate economic contraction.

Still, investors are concerned with the slow pace of economic growth and the uncertainty of that pace to support the current U.S. debt burden. This is putting pressure on the capital markets even though a Federal debt crisis was averted with another increase in the debt ceiling. Pessimism is at peak levels, which now appears to be priced into the markets. A positive resolution by Eurozone countries that would effectively bail out the at-risk countries, or a strong bipartisan agreement by the congressional budget panel that would reduce the U.S. budget deficit, could set the stage for the global economy to resume the healing process that began after the last financial crisis.

## THE STOCK MARKET

Stock markets dropped substantially around the world the last few days of September. For the third quarter stocks in the U.S. as measured by the S&P 500 Index had their largest decline since the fourth quarter of 2008. The S&P 500 dropped 13.9% for the quarter and is down 8.7% year-to-date. The Russell 2000 was down 21.9% for the quarter and is down 17.0% year-to-date.

The volatility was felt around the globe, with the European debt situation and political uncertainties in the U.S. cited as the two main drivers of the negative sentiment. As the economic data out of Eurozone countries weakened, the slide in stocks accelerated. The MSCI EAFE Index of developed foreign stocks was down 19.0% in the third quarter and is down 15.0% year-to-date. The MSCI Emerging Markets Index dropped 22.6% for the quarter and is down 21.9% year-to-date. The MSCI All Country World Index, which measures equity market performance of all capitalizations of stocks in domestic, foreign developed and emerging markets, was down 17.9% in the third quarter and is down 14.1% year-to-date. Even markets in financially stable European countries such as Germany and France sold off. Germany's DAX Index and France's CAC-40 each dropped 25%.

*The drop in stocks in the third quarter has lowered valuations to the point where stocks are cheaper than they were during the height of the 2008 U.S. financial crisis.*

## THE BOND MARKET

*It is unlikely that "Operation Twist" will have a major effect on bolstering economic or jobs growth. Rates are already low but it has had a minimal effect on economic growth.*

Investors are anticipating a recession, but the data still indicates a continuation of slow and moderate growth. This may be the first time in history that market sentiment leads the U.S. economy into a recession. In the months to come there will be plenty of economic releases with the potential to move the market, such as manufacturing and U.S. jobs data. However, there is unlikely to be any real direction in the market until there is a clear resolution in the Eurozone as to how they plan to contain the sovereign debt crisis.

While investors digest the data and reassess their emotions, the fourth quarter of 2011 will probably remain volatile. A potential catalyst for a sizable move in stocks in the next few months either up or down could come from corporate earnings announcements. Recently corporate America has been considered a safe haven due to healthy balance sheets and historically high profit margins. American companies are gaining market share globally because they have done a better job of competing in a slow-growth environment, and the falling dollar has helped.

Even if the economy does double-dip, it is comforting to look at equity valuation levels. According to JP Morgan, at the end of September, 53% of stocks had a price less than 12 times earnings and 33% were less than 10 times, more than at any time since the 2009 lows. By this measure the market is as cheap as it was during the height of the 2008 U.S. financial crisis, which seems to indicate that the sell-off at the end of the third quarter was not consistent with the true value of equities.

At the end of September, stocks in the S&P 500 Index were yielding 2.3% while the yield on the 10-year U.S. Treasury was 1.9%. The last time the yield on stocks exceeded the yield on the 10-year Treasury was in the 1950's, which indicates that stocks are attractive versus bonds. Of course, at times when fear is the dominant emotion, relative valuations are of little importance. Investors are concerned, but the question is whether or not the degree of fear is higher than what the data indicates it should be. Global equity markets appear to be oversold even though the risk in owning stocks is rising. However, stocks have proven in the past that they can remain oversold or overbought for months before correcting.

As world equity markets experienced extreme volatility during the quarter, investors once again looked to the U.S. Treasury market for price stability and safety of principal. Despite historically low yields, rich valuations and the potential for rising rates in the future, money poured into Treasuries. The yield on the benchmark 10-year U.S. Treasury dropped as low as 1.72% in late September, down from 3.18% at the beginning of the quarter.

The Federal Reserve announced further support for the Treasury market at the September FOMC (Federal Open Market Committee) meeting where they announced the implementation of "Operation Twist." This is a monetary policy tactic that was used in the Kennedy administration to stimulate the weak U.S. economy at that time. In a nut shell, "Operation Twist" refers to a strategy of selling short-term Treasuries and using the proceeds to purchase long-term securities, effectively twisting the shape of the yield curve. The goal is to lower long-term rates to stimulate business investment and housing demand while maintaining low short-term rates without an increase to the Fed's balance sheet.

It is unlikely this policy will have a major effect on bolstering economic growth or jobs growth. Rates are already low but it has had a minimal effect on economic growth. Individuals and businesses are not requesting loans because of the uncertainty in economic conditions, not because rates aren't low enough. However, the policy will assure investors that rates will stay low at least until the U.S. economy begins to stabilize.

Other sectors within fixed income experienced volatility similar to the equity markets during the quarter. Because of the fear and uncertainty around the world, investors shied away from credit risk both domestically and internationally, sending yield spreads of Treasuries wider. Corporate bond valuations have been extremely volatile, and currently appear attractive. In time high-quality corporate bond prices will recover, and the current yield on corporate bonds will provide income until that time.

In the municipal bond market, investors began to gain confidence as the balance sheets of state and local Governments continue to improve. Measures are being taken to balance their budgets, but it is still important to focus on the credit quality of the issuer. For the quarter the municipal bond market rallied to produce positive returns. Returns for the overall municipals matched those of the Barclay's Aggregate Index which was up 3.8%. Municipal bonds are at historically cheap valuations versus U.S. Treasuries, which makes the asset class attractive compared to taxable investments.

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