MONTHLY MARKET COMMENTARY

INNOVEST October 2011

The Economy

The U.S.

Just as the mood of world markets and the American consumer reached its gloomiest at the end of September, we had a surprisingly upbeat equity market in October. Reflecting this perceived misery, the October U.S. consumer confidence number registered 39.8, the lowest since March 2009. A series of reports indicating improved economic data helped to calm nerves and boost financial markets both domestically and abroad. An improving outlook for the U.S. couldn't have come at a better time, since we've endured growing economic pessimism over the last six months.

Historically, October has been among the worst months for financial markets. The Great Depression started with the Great Crash of October 1929, "Black Monday" occurred in October 1987, and our latest financial crisis reached its peak of distress in October 2008. Thankfully, the news from October 2011 was far more encouraging.

Economic data from October confirmed that the U.S. is not in a recession. For the third quarter, U.S. GDP rose at an annual rate of 2.5%. While far from robust, a 2.5% growth rate was welcome news to economists and Wall Street alike. Retail sales numbers rebounded in September—up 1.1%, which was well above expectations. Consumer spending was up 0.6% as well, a key contributing factor to an increase in GDP growth. Inflation remained tame: U.S. core CPI rose 0.1% in September, below market expectations. Finally, the non-farm payrolls data for October revealed an uptick in hiring, and the unemployment rate fell to 9.0%.

The Occupy Wall Street movement in October experienced what Andy Warhol described as its "fifteen minutes of fame." Reflecting the growing frustration among the unemployed and the economically marginalized, the protests garnered much attention last month. The movement's contentions revolve around the perceived gap between America's middle class and the very wealthy. Adjusted for inflation, median U.S. household income has remained flat over the last decade, while median income has grown for the wealthiest of Americans.

Private enterprise and entrepreneurship are likely to lead our country out of the current economic morass. Far from being the problem, growth in U.S. business activity is the solution. As Churchill once noted, "The inherent vice of capitalism is the unequal sharing of blessings; the inherent virtue of socialism is the equal sharing of miseries."

The World

Financial problems in Europe remain a concern for the overall health of global financial markets. Troubling news continues to come out of Greece, though there was some progress in October. European leaders hashed out a deal to reduce Greece's debts while providing it with additional rescue loans. As part of the arrangement, holders of Greek bonds will take 50% losses on their debt. Supporters of the debt reduction plan claim that Greece can reduce its debt to GDP ratio to 120% by 2020, which would be a significant feat from its currently unsustainable level of 180%.

Undoubtedly a 50% haircut on Greek debt is painful, and there continues to be a very real possibility of Greek sovereign default. As the English proverb goes: "fifty percent of something is better than one hundred percent of nothing." An "orderly" default is far preferable to a chaotic one, as European leaders seek to minimize the damage to the greater financial system. The process will likely take months to work itself out.

European leaders took a step in the right direction in October by vowing to increase the European Financial Stability Facility to $1.4 trillion. The proposed increase should give European leaders more firepower to fight against any financial contagion that could be brought on by a debt default in Greece. The real worry lies in the financial crisis spreading to Italy and Spain. If European leaders can bring a larger EFSF to fruition, the risk of contagion goes down markedly.

Italy remains the most important piece of the European crisis. Worryingly, debt costs for Italy surged at the end of October, with the yield on sovereign Italian 10-year notes exceeded 6.5%, the highest since 1997. Italian political turmoil has contributed to heightened unease for bond investors. The proposed International Monetary Fund (IMF) surveillance of Italian fiscal reforms has proven very unpopular in Italy, calling into question the continued rule of Italian Prime Minister Silvio Berlusconi. Italy has room to improve its fiscal situation, and news of its stability would go a long way to calming systemic fears.

According to the Financial Times, 80% of the European debt market is held on European banks' balance sheets. With such massive exposure to European sovereign credit, the risk of insolvency looms large for some European banks and indicates why this European crisis is so urgent. Preventing a Lehman Brothers type of bankruptcy in Europe is paramount and requires the full attention of European leaders.

The Market

October was one of the best months for stock market returns in the last half century. The S&P 500 finished the month fully 10.9% higher—the first time the index has experienced a double-digit monthly gain since 1991. The Dow Jones Industrial Average climbed 9.7%. Despite the slew of bad news during much of the summer and fall of 2011, the S&P 500 is now flat year-to-date.

Global equities rallied to the upside as well. The MSCI EAFE Index gained 9.6% in October. French markets are still down about 18% for the year, and the German DAX index is down just under 14%. On a valuation basis, western European markets are still cheap. The fear and uncertainty of the financial crisis in Europe will continue to weigh on price multiples. Long-term investors should be comfortable acquiring high quality, profitable European companies that have suffered this year.

Bonds experienced mixed results in October. The Barclays Capital Aggregate Bond Index posted a 0.11% gain. The rally in equities did not lead to a selloff in bonds, a common occurrence when economic data surprises to the upside. The flat returns for bonds in October suggests that credit markets are not as convinced about improving data as are the equity markets. High yield bonds had a great month, as the worries eased about corporate credit, driving the index upward by 5.99%.

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The Dow Jones UBS Commodity Index was up 6.62% in October. In general, risk assets rallied, and commodities reflected this upward momentum. Energy prices were up in October, as improved prospects for the global economy created an outlook for higher demand. Gold prices surged in October following news of the European bailout and its expected increase in Eurozone inflation.

Outlook

Tim Tebow became the starting quarterback for the Denver Broncos in October, creating a whirlwind of controversy. While Tebow has shown flashes of brilliance, he has also shown extended periods of mediocrity. There are strong opinions on both sides about Tebow's potential in the NFL, with many experts and pundits decidedly bearish on his ability to become a successful player in the league.

A great deal of uncertainty is hanging over the prospects for the U.S. economy and global financial markets at large. Bearish scenarios and a general pessimism about the prospects for financial markets are common among economists and the public. However, the U.S. economy showed encouraging promise in October, despite dismal predictions from the critics.

Warren Buffett was quoted in a 2009 CNBC interview saying: "There's no way you can bet against America and win." Indeed, the American economy has shown resilience through a myriad of economic cycles and downturns. While Europe continues to work through its financial struggles, we see slow-but-steady economic improvement here in the U.S. Maintaining a long-term view and being disciplined and patient in the midst of uncertainty and volatility are likely to remain among the enduring characteristics of successful investing. As we enter the fourth quarter of 2011, we wouldn't bet against the U.S. economy or the U.S. markets. Nor would we bet against Tim Tebow. We hope both the markets and Mr. Tebow have a great November.

Bond Rates	11/4/2011	12/31/2010
U.S. Federal Funds Target Rate	0.25%	0.25%
U.S. Two-Year Treasury Yield	0.23%	0.60%
U.S. Ten-Year Treasury Yield	2.06%	3.30%
U.S. Ten-Year Muni Yield	2.87%	3.75%
High Yield	8.50%	7.51%
Exchange Rates		
$ per €	1.37	1.34
$ per £	1.61	1.57
¥ per $	77.07	81.11

Latest Returns

EQUITIES Index	Oct-11	3 months	YTD	1 Year	3 Years	5 Years
S&P 500	10.93%	-2.47%	1.30%	8.09%	11.41%	0.25%
S&P 400 Midcap	13.75%	-5.53%	-1.06%	8.55%	17.87%	4.01%
S&P 600 Small Cap	15.00%	-4.75%	-0.86%	10.54%	13.79%	2.12%
MSCI EAFE	9.64%	-9.76%	-6.78%	-4.08%	9.90%	-2.41%
MSCI Emerging Markets	13.25%	-11.91%	-11.53%	-7.72%	23.23%	6.51%
FIXED INCOME Index	**Oct-11**	**3 months**	**YTD**	**1 Year**	**3 Years**	**5 Years**
BC Aggregate Bond	0.11%	2.31%	6.79%	5.03%	8.89%	6.42%
BC Muni Bond 1-10 Yr	-0.45%	1.12%	5.22%	3.31%	6.27%	4.96%
BC High Yield	5.99%	-1.58%	4.52%	5.17%	22.96%	8.04%
BC Global Aggregate Bond	1.33%	0.25%	6.80%	4.07%	9.73%	6.99%
CSFB Bank Loan Index	2.59%	-1.43%	1.67%	3.52%	12.79%	3.55%
OTHER Index	**Oct-11**	**3 months**	**YTD**	**1 Year**	**3 Years**	**5 Years**
DJ UBS Commodity	6.62%	-8.18%	20.19%	32.57%	14.05%	4.67%
DJ Wilshire US REIT	14.69%	-3.74%	8.73%	11.67%	16.69%	-1.71%
S&P Developed World Property	11.65%	-7.45%	-1.07%	1.64%	16.17%	-2.83%
LPX 50 TR	13.69%	-15.14%	-11.17%	-6.69%	9.06%	-9.14%
HFRI Fund of Funds Index	1.39%	-4.03%	-3.95%	-1.93%	2.77%	0.34%
3 Month T-Bills	0.00%	0.03%	0.10%	0.13%	0.18%	1.66%

* Returns provided by outside vendor. Innovest not responsible for accuracy of numbers presented.

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