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September 2012 Commentary

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The Economy: More of the Same

The U.S.

The U.S. economy continues along the path of too-slow growth. In September, we learned that Q2 GDP growth in the U.S. was revised downward to 1.3% from a previous estimate of 1.7%. While 1.7% growth was fairly abysmal to start with, the revision to 1.3% indicates a significant stalling of economic activity here at home. Though several one-time events (like the drought in the Midwest this summer) dragged down the data, Wall Street and Main Street alike cannot help but recognize that economic conditions are stagnant.

An emergency room simile seems appropriate. At the height of the recession in 2008, the U.S economy was in freefall and needed to be placed in the intensive care unit. Following unprecedented spending and monetary stimulus by our government, and the subsequent consumer spending growth, the U.S. economy started to heal. We were moved to stable, but not good, condition. And this is where we remain today.

A new round of quantitative easing (QE3) was announced by the Fed in September. Equity markets and riskier asset classes rallied nearly universally on this news of continued monetary stimulus. For political cover, Fed Chairman Bernanke's latest bond buying program could only come after what was perceived to be a significant downturn in the growth of the economy. While on one hand we welcome the stimulative measure's effect on capital markets, we also recognize the diminishing returns for each new round of easing.

Politics continues to dominate the headlines as we get closer to the Presidential election. Both President Obama and Governor Romney have emphasized the economy as part of their pitch to the American people. Equally important to the conversation is the fiscal cliff that will happen in 2013 should the Bush tax cuts expire and automatic spending cuts occur. While no solution is likely to be found before election day, Congress and the President are expected to arrive at some type of temporary solution before the fiscal cliff goes into effect. Stay tuned.

Manufacturing in the U.S. picked up steam in September, a welcome surprise to the upside. The ISM Manufacturing Index for the month was 51.5 percent, a number that indicates modest expansion. Manufacturing activity grew mostly as a result of new orders, which increased 5.2% for the month. Increased consumer confidence, and the resulting increase in consumer spending, drove the modest gains in manufacturing.

Housing data were strong again in September. Online real estate site Trulia reported that asking prices on for-sale homes nationally have risen 2.5% in the last year. Excluding foreclosures, the prices of existing homes for sale have risen 3.5% year-over-year. Record low mortgage rates and a low supply of available housing has provided a floor for U.S. housing. While there are still concerns about the large potential supply of homes that could flood the market as housing improves, the overall picture for residential housing looks bright going forward.

The World

Europe remains far from a full solution to its fiscal crisis, though the month of September showed a critical improvement in European sovereign credit markets. For a time this summer, bond yields for peripheral countries were dangerously high. As yields rose in places like Spain, their fiscal situation deteriorated and unsustainable deficits started to become a self-fulfilling prophecy. Higher borrowing costs made austerity even harder. Thankfully, bond yields dropped sharply in Spain, Portugal and Italy—a welcome sign amidst the mostly gloomy headlines.

The European Central Bank's Outright Monetary Transactions (OMT) announcement was the cause of lower bond yields and easing credit conditions in September. Under the direction of ECB President Mario Draghi, the ECB announced its plan to buy short dated sovereign European bonds. With the ECB buying bonds, the hope is to prevent yields in places like Spain from spiraling out of control. Historically, the ECB has been much more reluctant to engage in this type of easing than the U.S. Fed.

Europe's economic woes continue. Eurozone manufacturing activity shrank for the fourteenth straight month in September. Unemployment also hit fresh highs across the continent. Astoundingly, the unemployment rates for Spaniards and Greeks under the age of 25 are 52.9% and 55%, respectively. Structural problems exist for many European countries that are unlikely to go away soon. On the bright side, European equities remain at very attractive levels. European stocks continue to trade well below their U.S. counterparts on a valuation basis.

Geopolitics in the Middle East remain a concern for the financial markets. The U.S. and Israel have experienced unusually chilly relations recently, as President Obama elected not to meet with Prime Minister Binyamin Netanyahu on his recent visit to the United States. Much of the problem is with Iran. A nuclear Iran presents a whole host of problems for the Middle East. A pre-emptive attack by the U.S. or Israel to disable Iran's nuclear facilities would be challenging to accomplish, could result in loss of American lives, and could instigate a regional conflict. Energy prices would spike in the event of an Israeli or American strike on Iran.

The Markets: A Strong Month and Quarter

September was a good month for nearly all asset classes, providing the finishing touches on a massive rally for most markets in the third quarter. For the month, the S&P 500 registered a 2.58% gain, bringing the year-to-date return to 16.44%. Through September 30, on a one year basis the S&P 500 is up 30.2%.

Foreign equities experienced substantial gains as well, as monetary conditions improved across the European continent. For the month, the MSCI EAFE Index was up 2.96%. The index has registered an 11.12% return in 2012, all of this in spite gloomy economic conditions for much of the developed world. Emerging market equities were up significantly in September, gaining 6.03%.

Bonds gained for the month, but on a much smaller scale than riskier asset classes. The Fed's announcement of a new round of quantitative easing (QE3) in September was worth noting: the Fed will be buying mortgage backed securities and not Treasuries in their latest bond buying program. Treasury yields initially spiked on the news, but retreated later in the month. The Barclays U.S. Aggregate Index was up 0.14% for the month, while the Barclays Global Aggregate Index experienced a 1.22% gain. The Barclays Global Agg Index outperformed its U.S. counterpart again in September. U.S. high yield bonds rose once again for the month, up 1.39%. The search for yield in a historically low interest rate environment has continued to drive investors toward high yield bonds.

The Dow Jones UBS Commodity Index gained again in September, registering a 1.71% rise. Renewed political instability in the Middle East and a new round of quantitative easing drove energy prices higher for the month.

Table of Returns

September 30, 2012

	Performance(%)				
Equities Index	1 Month	Year To Date	1 Year	3 Years	5 Years
S&P 500	2.58	16.44	30.20	13.20	1.05
S&P MidCap 400	1.94	13.77	28.54	14.33	3.83
S&P SmallCap 600	2.33	13.80	33.35	15.14	3.29
MSCI EAFE (net)	2.96	10.08	13.75	2.12	-5.24
MSCI EM (net)	6.03	11.99	16.94	5.64	-1.28
Fixed Income Index					
Barclays Aggregate	0.14	3.99	5.16	6.19	6.53
Barclays Global Aggregate	1.22	4.82	5.07	5.04	6.22
Barclays 1-10 Yr. Muni	0.50	3.25	5.14	4.61	5.44
CSFB Leveraged Loan	1.08	7.79	10.72	7.74	4.46
Barclays US Corp: High Yield	1.39	12.13	19.37	12.90	9.34
Other Index					
HFRI Fund of Funds Composite Index	N/A	N/A	N/A	N/A	N/A
Dow Jones-UBS Commodity Index	1.71	5.63	6.00	5.26	-3.03
Wilshire US REIT Index	-1.83	14.74	32.43	20.72	1.73
S&P Developed Property	1.79	21.63	29.66	13.21	-1.95
LPX 50 TR	4.48	21.36	26.66	8.80	-9.65
Citigroup 3 Month T-Bill	0.01	0.06	0.06	0.08	0.63

Closing Thoughts

All eyes turn to the U.S. elections in early November. It is difficult to watch television these days without being barraged by political ads. The presidency and the balance of power in the House and Senate are all in play. Both in the mainstream media and in the financial world, a tremendous amount of attention is paid to politics. And yet, do the results of the election of one party over the other have any predictable influence on the financial markets? The answer is probably not.

Russ Koesterich, Global Chief Investment Strategist for iShares, weighed in on the effect of presidential elections in a recent research note. His conclusion: the winning party's affiliation has very little correlation to subsequent equity market returns. He also noted that there is no evidence to suggest that a divided congress and presidency drive better market returns. One other important takeaway: sound policy matters much more than political party. From a fiscal and monetary perspective, Washington needs to be very aware that the current deficits are unsustainable; we are well on our way to becoming Greece in a few decades.

The next U.S. chief executive, whether President Obama or Governor Romney, will have the responsibility to address the fiscal cliff and our weak economic recovery. As Americans, we hope the winner will be up to the task.