Capital Market Review

Third Quarter, 2009

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Summary

A global economic recovery is underway. In the US, the recovery is fragile. Unemployment, is very high with few signs of of a rebound. For the recovery to gain traction, we must see improvement in employment statistics. Expect 2010 growth to be positive but much weaker than previous recoveries.

All major asset classes produced positive returns during the third quarter. Real estate and stocks were particularly strong performers. Emerging markets produced strong stock and bond market returns outperforming both developed international and US markets. In the US, mid and small cap stocks outperformed large-cap stocks. High yield and investment grade corporate bonds performed well as Treasurys lagged.

Economic Conditions

Due to widespread fiscal stimulus and aggressive monetary relaxation, a global economic recovery is underway. Inventory restocking by businesses are also providing a boost. However, the foundation for a sustained recovery remains extremely fragile.

While real gross domestic product (GDP) is expanding, growth is inconsistent and insufficient for business to

resume hiring. Economic forecasters expect real GDP growth of around 3% during the second half of 2009. But, as the economic stimulus begins to wane, growth in 2010 will likely be lower (probably around 2%). Uncertainty around 2010 growth is high. Weighing on the economy is high unemployment and debt levels, weak wage growth, continued problems with the availability of credit, and residential and commercial mortgage defaults.

Whether this fragile recovery blooms into a self-sustaining expansion depends on whether businesses begin to hire. A sustained economic recovery is simply not possible with 10%+ unemployment. While businesses are curtailing layoffs, there is no evidence hiring has resumed.

Prior to full-time hiring, business usually hire temporary workers or increase the hours of existing employees. Unfortunately, temporary jobs are declining and hours worked are stuck at record lows. We expect employment statistics to improve very slowly. Many believe it will take 4-5 years before we even have a chance of reaching "full employment" (which is generally considered to be a 5% unemployment rate).

Internationally, expect more robust growth from the emerging markets, particularly Asia and Latin America. Asia, with its high savings rate and low debt levels, should boost household purchasing power and increase domestic demand. The growth in the European emerging markets is clouded by their financial troubles. A solid recovery in Western Europe is a likely precondition for recovery in the Eastern European emerging markets.

A concern among many investors is future inflation. It is a real possibility but not inevitable. It is true that the money supply has exploded – banks are flush with cash. However, that cash is just sitting there. It is not working in the economy because the banks have been very reluctant to lend.

The crucial point in time will be when banks regain confidence to lend. This is when money will start moving through the economy and has inflationary potential. Demand for new credit from consumers and businesses appear to be low as they are focusing on de-leveraging and not re-leveraging.

So, while one precondition for higher inflation is present (rapid growth in money supply), the other is not (excess money is not moving through the economy). If the Fed does not reduce these excess reserves and banks simultaneously start lending rapidly, then significantly higher inflation will become a reality. The Fed is in a very tricky situation – they cannot tighten the money supply too soon (and possibly choke off a recovery), but cannot wait too long (and have higher inflation). For now, we believe a 70's style inflation scenario is not likely.

Concerns about the sustainability of this recovery are leading to discussions about a second stimulus package. While premature and perhaps unlikely, it cannot (and should not) be ruled out. A "follow-up" stimulus would probably continue existing benefits such as extending unemployment benefits, accelerated depreciation for equipment purchases, and net loss carryback provisions for small businesses. Of course, stimulus package is simply code for "deficit spending".

While short-term deficit spending may be necessary to jump start the economy, the question remains whether Washington will have the discipline to "take the punchbowl away" once full-blown recovery starts. Their track record is not too good. With that said, the United States has no choice but to get its fiscal house in order. This year's budget deficit is expected to be around $1.5 trillion dollars – over 10% of GDP. That is the highest percentage since WWII.

Unless America wants to be thrown on the economic trash bin of once great economic powerhouses, Americans will face many unpleasant realities over the next few years. There are going to be changes to the large social programs (Social Security and Medicare). Expect some combination of changes that may include later retirement dates, reduced benefits, and health-care rationing.

Higher taxes are inevitable, but don't just expect them on the wealthy. In fact, the belief that most of us can live off a few is simply wrong. Many economists have noted that even if the wealthiest Americans (those making over $250,000) were taxed at 100%, tax revenue would not come close to closing the spending deficit.

Given our recent fiscal choices, the dollar has declined versus other currencies. While there may be some enticing short-term benefits to a declining dollar, a weak dollar policy is not in the national interest. The record of nations trying to devalue their way to prosperity is not good. Remember, someone must buy all the debt we are issuing. About 40% of recent debt issued is in the hands of foreigners. How likely are they to continue buying our debt if the currency is devalued (in other words the value of their holdings decline)? Not very.

To entice more buying of our debt (because we cannot get our fiscal house in order), higher interest rates will be required to entice foreign investors. Higher interest rates impede domestic economic growth which then leads to a recession and lower tax revenues and higher deficits. Well, you get the picture. Now is the time to take the hard steps.

The good news is that, since the dollar is the world's reserve currency, policymakers have a little bit of time to take action. That is also the bad news because action is needed now and policymakers seem to wait until a crisis unfolds. While there is a lot of talk of establishing a new reserve currency, that will take time. We need to take these steps before a "competing" reserve currency is created. The steps necessary will only be more painful after a competing reserve currency is established.

Third-Quarter Asset Class Returns

Real estate was the best performing asset class during the third quarter with a return of 32.0%, followed by the US stock return of 16.3%. Commodities returned 4.2% and bonds returned 3.7%. This was one of those unusual quarters when all major asset classes produced positive returns. Year-to-date stocks returned 21.1%, followed by the real estate return of 17.8%, commodity return of 9.0% and the bond return of 5.7%

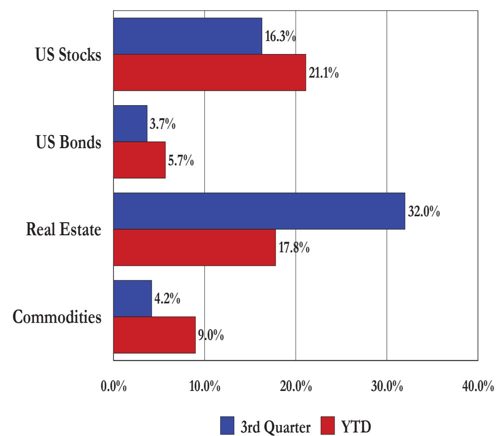
Stock Market Returns

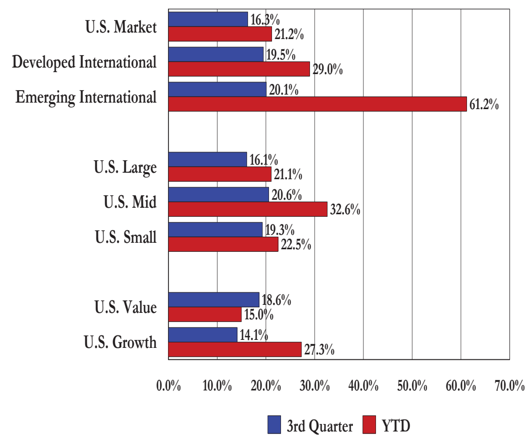
Emerging market stocks, once again, had the best quarterly return. On a year-to-date basis, emerging market returns have trounced the US and developed market index by returning 61.2%. Developed international stocks outperformed the US market both during the third quarter and on a year-to-date basis (19.5% and 29.0%, respectively).

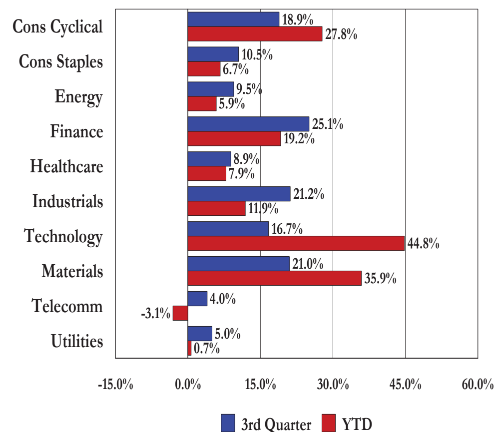
During the third quarter, mid-cap stocks were the best performing company size segment with a return of 20.6%, outperforming the small stock index return of 19.3% and the large stock index return of 16.1%. Year-to-date, the mid-cap index return of 32.6% is significantly ahead of the small and large cap index stock returns of 22.5% and 21.1%, respectively.

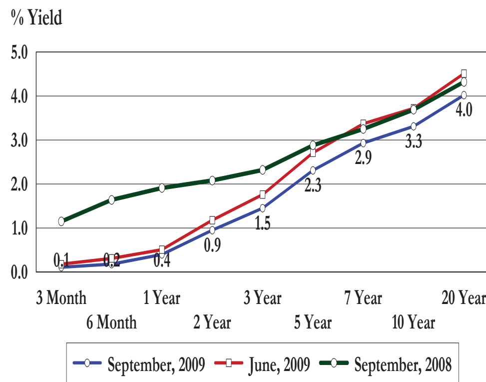
Value stocks had the performance edge during the third quarter with a return of 18.6%, compared to the growth index return of 14.1%. Year-to-date, as the result of strong first-quarter performance, the growth style maintains a healthy performance advantage over value (27.3% versus 15.0%, respectively)

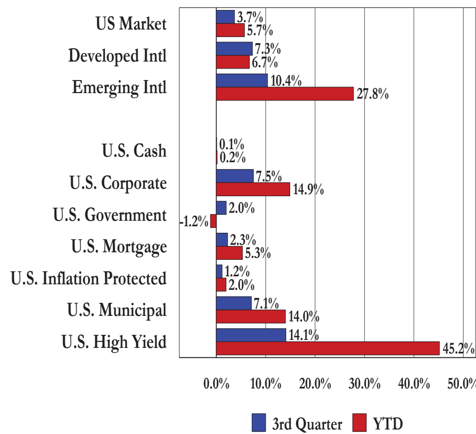
As economic Armageddon moved off the table, economically sensitive sectors such as finance, industrials,

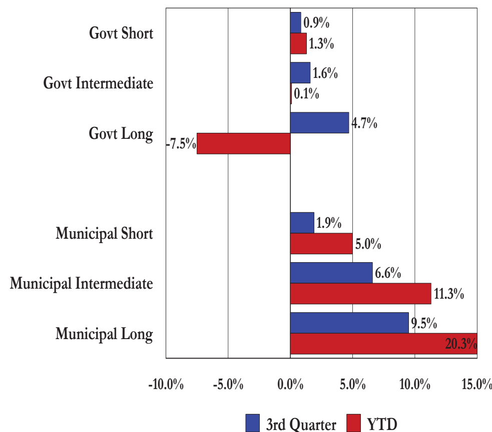












and materials performed best during the third quarter. In many ways it was simply a reversal of the trouncing these stocks took during height of the financial crisis. Best performing sectors on a year-to-date basis include technology, materials, and consumer cyclical. Interestingly, the relatively "safe" telecommunication and utility sectors have substantially underperformed.

Generally speaking, companies with little competitive advantages or considered lower quality have performed the best. Alternatively, companies with significant competitive advantages and high returns on invested capital have underperformed during 2009. We would be surprised if this scenario continued for an extended period of time.

Bond Market Returns

Surprisingly, as economic recovery started, bond yields fell across the various maturity segments. The yield curve is very steep meaning yields on longer-maturity bonds are significanthly higher than shorter maturity bonds. This makes banking extremely profitable (lend at high rates, borrow at low rates). The Fed will maintain this low-rate policy so banks can have time to heal their balance sheets.

Bonds that focus on riskier segments have done exceptionally well during 2009. Namely, emerging market and high yield bonds have, by far and away, been the best performing bond segments. Within the investment grade space, municipal bonds performed well as several large states passed budgets providing a sense of relief. Investment grade corporate bonds have also performed well during 2009. US Treasurys have been the laggard compared to other bond segments. This is not too surprising as the "flight to quality" trade that occurred during the fourth quarter of 2008 is being reversed.

Current Portfolio Strategy

We are entering a very important period for the economy and markets. The economy must show improvement to justify the market's strong move. Investors must be realistic about future stock returns.

During the quarter, we did not make any significant allocaiton changes. We maintained overweight postions to mid-, and small-stocks, developed and emerging market stocks and the value approach. Our bond allocation has an overweight position to both high yield and investment grade corporate bonds. In the near term, we do not forsee any major changes to these strategies.