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“Earlier predictions of widespread municipal defaults have thus far proven far exaggerated.”

Equity market conditions proved challenging in the third quarter as economic and political headwinds intensified, with prices declining across all major equity asset classes:

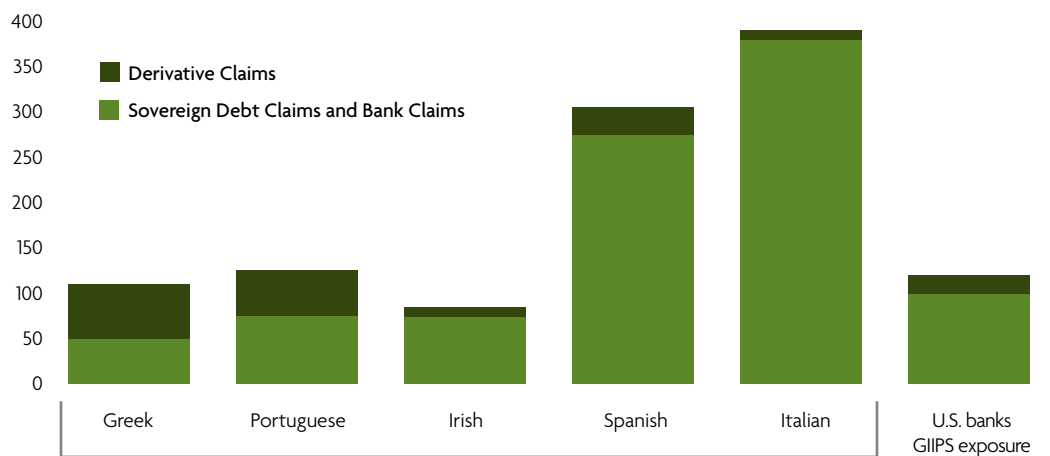
S&P 500	Large Cap Equities	-13.8%
Russell 2000	Small Cap Equities	-21.9%
MSCI EAFE Index	International Equities	-18.9%
MSCI Emerging Markets Index	Emerging Market Equities	-22.5%

Investment grade fixed income markets performed well in the third quarter with investors in a “risk-off” mode. Treasury securities were the best performers in the quarter as 2-year, 10-year, and 30-year yields dropped to 0.3%, 1.9%, and 2.9%, respectively. While it is hard to fathom these yields dropping further, we note that 10-year Swiss and Japanese bonds yielded only 0.9% and 1.0%, respectively, at the end of the quarter. Municipal and investment grade corporate bonds also benefited from the investor shift toward fixed income securities. Earlier predictions of widespread municipal defaults have thus far proven far exaggerated.

Much of the investor angst and associated market volatility in the third quarter was attributable to the large sovereign debt load in Europe and the tentative and halting steps that were being taken by political leaders. If left unchecked, a European banking and financial system crisis could ensue with unpredictable consequences for economies and markets around the world. However, equity markets have rallied in October as it became apparent that the leadership in Europe was coalescing around a solution. In fact, as of this writing, European leaders, led by Germany and France, announced a package which includes: (1) an agreement with bondholders for a 50% haircut of Greek debt, which significantly helps alleviate the fiscal situation in that country, (2) a recapitalization plan for European banks, providing much needed capital, especially those impacted by the Greek debt write down, and (3) a plan to leverage the European Financial Stability Facility to increase its impact.

While there is obviously additional detail to be determined and communicated, this package appears to be a positive step in putting a firewall around the “too-large-to-rescue” markets of Italy and Spain. As can be seen in the adjacent chart, any serious problems in Italy and Spain would have a significant impact on European banks and thus credit markets. The ability for individuals and businesses to be able to obtain credit is a critical factor for economic expansion. The Lehman Brothers-induced financial system meltdown and subsequent deep recession reminds us of the importance of maintaining fully functioning credit markets.

EUROPEAN BANK EXPOSURE - \$ BILLIONS



Source:
 International Monetary Fund

MARKET COMMENTARY *(cont'd)*

“...private sector job growth has matched the pace of prior recoveries.”

After anemic performance in the first half of the year, U.S. economic activity expanded somewhat faster than expected in the third quarter, registering growth of 2.5%, with consumer spending leading the way. While a welcome improvement, still high unemployment, a very weak housing market, and slow manufacturing activity will continue to cause impediments for growth. Any major shock, including an escalation of problems in Europe, would likely push the still fragile economy into a recession. Absent that, we would expect the economy to muddle along over the next few quarters with low to moderate growth.

The Federal Reserve remains cognizant of the potential downside risks to the economy and recently pledged to keep short term interest rates near zero through mid-2013. In addition, the Fed took an additional step in September with the announcement of “Operation Twist”, a program that is directed at lowering long term interest rates by shifting the Fed’s balance sheet toward long term Treasury securities and away from short term Treasury securities. The housing market, a still troublesome area of the economy, could benefit as it will reduce mortgage rates. Finally, Federal Reserve Chairman Bernanke indicated that additional, and unconventional, policy tools are at the Fed’s disposal and may be initiated to stimulate the economy.

The bright spot in the economy continues to be Corporate America. Balance sheets and profits are in excellent shape, with revenues displaying solid growth this year. Corporate cash, which remains at record levels, is slowly being deployed by management teams. In fact, private sector job growth has matched the pace of prior recoveries. However, the unemployment rate remains anchored around 9% due to downsizing of government employees. This will likely continue to be a trend as spending cuts will be necessary for budgetary reasons.

Wide partisan rifts ahead of upcoming elections in 2012 look to limit any fiscal stimulus in the US. This deep political wedge in Washington was highlighted by the brinkmanship displayed during this summer’s debt ceiling negotiations. In addition, the lack of any credible plan to deal with the growing mountain of debt in the U.S. caused Standard & Poor’s to downgrade the credit worthiness of U.S. Treasuries. All of this has significantly lowered the public’s opinion of Washington, and is causing rising uncertainty regarding future tax, health care, and regulatory policies. This cloud of uncertainty seems likely to cause a continuation of cautious spending by cash rich corporations.

Of course near term volatility in the markets will likely remain, as it is obviously difficult to predict investors’ collective mood swings in their attempts to forecast the future direction of the global economy, where there are many decision makers and many moving pieces. We continue to advise against making large shifts in asset allocation to chase a particular asset class because it is currently “in favor” (think U.S. Treasuries and gold at the end of September). The October surge in equity values serves as a reminder that some of the strongest price moves to the upside have quickly followed some of the largest downside moves. Well diversified portfolios, with exposure to a variety of asset classes, remain the preferred route as we navigate an uncertain terrain over the next year.