

Economic & Market Commentary

It's now official – the “Great Recession” of 2007-2009 has ended. The National Bureau of Economic Research Cycle Dating Committee has declared it so! What began in December 2007 has officially been declared to have ended in June 2009. This is not cause for celebration, as it sure doesn't feel like it's over, with second quarter real Gross Domestic Product (GDP) bumping along at 1.7% and unemployment still hovering close to 10%. The deceleration comes as a further surprise since real GDP has only recovered 2.9% points of the 4.1% points lost in the recession – so real GDP is still below where it was at the outset.

Nevertheless the equity market took this news to heart, and ended the third quarter on a strong note (as has been widely mentioned in the business press, equities had the best September in 71 years). The strong performance for the quarter resulted in equities returning to the plus side for the year. Stocks have been in a sawtooth pattern for most of the year, alternating up/down moves depending on the economic data reported each month. We have had 8 swings of $\pm 5\%$ to 14% during the first 9 months. The third quarter was no exception, with July and September up and August down. The character of the equity market also reflected the perception of the monthly economic data, with economic sensitivity doing well when data pointed to economic growth, and defensive issues gaining when the data were less robust. The third quarter got its definitive boost from the remarks of Fed Chairman Bernanke, at the end of August, stating that the Fed might reengage in quantitative easing (creating money to purchase US government fixed income securities primarily), implying that monetary policy would do “whatever it takes” to keep the economy from rolling over. Most of the economic data reported in September was better than expected, and overcame earlier negative sentiment, leading to a strong finish to the quarter. This volatility has resulted in stock leadership being bifurcated, making it difficult to develop a consistent strategy for portfolios. As a result, stock selection has been less important than usual, while macro factors have the leading role.

So the longest recession since World War II (18 months) has officially ended, yet the pace of recovery is nothing to write home about. The last 3 quarters have shown significant deceleration, with real GDP slowing from 5.4% in Q4, to 3.7% in Q1, to an initial estimate of 2.4% for Q2, which has been revised to 1.7%. This deceleration is not surprising to us, and we find the elements of the economy playing out as we discussed in our last outlook

The consumer has continued to be a strong factor through the first 9 months in spite of fiscal stimulus waning. Consumer leverage has come down, with an estimated \$600 billion decline in household debt, and the household savings rate up to 6%. Housing is showing signs of stabilization, and financial asset prices have been strong, so household balance sheets are less fragile than earlier. Layoffs have fallen, but employment growth has been more tepid than hoped for. We expect this to be the case for some time. It is estimated that the economy needs monthly employment growth of 150,000 for the unemployment rate to stabilize, and we do not see this rate of job creation until well into 2011. Given these factors it is our expectation that household contribution to US economic growth will diminish from today's level.

Business spending has been satisfactory in recent months. Inventory building continues albeit at a diminished rate, as does spending on productivity enhancement – largely technology: hardware and software. This should continue over the coming months.

Net exports have slowed, largely as a result of a pick up in imports. Recent weakness in the dollar may allow this to reverse and again be a source of growth.

Most of the economies of the developed world seem to be in this same slow growth mode, while the developing economies are growing at a faster rate. China falls into the latter category, and while slowed from its earlier pace, is still growing at a good clip.

As a result of these factors, we see no reason to change our expectations of below trend economic growth for the next several years. We enunciated this in our last outlook and feel comfortable with that viewpoint as a base for establishing policy going forward. We are still not persuaded that the economy will rollover, and experience the “double dip” that some may expect. The Leading and Coincident Indicators are still positive, shocks to the system have been absent, and the Fed is friendly, so the necessary conditions for a double dip are not yet present. Real GDP growing in the 2% area is below what is necessary to meaningfully reduce unemployment, but enough to produce modest growth in profits. Nevertheless, the probability of a double dip has increased since the beginning of the year.

Profitability continues to be the bright spot in the economic outlook. Third quarter earnings are about to be released, and they should be good, although it is fair to say that the peak rate of change has passed. Margins for non-financial businesses are close to all time highs and are probably not sustainable. Business has taken a knife to costs, is not hiring, and yet is spending on productivity enhancements. As a result, cash has built on most corporate balance sheets to an unprecedented degree. Standard & Poor’s points out that cash on the balance sheets of 376 companies in the “old” industrials was close to 12% of the market value of the stocks – a large hoard. Consensus estimates for S&P 500 operating earnings are close to \$80 for 2010 and \$90 for 2011. While next year’s expectations may be too high, a modest gain should be acceptable in any case. Given this view, we think stocks are at their median valuation range, and are attractively valued relative to cash, bonds, and inflation. The cash hoard on corporate balance sheets is beginning to be returned to shareholders. Dividends are increasing from the low payout ratios of 28%. So far this year 187 members of the S&P 500 have increased dividends, and this excludes banks, typically high payers, which have yet to resume previously reduced payments due to capital and regulatory questions. Dividend growth should accelerate. Share repurchase has picked up steam, with US corporations announcing \$40 billion in repurchases in the last 2 months. Merger and acquisition activity has also begun to pickup. In a slow growth world, one way to get growth is to acquire it, and that is being done. Multiples are reasonable, and cash is cheap, fueling this activity. We expect this to continue. In spite of these factors, investors are fleeing stocks, and moving to bonds at a time when many high quality stocks are providing a better yield than 10 year treasuries.

In addition to the above, we have mid-term elections in a couple of weeks. Recent polls indicate a

probable change in legislative control in the House and possibly the Senate as well. Policy actions from the politicians have been frequent and have created a high degree of uncertainty in the minds of business people – in effect too much has been done too fast. A vote for legislative change could slow legislation and diminish this uncertainty, which could well have a positive impact on business conditions.

That is not to say there are no risks in the environment.

- The developed world's economies are operating well below potential, and will continue to do so for sometime. The deleveraging process is ongoing, and many studies have indicated the process could take 5 years or longer.
- The risk of financial crisis still exists, primarily in relation to some of the weak sovereign credits in Europe, which could spread beyond their borders.
- Currency issues are apparent, and potentially harmful. Most countries want their currency weak to encourage exports, and maintain economic activity. Competitive devaluation could become dangerous.
- The looming risk of the US deficit, with its inflationary implications, hangs over our heads. This has yet to be addressed by the authorities as the solutions require near term sacrifice and cutbacks. There are no easy solutions as entitlement spending is overwhelming tax receipts.
- The Fed's quantitative easing, and potentially QE2, has provided liquidity to the system and boosted asset prices. While the program has so far been successful, the magnitude of the experiment could result in unforeseen and damaging consequences with the biggest fear being hyperinflation and a collapse of the dollar and treasury markets.

These are all issues that demand attention. However as we weigh all the above factors we conclude in favor of owning stocks for the near term. With multiples reasonable, and companies increasing payouts to shareholders, there are many high quality businesses selling at attractive prices. As always, it is our job to find those that meet our criteria.

Fixed Income Review and Outlook

Trends in the fixed income market were somewhat similar to those in the equity market during the third quarter. As the Federal Reserve hinted at more action to lower rates and stimulate the economy, investors bought risky assets. The Barclays Capital Aggregate Index returned 2.48% during the quarter. High yield corporate bonds were the strongest performers (6.7%), followed by commercial mortgage backed securities (6.4%), investment grade corporate bonds (4.7%), and municipal bonds (3.4%). US Treasuries (2.7%), asset backed securities (2.5%), and residential mortgage backed securities (0.6%) were relative underperformers last quarter.

As we move toward the end of the year, fixed income investors face two divergent economic

phenomena that could adversely impact certain bond prices. The first is that the economy could retrench and move toward deflation. This would likely push Treasury yields lower but hurt values of the risky assets that investors have eagerly purchased throughout 2010. The other major risk to bond investors is that the size of the US deficits (trade and budget) will at some point require rates to rise and Treasury bond prices to fall as concerns about the ability of the US to service its debt increase. This scenario will likely lower prices of most fixed income securities as bondholders look to lock in gains in a rising rate environment. We as fixed income investors must anticipate the possibility of either scenario. It is our belief, however, that the greater risk to investors comes from rising rates. As a result, we are seeking to lower our sensitivity to interest rates through the purchase of shorter duration securities when opportunities arise.

It is likely that the Federal Reserve, in addition to buying Treasuries with proceeds received from bonds acquired in its last round of quantitative easing in 2008 and 2009, will embark on a new round of securities purchases. Much of the market's rally in the third quarter was in anticipation of this "QE2." If the Federal Reserve buys fewer securities than the market expects, or if it makes its purchases at a slower rate than the market desires, then we could see both higher rates and wider corporate spreads. The greater likelihood, however, is that Fed actions will meet market expectations and the bond market will remain relatively flat during the balance of 2010. With very low Treasury yields, investors are likely to continue to look to risky assets to earn higher returns. We worry that the risks associated with lower rated securities are not factored into the prices of investments such as high yield or BBB-rated corporate bonds and that the stretch for yield has pushed prices of these bonds too high. For these reasons, we are also focusing fixed income investments in securities with higher credit quality.

Our activity for the third quarter was modest as market trends were favorable for the current structure of the portfolio. We moved the core bond portfolios into slightly shorter securities to reduce duration to a level slightly below that of the Barclays Aggregate Bond Index. We also took profits in corporate bonds as demand for risky assets raised prices for corporates to very high levels. In spite of these sales, all portfolios continue to hold above benchmark weights in corporate bonds as their yields offer greater return potential to investors than Treasuries. We expect to maintain this overweight for the balance of 2010. In the mortgage sector, we continued to allow exposure to decline by not reinvesting proceeds from prepayments into new mortgages. The core bond portfolios are underweight their mortgage benchmark. We expect no near term change in this strategy. The limited duration portfolios have no mortgages in their benchmark so these portfolios are overweight this sector. While mortgages were the lowest performing fixed income asset class during the past quarter, mortgages outperformed very short Treasury and agency securities. As a result, the limited duration portfolios did not suffer by holding mortgages this quarter. Going forward, we expect to reduce mortgage exposure further in the limited duration portfolios by selling bonds and continuing to reinvest prepayment proceeds in other fixed income asset classes. Tradition's limited duration portfolios are slightly longer in duration than their benchmark, the Barclays Corporate/Government 1-5 Year Index. The miniscule yield levels of bonds with maturities shorter than two years have caused us to look at slightly longer maturities to find adequate portfolio returns.