QUARTERLY REVIEW AND OUTLOOK
THIRD QUARTER, 2010

Table 1

Index	3rd Qtr. 2010	YTD	Last 12 Mo.	Last 3 years	Last 5 years
S&P 500 Index	11.29	3.89	10.16	(7.16)	0.64
Russell 2000 Index	11.29	9.12	13.35	(4.29)	1.60
MSCI EAFE Index	16.48	1.07	3.27	(9.51)	1.97
MSCI Emerging Markets Index	18.03	10.75	20.22	(1.48)	12.74
Barclays Capital US Aggregate Bond Idx	2.48	7.94	8.16	7.42	6.20
Barclays Cap. US 20+ Yr. Treas. Idx	4.99	20.63	11.50	10.49	7.39
iBoxx $ Liquid Investment Grade Index	5.67	12.00	12.35	9.01	6.69
iBoxx $ Liquid High Yield Index	6.24	9.29	14.79	5.95	

Source: iShares.com

The stock market continued its recent trend of high volatility (Chart 1) in the third quarter with September's strong gains bringing returns solidly into positive territory for the quarter (Table 1). Year-to-date returns as of the end of *August* for many of the most widely followed stock indices were mostly negative. However, September – which is historically the worst month of the year – posted its strongest return since 1939 (although referencing that decade should provide little comfort) and propelled the indices into positive territory for the year-to-date.

Chart 1: S&P 500 Index – Trailing 12 Months

Source: eSignal

While stocks turned around in the third quarter, Treasury bond *yields* (i.e. interest rates) continued on their path lower (chart 2) leading to gains in the fixed-income markets. Commodities also produced solid returns for the quarter (Dow Jones-UBS Commodity Index Total Return: +11.61%).

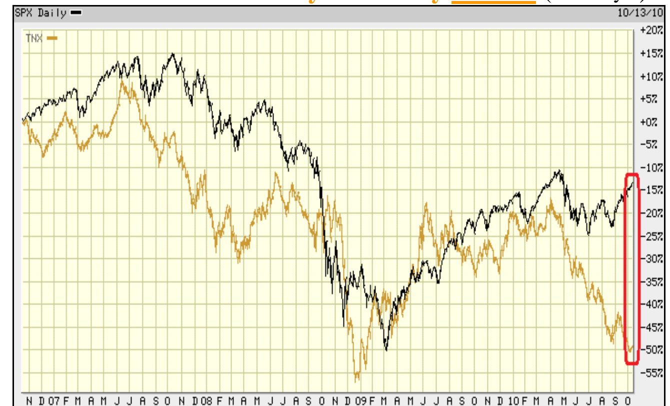
There hasn't been a simultaneous positive quarterly return in these three asset classes (stocks, bonds and commodities) since the first quarter of 1986, after which bonds declined 10% within two-months. They also declined after synchronized moves in 1980 and 1982.

Stock prices and bond yields tend to be positively correlated. At this time, however, Treasury bond yields are closing in on all time lows, and stocks are closing in on or making new recovery highs (chart 3). It is unlikely that the relationship between stock prices and bond yields has been repealed. Therefore, we must be prepared for the convergence of the two at some point in the future…and bond yields tend to lead stock prices.

Chart 2: 10-Year Treasury Note Yield

Source: eSignal

Chart 3: S&P 500 and 10-yr Treasury YIELD (last 4-yrs)



Source: bigcharts.com

While September's batch of positive economic data and the fact that polls indicate the November 2nd mid-term Congressional elections will likely see Republicans gain control of the House and narrow the current Democratic majority in the Senate have contributed to recent gains, our view is that the primary cause of recent strength in risk assets is the market's belief that the Fed will make good on its commitment to further boost asset appreciation through additional quantitative easing. David Tepper, a well known hedge fund manager recently laid out his very basic argument for his outlook that stocks will go higher: either the economy strengthens on its own and stocks go up, or

weak economic data forces the Fed to act…sending stocks higher. This strategy may work for a while, but unless further easing by the Fed manages to induce a renewed credit and spending spree, a more somber reality will set in.

From our perspective, it's hard to figure out just what, at the margin, lower interest rates are going to do to stimulate the economy (other than boosting the "wealth effect" due to asset appreciation). The five-year Treasury note is already at 1.1% and the ten-year note is around 2.5%. It's hard to argue that liquidity and interest rates are an impediment to economic growth:

- Corporations are sitting on $1.6 trillion of cash on their balance sheets.
- There is $2.6 trillion of cash sitting in money market mutual funds.
- Commercial banks are flush with cash with well over $1 trillion of reserves left over from the first round of quantitative easing.

The Fed can print money, but it can't control where it goes. While the Fed has been successful in generating asset bubbles in the recent past (the tech bubble in the late 1990s and the housing bubble in the last cycle), we know from experience that bubbles never end well.

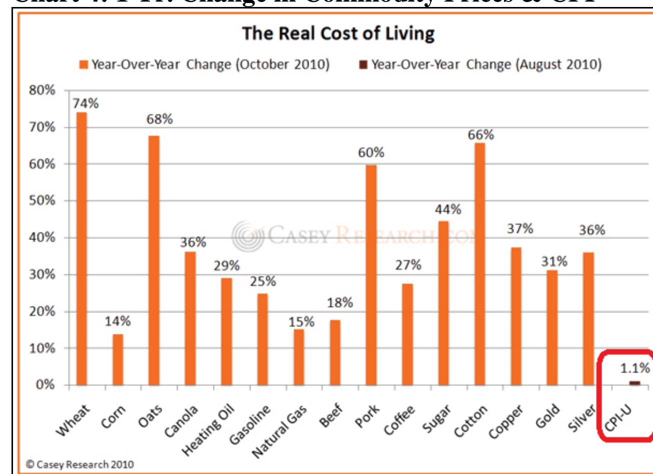
Ultimately, we have to work with what we know. The Fed wants inflation HIGHER. Chairman Bernanke wants inflation to reach a target of around 2% - it is presently around 1% (chart 4). The Fed has been dropping hints of another round of quantitative easing since late-August. The press release from the September 21 Federal Open Market Committee (FOMC) meeting reinforced this intent. It is now a question of when and how big. Based on the markets' returns since late August, investors are counting on the Fed making good on its statements. So, an important question is to what degree is this already reflected in asset prices. We believe asset markets have already 'priced in' significant quantitative easing in the US.

The widely held consensus view is that the Fed will initiate a second round of quantitative easing (QE2) following the November 2 – 3 FOMC meeting. While various estimates exist regarding the size and form of the program, most investors are optimistic regarding the market impact of the Fed's actions.

The decision to begin QE2 represents an explicit acknowledgement by the Fed that US economic growth remains very weak and unemployment is likely to remain much higher than its policy mandate. Nevertheless, investors seem to believe the market will continue to rally even after the Fed's announcement next month. This leaves markets vulnerable should the Fed not deliver.

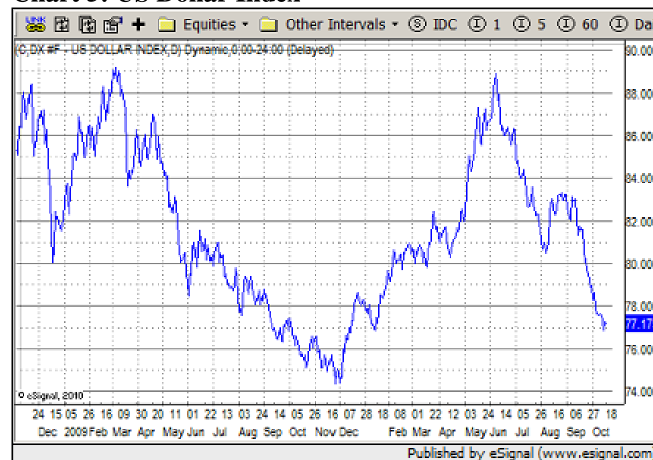
Over the shorter-term, we believe there is a rising likelihood of a correction in the financial markets given the degree of the markets' recent advances, the stock price/bond yield divergence, the degree of the decline in the US dollar (chart 5), the impact of the rising cost of commodities, and the potential for disappointment out of policymakers.

Chart 4: 1 Yr. Change in Commodity Prices & CPI



Source: Casey Research

Chart 5: US Dollar Index



Source: eSignal

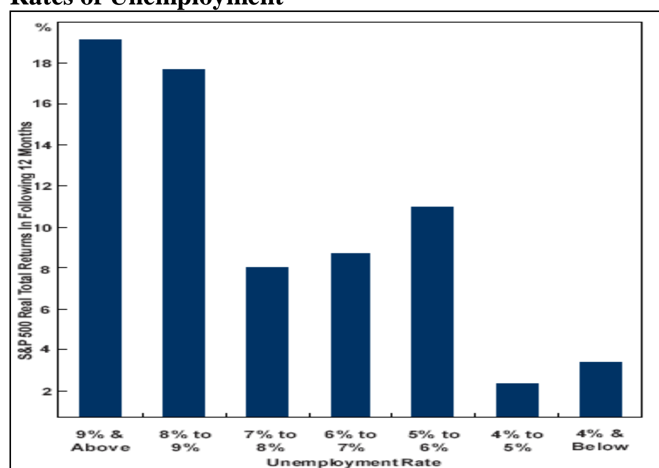
Looking a bit further out, we expect the global economy to become increasingly divergent in terms of the strength of growth, cyclical patterns and monetary policy among regions and countries. In general, the developed world's economies will at best be described as "slush": after a snap-back surge following a bad recession, the economy will be characterized by reduced growth, weak pricing power, periodic threats of deflation, higher than "normal" unemployment and lingering debt crises. For the emerging world, however, the story should be different: The major emerging market nations have been undergoing a much stronger recovery, with rising asset values, strengthening business activity and even growing inflationary pressures. Asset prices and financial markets will likely reflect these divergences.

"Slush" is not necessarily bad for stocks. The combination of modest growth, very low inflation and highly

accommodative monetary policy is usually supportive of equities. In the early 1990s, the broad investment climate was somewhat similar to today: A damaged banking system, pressure on US corporations to de-lever, a high unemployment rate and "corporate downsizing" all contributed to high levels of investor anxiety over whether the US economic recovery would be sustained – yet stocks continued climbing a wall of worry.

Today, we have slow economic growth, low inflation, a high jobless rate, but solid profit growth. An interesting observation is that stocks have generated strong returns following periods of high unemployment in the past (chart 6).

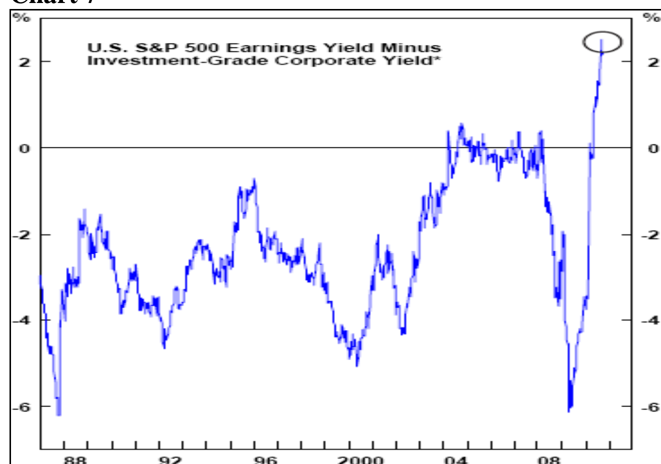
Chart 6: 12 Month S&P 500 Returns Following Various Rates of Unemployment



Source: BCA Research

With government and corporate bond yields at very low levels, and commodities flirting with pre-crisis highs, stocks are actually *relatively* attractive compared to other competing asset classes. One measure of relative valuation is illustrated in Chart 7 which shows that the S&P 500 earnings yield (the inverse of the price/earnings ratio) exceeds corporate borrowing costs by a wide margin.

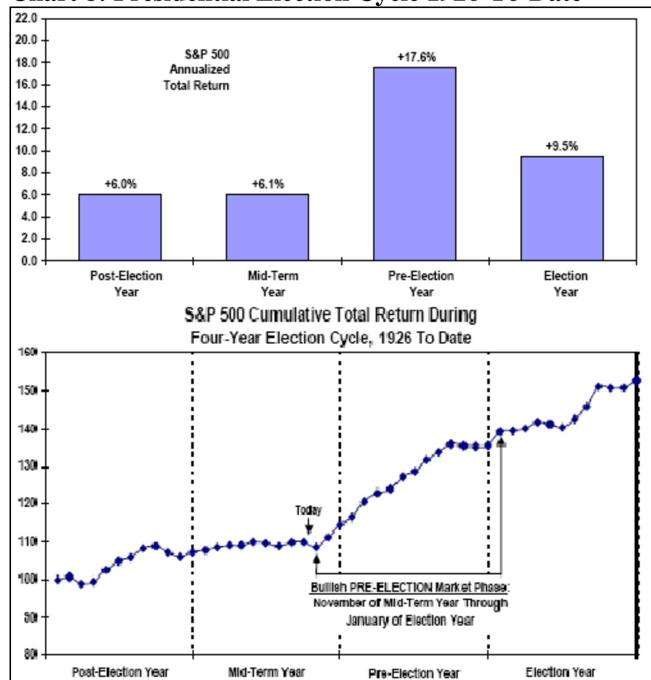
Chart 7



Source: Bank of America Merrill Lynch

Another factor in support of stocks over the medium-term is the well-know presidential election cycle in the stock market in which "Year 3" has produced the strongest stock market returns of the 4-year election cycle. Since 1926, average pre-election year total returns for the S&P 500 have been +17.6% - eight percentage points better than the next best year (the election year itself), and almost triple the average returns of each of the first two years of the cycle (chart 8).

Chart 8: Presidential Election Cycle 1926-To-Date

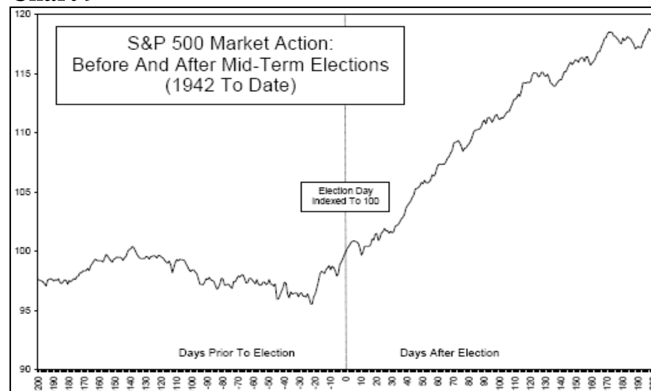


Source: The Leuthold Group

These charts mask substantial variance in the underlying *pre*-mid-term return data:

- In 9 of the last 17 200-day periods leading up to the mid-term elections, the S&P 500 posted losses.
- In 8 of the last 17 200-day periods leading up to the mid-term elections, the S&P 500 posted gains.

Chart 9



Source: The Leuthold Group

However, in all seventeen instances, the S&P 500 posted gains in the 200-day period following a mid-term election (Table 2).

Table 2

	S&P 500 Performance 200 Days Leading Up To Mid-Term Elections	S&P 500 Performance 200 Days Following Mid-Term Elections
1942	15.6%	30.5%
1946	-15.3%	3.9%
1950	12.4%	13.0%
1954	23.7%	31.8%
1958	25.1%	14.7%
1962	-14.6%	22.6%
1966	-14.0%	15.3%
1970	-6.4%	16.6%
1974	-22.2%	10.6%
1978	5.2%	15.7%
1982	18.6%	20.2%
1986	19.6%	36.0%
1990	-6.0%	25.6%
1994	-1.3%	19.7%
1998	13.5%	20.3%
2002	-18.2%	8.5%
2006	9.2%	6.1%
Average	2.6%	18.3%
Std Deviation	15.4%	8.7%
# Positive	9	17
# Negative	8	0

Source: The Leuthold Group

Further, by isolating S&P 500 performance for the election cycles that resulted in a change in the majority structure in Congress, and comparing that to the S&P 500 performance in all mid-term elections, we find it does not seem to affect stock market performance one way or another whether or not there is a change in majority power on Capital Hill.

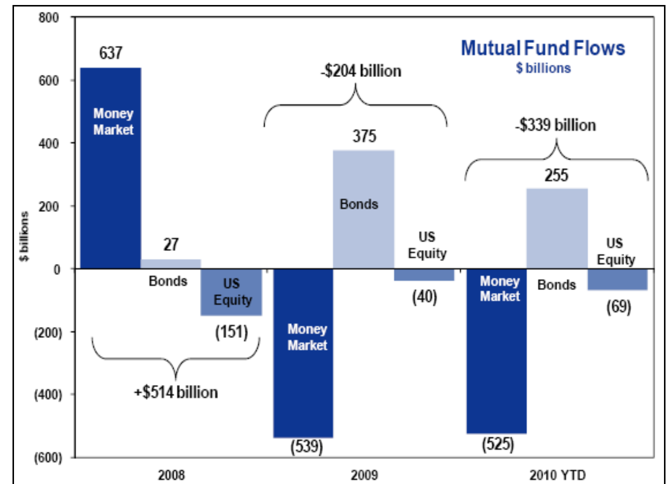
Most market participants are looking forward to political gridlock. They view this as preferable to the Obama administration's anti-business agenda. While we agree that President Obama's policies are failing, gridlock is also a sad state of affairs. The US is facing massive economic problems and two years of paralysis hardly seems like a desirable solution.

While stocks may be attractive *relative* to competing investment opportunities, the outlook for absolute returns are far less certain. Unlike 18-months ago, sentiment is not washed out, the market is not cheap, GDP in not about to form a bottom, and profit expectations are not at rock bottom and about to start a new uptrend. In order for stocks to make (and hold) significant gains from here, we believe individual investors must return to the market.

In response to the dislocation in equity markets during the past two years, individuals have consistently reduced their holdings of domestic equity mutual funds. Since the start of 2009, more than $1 trillion has been withdrawn from money market mutual funds. None of the assets were re-directed to US equity mutual funds on a net basis. Instead, 60% was invested in bond mutual funds and 6% went to international stock funds. The remaining amount likely went to reduce debt and fund living expenses.

Looking ahead, money often follows performance. Therefore, the recent uptrend in stocks *could* lead to net inflows to US stock mutual funds. In terms of QE2, if the Fed pushes interest rates lower, individual investors may increase their allocations in favor of stocks versus bonds.

Chart 10



Source: Goldman Sachs

Summing it up, we anticipate a modest near-term correction in the stock market followed by a moderate recovery into 2011 consistent with ongoing easy monetary policy, decent *relative* valuations and the year-three presidential election cycle effect. Longer-term, the US economy remains fragile and is still characterized by excess capacity and a surplus of labor. If we were in a sound and non-jeopardized economy, the Fed would not be having a QE2 discussion nor would the administration be seeking extreme fiscal solutions. Our investment stance reflects this outlook by being underweight stocks overall (particularly small cap stocks), underweight long-term government bonds, and overweight foreign stocks and cash.

We continue to be concerned over the longer-term structural issues we have written about in the past and the critical shortage of political will to tackle the problems on a long-term basis. The combination of the US's political predisposition toward aggressive borrowing to stimulate consumption and the growing trend of nationalist economic policy is unlikely to break the cycle of lurching from one crisis to the next as long-term policies are set as a matter of responding to emergencies.

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