MONTHLY MARKET COMMENTARY

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The Economy

The U.S.

Despite a slew of worrying headlines from Europe, the U.S. economy continues on a relatively positive upward trajectory. Economic data from November surprised to the upside, reflecting a modestly improving growth story for the U.S. While Europe and China face potential slowdowns in economic activity in the coming months, the U.S. trudges forward.

November was a Jekyll and Hyde month for the economic outlook and for financial markets. There is a wide dispersion of opinions from economists and Wall Street, as both good news and bad news are found in good supply. In quantum physics there exists the Paradox of Schrodinger's Cat, an Einstein et al thought experiment which allows that the observation of matter fundamentally changes with that which is being observed. The experiment deals with a hidden cat that could be both dead and alive at the same time, but not definitively one or the other until it is observed. And so this "dead or alive" concept can be applied to the financial markets and the economy. When looking for confirmation of either economic growth or recession, economists could have observed both in the month of November. Depending on their biases, they draw different conclusions for the health of our economy going forward influencing public policy and private sector investment. Perhaps we could call it the Paradox of the U.S. Economy's Health.

First, the good news. Consumer confidence rebounded strongly in November after touching new lows in October. The ISM Manufacturing Index was expansionary, registering a reading of 52.7 for the month—above expectations. Pending home sales in the U.S. increased 10.4% for the month, the largest gain in a year and also above estimates. Investment grade and high yield fixed income spreads both improved in the U.S., as credit conditions eased slightly. Consumer spending rose 0.1% for the month, while "Black Friday" and "Cyber Monday" retail sales numbers were up markedly from last year. The companies of the S&P 500 have posted double digit earnings growth for eight consecutive quarters.

Economic bad news was mostly a European phenomenon, though an increasingly interconnected world weighed on prospects for the U.S. November's ISM non-manufacturing number was 52.0, the lowest reading since January 2010 and an indication that activity slowed in the service sectors of the economy. The national unemployment rate fell to 8.6% for the month, though this number was largely deceiving. Approximately 315,000 workers stopped looking for employment, driving down the unemployment rate. We look for the unemployment rate to drop as a result of increased jobs, not an increase in discouraged workers who give up searching.

Consumer spending continues to rise in the U.S.—a decidedly good thing. The increase in spending isn't all good news, however. Wage growth continues to remain subdued. Accordingly, consumers are spending a higher percentage of their pay checks, saving less instead of making more money. Over the long term, this kind of spending growth is unsustainable as savings rates will eventually decline to zero. An increase in hours worked and income would be most welcome.

The World

America celebrated Thanksgiving on November 24, and households across the country enjoyed too much turkey. In the global financial markets the only turkeys to be found in November were the Euro zone countries, which cast a dark shadow across the macroeconomic outlook. Sovereign debt in Western Europe has remained a cause for concern, as overextended countries like Greece, Portugal, Spain and Italy place stress on the entire Euro zone.

Italy became the focus of concern in November. The yield on 10-year Italian government bonds spiked to over 7% in the month, indicating serious fiscal stress. With a total debt load of approximately 120% of GDP, Italy needs to roll over €300 billion in the next twelve months. The Italians can't possibly service their debt at such high interest rates, putting pressure on the European Central Bank and others to implement measures to bring down yields. Financial conditions in Italy improved by the end of November, and yields have thankfully come down. We see renewed optimism as new Prime Minister Mario Monti has brought swift reforms, budget cuts and new taxes aimed at salvaging their dire fiscal outlook.

Regardless of whether European leaders can impose the proper austerity measures and right their fiscal ship, a recession has descended upon Western Europe. Most economists estimate a contraction for the European economy in 2012, to the tune of about 1% of GDP. Large budget cuts and a rapid reduction in bank lending have been the leading contributors to the contraction.

A critical meeting of European leaders on Friday, December 9 will have important consequences for the Euro zone. Germany and France will lead talks to strengthen the European Financial Stability Fund (EFSF). The size and terms of the proposed Euro zone bailout will have important implications for fixed income and equity markets.

Germany is the strongest country in the region and in the best position to lead Europe out of its current struggles. Politically, Angela Merkel and her government have had a difficult time convincing Germans to bail out their fiscally reckless European brethren. Political sovereignty remains a huge obstacle to creating a meaningful, sweeping financial solution to Europe's current situation. Expect continued volatility based upon headlines, driving returns in Europe and across global markets.

The Market

For all the negativity in November, U.S. markets finished the month relatively flat. The S&P 500 ended the month down 0.2%, thanks to the last week of November in which the U.S. market rallied 7%. This was the largest weekly rally in two years. The Dow Jones Industrial Average was up 1.2% for the month and is now positive for the year.

Global equities were mostly down for the month, reflecting heightened stress in Europe. For November, the MSCI EAFE Index was down 4.6%, while the MSCI Emerging Markets Index was down 6.6%. Until more clarity emerges out of Europe, volatility will remain.

Bonds declined slightly for the month. The Barclays US Aggregate Index was down 0.9%. Municipal bonds rallied slightly. U.S. Treasurys rallied again in November, as fears of contagion in Europe drove capital

into the perceived security of U.S. sovereign debt. The yield on the 10-year U.S. Treasury bond finished November at 2.07%. Yields on U.S. Treasury bonds remain near record lows.

The Dow Jones UBS Commodity Index was down 2.2% in November. Potential slowdowns in Europe and China dimmed the outlook for commodities in general. Oil rose to nearly $100 a barrel for WTI crude. Keep an eye on Iran, as Israel and its western allies prepare for a potential skirmish to limit the country's nuclear capabilities. A conflict in Iran would cause the shutdown of the Strait of Hormuz, through which 33% of the world's seaborne oil shipments pass. Such an event would signal a meaningful rise in global energy prices.

Outlook

It is anyone's guess what the markets will deliver in the final month of 2011. Increasingly positive economic data in the U.S. suggest a Santa Claus rally for risk assets. Increasingly negative news out of Europe suggests a bearish outcome for the markets. Importantly, there is already a large amount of pessimism baked into global equity markets. Any surprises to the upside could trigger a bullish finale to the year.

Frustratingly, the markets in recent months have traded on headlines and not on fundamentals. Short-term announcements from European leaders have crowded out nearly every other data point. Equities in the U.S. and across the globe still trade at discounts to historic averages.

As winter time approaches, we are reminded of the Robert Frost poem "Stopping by Woods on a Snowy Evening."

The woods are lovely, dark, and deep,

But I have promises to keep,

And miles to go before I sleep,

And miles to go before I sleep.

We are not yet "out of the woods" with respect to the European financial crisis and a slower growth outlook for much of the developed world. The U.S. and the Euro zone both are on unsustainable fiscal paths that will require real sacrifice. After the elections in 2012, the President and Congress have "miles to go" in order to improve our country's balance sheet. Financially responsible reforms from Europe and the U.S. would be most welcome news as we close out 2011. In the mean time, we wish the markets a lovely trip through the woods. We wish you a Merry Christmas and Happy Holidays as well.