QUARTERLY COMMENTARY

3RD QUARTER 2009

Domestic Stocks

The Standard & Poor's 500 Index had an auspicious start with the month of July contributing most of the quarter's 15% advance. August and September witnessed positive albeit less impressive price moves suggesting a possible resistance to significant upward price movement in the near term. While the major averages taken in aggregate suggest broad market participation, results for the third quarter tend to be somewhat offset by low trading volumes. Articles have been littered with expectations that the market will undoubtedly pull back after such a generous run-up from March lows. On the other hand, some see a market poised to advance upon improving global economic indicators.

With third quarter earnings season just underway, investors will be listening intently for top line improvement. Whereas cost cutting has been a boon to earnings, firms cannot continue to cost cut into sustainable profitability. While an uptick in revenue against such trim expenses could be punctuated by substantial rallies, the incidence and magnitude of stock price appreciation is likely to be fleeting if revenue growth fails to keep pace with market expectations.

Furthermore, this rally has proceeded despite rising commodity prices. Higher input costs typically erode corporate profit margins. Perhaps investors are equating an uptick in commodity prices to burgeoning global trade and demand health. Such conditions, investors speculate, must assuredly indicate better economic times ahead. The cipher to this conundrum may be more obvious – a weak dollar. We have casually observed that most instances of dollar weakness have been met by stock market gains. The market could be responding to the fact that a weak currency will encourage net exports; however, with an improving but still anemic global economy, it is more likely that the weak dollar has allowed foreigners to scoop up assets relatively cheaply.

Although we refrain from making forecasts, a slow growth, low inflation, and low interest rate environment may just be a reasonable outcome over the foreseeable future. Again, we advocate for broad and diversified equity exposure that spans economic sectors and international markets. We believe that asset allocation is more about positioning client portfolios for potential scenarios – deflation, inflation, weak dollar, etc. – than it is about calculating the historic correlations and returns of different asset classes. Although subtle, this is a significant distinction. To wit, we recommend quality companies with strong balance sheets, earnings power accompanied by healthy free cash flows, and reliable dividends.

Fixed Income

The Great Debate in the fixed income markets is this: will we have inflation, or deflation? Persistent and stubbornly high unemployment, along with its expected deleterious effect on spending in our heavily consumer-biased economy, does not support an inflation thesis and may instead portend continued deflation. If consumer spending stays slow, corporate profit margins will remain compressed and contribute to additional layoffs exacerbating slack employment conditions and elusive wage growth. The deleveraging of the consumer balance sheet and tight credit markets may lead a spending generation to accept a savings zeitgeist. In fact, both Kroger and Walmart have blamed recent earnings misses on soft demand and related pricing pressures, namely, deflation. Add in the excess capacity in manufacturing worldwide and lack of home price and rent inflation and one finds it difficult to spy the threat of inflationary pressures.

On the other hand, continued money creation by the Fed invites inflation. The din in the investment community around "exit strategies," whereby the Fed eases off the pedal of money creation, has grown loud. Investors are clearly demanding a plan, and the Fed has responded with noises indicating a pullback "in October." Meanwhile, behind the scenes, money creation has actually eased. The Fed is already underway with its plan though the details are not apparent. Let's hope this is not a policy mistake that will bring about a "double dip" recession.

The bond market is casting its bet on this Debate, right in front of us. During the quarter, Treasury prices rallied across the yield curve pushing yields down. Yields on the short end of the curve have compressed dramatically with the 3-month Treasury dropping from a 0.18% yield in July to 0.11% at the end of September and recently offered a meager 0.03% yield. While the steep yield curve has been a boon to struggling banks that borrow at short-term rates and reinvest at long-term rates, for all others the bond market is countenancing years of low growth and low inflation with the long bond at 4.06%. Even though that rate would be acceptable in a deflation scenario, we find Treasuries overvalued. And if the countervailing forces of increasing public debt and debt monetization do pressure interest rates higher, Treasuries quickly lose their luster. We contend that government agency issues, allied with strong credit quality and more than adequate differential yields versus Treasuries, currently offer the best risk-adjusted returns.

Over in the credit side of the bond market, trouble is brewing. For months now, corporate bonds have rallied in a near straight line, pushing yields down towards those of Treasuries. Some junk bond funds have returned 30% to 40% this year. But in a prelude that corporate spreads may widen, bringing a stop to the rally, the Bank of England's most recent corporate bond purchase program – part of that country's Quantitative Easing Programme – was three times oversubscribed. The eagerness to sell holdings to the BOE may suggest that investors are ready to take profits generated since the beginning of the year thereby creating a supply/demand imbalance. Corporates have been our favorite sector all year, but lately we have found that most issues have become simply too expensive.

The issuance of Build America Bonds (taxable municipals with federal government subsidies) has displaced traditional municipal supply. The dearth of traditional supply has led to significant price increases with yields on tax exempt bonds touching 40-year lows. With continued pressure on state and local budgets, credit quality is not improving. From benign at the beginning of the year, this market has turned treacherous.

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Foreign Markets

The United States' mushrooming fiscal budget deficit, growing national debt (a mere substitution for private debt and surrogate for private demand) and low interest rates have undermined the strength of the greenback. Thus, as in the movie *Groundhog Day,* we awaken to a repeat of last quarter with foreign markets, for the most part, besting our domestic showing. Brazil and Mexico led the rally with roughly 20% gains, each, for the quarter. With a comprehensive fiscal and monetary policy, commodity-based economy, and burgeoning investor risk appetite, Brazil in particular has garnered much attention evidenced not in the least by its successful 2016 Olympics bid. Developing market darling China chipped in a robust 14.02%.

Not to be left out, the Financial Times Stock Exchange index of 100 large European companies produced a generous price return of nearly 16%.

Canada, our brethren to the north, whose banks did not have to go hat in hand to the government for support, reported a decent 9.83% advance. We'd expect a pickup in returns in this country, as the economy is commodity based, the management culture is relatively conservative, the imminent Winter Olympics are benefiting British Columbia for the near term, and the currency has been strong.

Japan was the laggard with a relatively weak 1.76% gain. With the LDP losing their status as the political power brokers, an export-based economy suffering from the US pullback in spending, an aging population, onerous public debt, and a culture of savers, Japan has now struggled with low growth and deflation for over twenty years. Let's hope this is not the path of the US in coming years.

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