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3rd Quarter 2011 Financial Market Commentary

As you've no doubt noticed, global stock markets have declined sharply in recent weeks, hit by concerns over economic growth, sovereign debt crises, and shrinking odds of further stimulus. However, to some extent the selling seems to be overdone, with sentiment overtaking fundamentals in many cases. The market appears to be pricing in a high likelihood of recession, but not all valuation and economic data support such gloom. Current stock valuations are attractive, and high-quality bond prices are on the verge of being unattractive. In response, it is our aim to keeping both equities and fixed income within diversified portfolios.

The Global Sell-Off

During the third quarter, the S&P 500 Index of U.S. stocks tumbled 14% and foreign stocks, represented by the MSCI EAFE Index, fell an even steeper 19%. Through the end of the quarter, the S&P was down 232 points, or 17%, from its April 29, 2011 high.

Why have stocks sold off? Investors appear to be de-risking amid concerns over the pace of global economic growth, uncertainty surrounding the sovereign debt crisis, and the prospect of limited fiscal and monetary stimulus from here.

While this is unnerving, some of the selling is overdone, as fundamentals do not appear to have deteriorated to the extent that sentiment would suggest. Investors seem to be pricing-in a fairly high likelihood that the U.S. has entered a recession. Yet, the evidence is hardly overwhelming, with mixed data pointing to a continued sluggish, uneven expansion. The flight-to-safety has made stock valuations increasingly attractive and, conversely, pushed high-quality bond prices to unsustainably lofty heights.

That said, there is no denying that the situation in Europe is complex, making it difficult to predict the final outcome, let alone its ultimate impact on global financial markets. In view of that uncertainty, we are standing pat in our diversified portfolios, neither further hiking our equity overweight nor reducing it. Instead, we will continue to monitor developments.

Why Stocks are Pulling Back

Stocks appear to have sold off for several reasons.

- First, the pace of global economic growth has clearly slowed amid tighter monetary policy in developing economies and the effects of deleveraging in developed nations.
- Second, the sustainability of global corporate earnings has been called into question given slowing demand and already high profit margins.
- Third, the unresolved nature of the European debt crisis raised questions about the fragility of global capital markets.

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- Fourth, the impotence of elected officials and monetary authorities, who have been unable to formulate an effective policy response amid a highly-charged, partisan atmosphere.

Taken together, these factors seem to have prompted investors to rethink their growth expectations and confront the sobering reality that further monetary and fiscal stimulus (or, at least, fiscal rationalization) may not be in the cards. This has jolted equity markets, which are sensitive to changes in expected future profits.

The State of the Economy

As mentioned, it is increasingly evident that global growth has decelerated and the risk of recession has risen. There are several root causes. Monetary authorities in developing economies such as China have tightened policy in order to cool overheating capital and property markets and contain inflation. Developed economies such as Europe have been plagued by deleveraging, which has stymied credit creation. Here in the United States, persistent high unemployment and a sluggish real-estate market has weakened our aspects of the domestic recovery.

Other factors have also contributed to the slowdown. For instance, policy-makers have gradually withdrawn stimulus amid calls for greater fiscal austerity, further exposing softness in demand. In addition, the Japanese earthquake in the Spring unsettled global supply chains, weighing heavily on vehicle production and sales, while the U.S. debt-ceiling impasse likely chilled capital investment for a time.

The question is whether these signs, taken together, indicate that the global economy has entered recession, or is on the verge of doing so. Judging from the market's reaction, it appears that a critical mass of investors have already made up their minds, and are pricing in a high likelihood of recession.

However, it's not that clear-cut. The recovery has been relatively tepid and highly uneven almost from the onset. While it's true that this has left economies more susceptible to shocks like the Japanese quake or the sovereign-debt crisis, it also can make it difficult to see the true trendline. And what is that trend-line? Judging from the data we've analyzed, it remains upward, though on a disappointingly flat trajectory.

Uncovering Signs of Growth

Conventional wisdom has it that the beleaguered U.S. consumer has yet to get up off the mat. Yet, while the pace of growth has been less-than-satisfying, the trend in real personal consumption expenditures, i.e., consumer spending, has been unmistakable—it has been rising, even through the crucible of the third-quarter.

Manufacturing output has clearly been buffeted by disruptions caused by the Japanese quake as well as the gradual downshift in importing developing-market economies. Despite that, the Institute of Supply Management's (ISM) closely-followed manufacturing index rose from August to September, indicating that the factory sector had expanded. This jibes with data showing that September vehicle sales rose sharply off of their August levels, nearing a high for the year.

The U.S. trade deficit, or the difference between what the U.S. economy exports and imports, has also been narrowing amid a weakening dollar (which bolsters the price-competitiveness of U.S. goods and services abroad) and falling commodity prices. Why is this relevant? Apart from denoting a healthier balance of trade, any narrowing qualifies as a positive contribution to gross domestic product.

Clearly, all is not well with the U.S. economy amid high unemployment, sluggish demand among small firms, and continued duress in the housing market. Further, there is no doubt that downside risks that could weigh on growth in the fourth-quarter into next year. The most notable is the possibility that the European debt crisis could further destabilize

capital markets and chill worldwide demand. I'm optimistic that this worst-case scenario will be averted and, as that uncertainty recedes, attention will turn back to more-enduring fundamental measures, including profit growth and valuations.

Stock Valuations are Attractive

Stocks looks quite cheap on a variety of metrics, even after factoring in the current economic headwinds. For instance, consider the following valuation measures for the S&P 500 Index (all current as of 10/4/2011):

- Trailing Earnings: The S&P 500 was trading for 12.3 times trailing earnings per share, substantially lower than the market's 140-year average (15.5 times). While it's true that the market can look exceptionally cheap early in a recession (given the way peak-profits tend to inflate the multiple's denominator at such times), the S&P even looks inexpensive by the standards of past recessions. According to Bloomberg, the S&P has traded for 13.7 times trailing earnings, on average, in the last nine recessions since 1957.
- Intrinsic Value: According to Morningstar, Inc.'s equity analysts, the S&P was trading at a hefty 23% discount to their estimate of the index's aggregate fair value. (That estimate is derived from the analysts' company-by-company research, which spans the vast majority of the S&P's constituent holdings.)
- Yield: The S&P is sporting a 2.40% current dividend yield, which is well above the 1.84% yield of the benchmark ten-year Treasury bond, despite stocks offering the prospect for growth in income and capital appreciation.

Taken together, these measures may suggest that equity investors can invest in stocks with a healthy margin of safety. This bodes well for future equity-market returns, though it is not wise to fully discount the possibility of jarring volatility over the short-term, especially until the European debt crisis has been more-satisfactorily addressed.