

## **Custom Strategies**

Investment Consulting

### **MARKET SUMMARY THIRD QUARTER 2011**

#### **INVESTMENT ENVIRONMENT**

Global equity markets ended the quarter on a dour note as stocks sank in value during the period's final two months. Stocks were pummeled across the globe as pervasive fears over the health of the world's financial system drove investors out of risk assets and into securities which, even though possessing de minimis returns, had the assurance of the return of capital. Anxiety over the European sovereign debt crisis, a U.S. economy searching for growth and hints of slowing activity in the fast growing economies of Asia and Latin America all served to deliver a very downbeat atmosphere. The very notable exceptions to the carnage in equity markets were U.S. Treasuries, mortgage securities, high quality corporate bonds and municipal bonds. Prices on long-term U.S. Treasuries soared, a verb rarely employed when discussing bonds, returning 9.8% in September and 24.7% over the quarter. While commodity prices fell broadly in reaction to declining prospects for world economic growth, gold rose 20.5% in July and August on renewed anxiety over currency debasement, but gave back 10.7% in September.

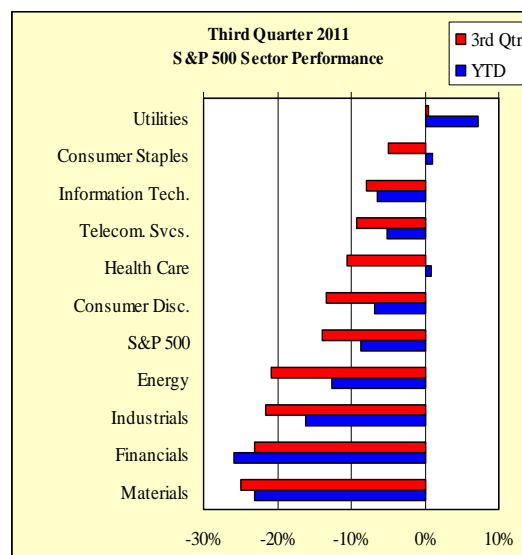
Paradoxically, worries about inflation became increasingly prominent, particularly in regard to price increases in developing economies even as deflationary concerns persisted. Europe, though, has been front and center to financial system concerns. The well-chronicled problems of budget deficits, high levels of sovereign debt, and the suspect health of European banks have conspired to weave a web of great foreboding. The interdependence of global financial entities makes for a complex set of issues. The European banks are less forth coming than U.S. entities when delineating their obligations and how assets are valued. While it appears that U.S. banks are not directly exposed to European banks or sovereign debt problems, the potential for severe disruption in the payments system would be punishing. Additionally, there is the unease regarding all banks' exposure to financial derivatives. While a financial debacle is an unlikely probability, expectations are for continued volatility with emotional swings between positive and negative developments the norm.

Although cross currents are pulsating through the financial world, most observers agree that there will be slower economic growth on a global basis; Europe and the U.S. seem stuck in low gear. Unemployment and housing continue to plague the U.S. with no clear cut solutions. While Europe looks closer to recession, the U.S. will probably squeak by but is unlikely to achieve growth in excess of 3% in the quarters ahead. The developing countries' economies are also likely to experience slower growth, perhaps by as much as 2% percentage points or so. Though growth there will subside, it will remain robust by comparison to developed countries.

## U.S. EQUITY ENVIRONMENT

U.S. stocks had their worst quarterly performance in two and a half years. The Standard & Poor's 500 was whacked for a loss of 13.9% as an onslaught of bad news in the U.S. and abroad drove equities into the ground. The outlook was reasonably favorable in the first part of the quarter but began to falter in late July and early August as questions surfaced about the underlying strength of the U.S. economy. Consumer confidence slipped with unemployment a major concern; housing problems were no closer to resolution, and the possibility of entering a period in which the economy would stall seemed increasingly likely. Wrangling over budget deficits and arguments over whether to raise the debt ceiling were responsible for heightened unease. As the country edged to the brink of default sanity won out, but market reaction was swift when Standard & Poor's downgraded U.S. Treasury debt to AA+ from AAA. Equities dropped for the remainder of the quarter.

The best third quarter returns came from large capitalization stocks as investors favored companies with more heft and greater diversification across global markets. Companies with visible earnings growth outperformed by a large margin but were solidly lower in the period. The S&P 500 was off 13.9% while the S&P 500 Growth index lost 11.6%. The S&P 500 Value index fell by 16.3%. Year-to-date, growth indices have substantially outperformed value at all market cap levels. A major reason for this underperformance has been the value benchmark's exposure to Financials, a group under duress for many reasons. The only S&P sector to register a positive return was utilities, up 0.4%. The worst performing sector was Materials at -25.0%, having been up 2.6% in the prior two quarters. Other more economically sensitive sectors also declined; Industrials lost 21.5%, and Energy was off 20.9%. Consumer Staples was the second best performer, but finished the period with a negative 4.9%.



Investors have become progressively worried about the global economy and the outlook for corporate profits, but the news is not all bad. Contrary to press reports, bank lending in the U.S is not only alive but growing, albeit at a modest rate. Banks have improved their capital ratios, are experiencing somewhat lower delinquencies and their lending standards have become more relaxed. Consumers have improved their balance sheets as well, and have increased their borrowing, as have commercial institutions. In the soggy housing market, the inventory of unsold homes, while still large, has been reduced. The decline in oil and gasoline prices helps consumers, and automobile sales are improving. Corporate profits have held up extremely well and should continue to do so unless a more severe economic downturn ensues. One can be assured that if more trouble appears and markets begin to fall, the Federal Reserve will crank up the printing press. Under such circumstances, stocks should provide some protection against the inflation that would likely follow. The unusually high volatility which equity markets are experiencing seems almost certain to continue. News items drive markets without hesitation and the growing influence of flash trading through the use of Exchange Traded Funds poses a serious challenge to equity investors' patience. A long-term commitment to equities, versus a trading mentality, is necessary.

## **FIXED INCOME ENVIRONMENT**

In what must be one of the most dramatic moves in any fixed-income market, U.S. Treasuries had a spectacular quarter. Yields plunged to lows not seen in nearly sixty years as investors fled market turmoil in search of a safe haven. The Barclays U.S. Aggregate Gov't-Treasury Long Index advanced 24.7% in the quarter, a breathtaking move. The benchmark 10-year Treasury dropped in yield to its lowest level in its history, to under 2%. This all transpired despite the credit downgrade of U.S. government debt. Risk aversion, falling long term inflation expectations, and anticipated moves by the FED simply overwhelmed everything else. Reflecting inflation expectations, Treasury Inflation Protection Securities (TIPS) breakeven inflation rate was at 1.75%, suggesting that a slow economy and low interest rates will persist.

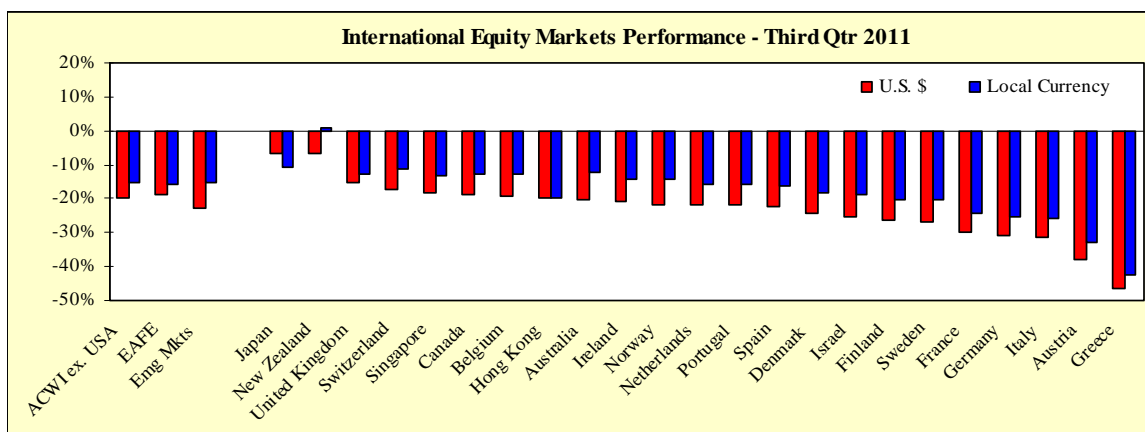
Outside the positive returns from Treasuries, the Barclays Aaa Credit Index returned 3.8% in the quarter. Lower quality bonds naturally performed less well than higher grade corporates possessing generally healthy balance sheets, upward trending earnings and low default rates. Moving down the quality scale to riskier bonds was a punishing exercise, with the lowest rated high yields off between 11.7% and 25.0% as spreads blew out. All market sectors were influenced by the October 1<sup>st</sup> implementation of Operation Twist, the FED's plan to shift its Treasury holdings into longer term U.S. debt. The action involves the selling of shorter maturities and the purchase of longer bonds. The central bank's intent was to buy \$400 billion in Treasury bonds with maturities between 25 and 30 years and to sell a like amount of shorter issues. In anticipation, the 10-year note's yield tumbled 123 basis-points and the yield on the 30-year issue fell by 1.46 points. Holders of Treasuries were ecstatic, but savers are not pleased by so-called "financial repression," where interest rates are manipulated to below-market levels.

European bond markets were greatly challenged, and continue to be buffeted by severe sovereign debt problems. High borrowing costs plagued Italy and Spain where 10-year government bond yields rose above 6%, but finished the quarter lower after the European Central Bank instituted large scale purchases. The grave circumstances in Greece, Ireland, and Portugal tipped into a much more serious sphere and the contagion spread to Italy. While there may be sufficient capacity in the European Financial Stability Facility (EFSF) to fund Greece, Portugal and Ireland's problems, there is not nearly enough to lift Italy, which has the third largest bond market in the world. The major problem affecting almost all of the developed countries is how the large debt burdens can be serviced. These debt problems become magnified when unfunded liabilities are considered. Drastic measures need to be undertaken to solve economic imbalances.

## **INTERNATIONAL ENVIRONMENT**

Europe's debt troubles and failure to deal decisively with the crises continued to plague investors in the third quarter. The MSCI Europe Index performed much worse than U.S. markets, falling 22.6% in dollars, with currency playing an important role in the results as the dollar rose 8.0% versus the Euro. Even countries with relatively strong economies suffered: Germany was off 31.0% (25.4% in local terms) led lower by automakers and materials issues; France was down 29.9% (24.3% local). Italy came in at -31.2%. Greece was the worst performing with a loss of 48.6%. Ongoing credit worries and slower economic growth had the most adverse impact on financial and materials stocks in Europe.

The problems in the U.S. and Europe are similar but differences, including the magnitude of debt levels, make the situation in Europe more pressing. While high in the US, debt is higher in Europe which also lacks the advantage provided by the reserve currency status of the dollar. The problem of a common currency without fiscal cohesion makes solutions very hard to meld within the eurozone. The largest countries must somehow come to agreement on financial issues and convince markets that this flawed system can be fixed. Continuing bailouts of excessively indebted nations is not a solution and only postpones and exacerbates the fallout. It looks increasingly that Europe will not be able to escape recession, which will bring calls for increased public spending. Bold actions are required everywhere. The politics are byzantine, and economic battles are bound to be epic.



In Japan, equities did relatively better as optimism increased about the prospects for corporate profits and overall growth. The stronger yen, up 4.6% versus the dollar, brought Japan's dollar return to minus 6.9%, versus -10.7% when denominated in yen. The EAFE Index (Europe, Australasia & Far East) was also boosted by yen strength although it closed down 19.0%, the worst quarter since 2008.

Emerging Markets also fell hard, providing no refuge to a stressed global scene. The MSCI Emerging Markets Index lost 22.6%, with every country in the index declining. Deterioration finally set in for emerging markets that had held onto small gains over the prior six months. The increasingly negative global sentiment has impaired export growth. The demand for commodities has cooled and prices were down sharply in the quarter. The Commodity Research Bureau Index finished down 12% in the quarter and is now off 10% year-to-date. Crude oil dropped 17% and is at its lowest level since September 2010. Copper, an important component of overall economic activity, was down more than 25%. Commodity exporting nations were set back by these developments.

