2010 Quarter 3 Commentary

My Quarterly Commentary is in two parts this quarter because there has been so much that has happened over the past year and especially this quarter.

PART I: **Darkness Before The Dawn?**

If you're feeling a bit gloomy about the economy and the markets, you have a lot of company these days. Despite U.S. stocks getting off to a positive start in the scary month of September when bad things have happened far too frequently in the past, the news seems to be all about the possibility of a double-dip recession. One economist, David Rosenberg of Gluskin Sheff, has suggested that the recession never ended despite positive economic growth in the first half of 2010. Meanwhile, the put-call ratio, which compares the number of put and call options being bought and sold in the market, stands at an unusually bearish 1.28, according to the investment web site EquityClock.com. That means many more professional investors are betting against a market rise than in favor of one.

All of this gloominess is leading investors to search for alternatives to corporate stocks--including gold and cash equivalents like CDs and Treasury bills. One online blog is titled "Nine Adult Entertainment Stocks to Weather the Recession;" it recommends Playboy and several providers of "mature entertainment" in hotel rooms. It seems sin does indeed pay well!

There's only one problem with following the herd down this gloomy path, or stuffing your portfolio with gold and smut. In the past, people have been least optimistic about stocks and the economy right before the economy recovered and the markets produced higher-than-average returns. Business Week published its famous cover article entitled "The Death of Equities" in August of 1979, after the stock market had sustained serious losses and the long-term health of the U.S. economy was in doubt and after a decade in which stocks did poorly compared to treasuries and cash. The article noted a massive flight of investors from the market--right before one of the longest and most powerful bull runs the market has ever seen, which would take the S&P 500 index from just over 95 in 1979 to more than 1469 over the next 21 years.

And that gloomy put-call ratio? According to the investment encyclopedia, Investopedia: "Many traders will consider a large ratio a sign of a buying opportunity."

If you want an extreme view of gloom and doom, then consider this quote from Time Magazine: *"In a normal rebound, Americans would be witnessing a flurry of hiring, new investment and lending, and buoyant growth. But the U.S. economy remains almost comatose a full year and a half after the recession officially ended. Unemployment is still high; real wages are declining... The current slump already ranks as the longest period of sustained weakness since the Great Depression."*

Sounds pretty awful, right? Except that this is a quote from Time's **September 28, 1992** issue, talking about the gloomy prospects for the economy coming out of the 1990-91 recession. It reflected the mood of economists and the country at large--and, with the generous benefit of hindsight, we now know that this severe downer of an article was followed by a 16 year economic boom in the U.S. economy, without a single down year until 2008. The S&P 500 ended calendar 1992 at just over 435, and climbed, with more ups than downs, to just over 1576 at the peak in 2007.

There are good reasons to be cautious in today's economy and investment markets. We don't know what the markets are going to do tomorrow or next year. But the good news is that no one else does either.

PART II: **September's returns lift nearly every liquid asset class into positive territory.**

Investors entered the month of September fearful of past downturns, still haunted by the catastrophic decline in 2008. (You will remember that I was in Italy celebrating our 25th wedding anniversary at the time.) But yet again, the markets did the opposite of what many were expecting, posting the highest returns for the month since 1939, and the third best single monthly return in 10 years, according to the Associated Press. The Russell 3000 rose 9.44% in September, putting it up 11.53% in the third quarter, and in positive territory--up 4.78%--for the year. The Wilshire 5000 index was up 9.43% in September, registering a third-quarter return of 11.50%, and bringing the year-to-date return up to a positive 5.57%.

The good news could be seen in all sectors of the U.S. stock market. After dipping to its yearly low on the first day of the third quarter--1,011--the large cap S&P 500 eventually rose 11.29% for the three months ending September 30, putting it in positive territory for the year, with a gain of 3.89%. During the month of September, the index rose 8.92%--which more than made up for the losses registered throughout the rest of the year. Similarly, the Russell 1000 large cap index rose 11.55% for the quarter, putting it up 4.41% for the first three quarters of the year.

Interestingly, for all the gloomy news about industrial unemployment in the U.S. economy, the largest yearly gainer was the Industrials sector of the S&P 500, up 11.45% for the first three quarters of the year. The worst-performing sector: energy, down 2.48% going into the last quarter.

Among the various categories of U.S. equities, mid-cap stocks have enjoyed the best returns: the Russell Midcap index was up 13.31% in the third quarter, putting it up 10.97% for the first three quarters of the year. Meanwhile, the Russell 2000 small cap index rose 11.29% in the third quarter, and was up 9.12% for the year. The Nasdaq Composite Index rose 11.30% for the quarter, putting it up 11.89% going into the last three months of trading days.

Some of the stock market gains appear to reflect good news in the economy. The Bureau of Economic Analysis reported on September 30 that it was revising its estimate of second-quarter growth in the economy: up 1.7%, after an increase of 3.7% in the first three months of the year. Corporate profits increased $47.5 billion in the second quarter after rising $148.4 billion in the first quarter.

International investors are beginning to recover some of the losses from earlier in the year. The MSCI EAFE index, which measures the composite returns of the developed nations (although it excludes Canada, for some reason) was up 15.79% for the quarter, but the index is down overall 1.25% heading into the fourth quarter. European stocks rose 18.87%, but were still down 2.98% for the year. The MSCI Far East index rose 7.05% for the quarter, up 3.10% for the year as of September 30.

Meanwhile, the emerging markets are still booming. The MSCI Emerging plus Frontier Markets index was up 21.53% for the quarter, putting it up 15.07% for the first three-quarters of the year.

Alas, our crystal ball wasn't quite good enough to bet your entire portfolio on the Sri Lanka ASPI Index (up 50.3% for the quarter), or Peru's Indice Selectivo Peru-15 (up 25.4%). But we were also fortunate enough not to have bet heavily on Iceland's OMX FO Price Index (down 22.8% for the quarter), or Nepal, whose NEPSE Index fell 14.4% these last three months.

Real Estate investment trusts, portfolios of real estate property that trade on exchanges, also posted aggregate gains. The Dow Jones All Equity REIT index, which tracks 155 real estate investment trusts, was up 12.5% for the third quarter, helped by perceptions that credit may be becoming more available to commercial real estate, which depends more than most industries on credit supplies to refinance debt payments and fund new acquisitions. The NAREIT index rose 7.46% for the quarter, from 2,862.01 to 3,075.61, up from 2,711.15 at the start of the year.

In the commodities sector, the Standard & Poors GSCI index rose 8.27% for the three months ending September 30, but was still down 3.87% for the first three quarters of the year. Notable movements came in industrial metals, which were up 21.01% for the quarter and 3.74% for the year, and precious metals, up 6.03% for the quarter and 19.8% for the first three quarters of 2010. Gold continued its remarkable rise, up 18.75% through September 30, while silver rose even farther, up 28.56% for the year's first nine months.

Treasury Bond prices rose slightly as the yield on 10-year maturities fell from 2.95% on June 30 to 2.51% at the end of the quarter. Remarkably, the yield on 6-month Treasury notes is still hovering at 0.19%, and returns on shorter-term paper are even lower. Yield to maturity on 20-year Treasuries stand at 3.38%, and the longer 30-year maturity issues were yielding 3.69% as the quarter ended.

It should be noted that the U.S. markets are close to finally climbing out of the deep holes they fell into in 2008 and early 2009. The 3-year performance of various indices, for the period ending September 30, is within striking distance of positive territory. The Russell 3000 broad market index is still down 6.59% from the end of September 2007, and the large cap Russell 1000 is down 6.79% over the same three years. Over the same three-year time period, the Russell Midcap index is down 4.16%, and the Russell 2000 smallcap index is down 4.29%. If the markets offer gains in the last quarter similar to what we experienced in the third, investors who managed to stay in the market through the turmoil might be able to celebrate a full recovery of their portfolio value after a little more than 36 months from the market top in 2007 and the worst crash since the Depression.

Meanwhile, it's helpful to remember that at the start of the quarter, people were questioning the viability of U.S. and global markets after the near-meltdown of Greece, Portugal, Spain and other Southern European economies. Each quarter, each year, seems to bring a new thing to worry about. But looking longer term, the U.S. equities markets have managed to post long-term gains despite some fairly serious disruptions, including World War II, the Cold War, the conflict in Vietnam, stagflation and the oil shocks of the 1970s, the market crash of 1987, the bursting of the tech stock bubble, and the subprime mortgage meltdown and collapse of Bear Stearns, Lehman Brothers and AIG in 2008.

Indeed, if you look at the long-term movements in the stock market since the Great Depression, all of those events, which seemed pretty dire at the time, look like blips on the screen, small dips in the long-term growth of value in American and global publicly-traded enterprises.

There is no doubt that there will be other events in the future which will seem to endanger--or at least derail--the long-term growth of capitalism. But based on the history of the past two centuries, one might feel confident that whatever challenges await us, people in all sectors of the U.S. economy will find ways to build additional value.

The final three months of the year may bring the market indices back up to pre-meltdown levels, or they may disappoint. We simply cannot predict the short-term movements in stock prices. Despite all of our attention on protecting client portfolios, and the complex work of identifying risks and opportunities, the primary focus is still on a long-term bet that risk assets will be up more often than they are down, regardless of what dire thing you will read in the paper between now and the end of the year.

And it is this focus on the long term driven by your financial goals and dreams which guides our overall work with you.

-sources-

GDP estimates, inflation and corporate profits:
http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm

Wilshire index data:
http://www.wilshire.com/Indexes/calculator/

Russell index data:
http://www.russell.com/indexes/data/daily_total_returns_us.asp

S%P index data:
http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usduf--p-us-l--

Nasdaq index data: http://quicktake.morningstar.com/Index/IndexCharts.aspx?Symbol=COMP

International indices:
http://www.mscibarra.com/products/indices/international_equity_indices/performance.html

Individual country data: http://www.emerginvest.com/WorldStockMarkets/Countries.html

Commodities index data:
http://www.standardandpoors.com/indices/sp-gsci/en/us/?indexId=spgscirg--usd----sp------

REIT Index:
http://online.wsj.com/article/BT-CO-20100930-713516.html

NAREIT data: http://www.reit.com/IndustryDataPerformance/IndustryDataPerformance.aspx

Treasury market rates:
http://www.treas.gov/offices/domestic-finance/debt-management/interest-rate/yield.shtml

Treasury Bond returns:
http://www.latimes.com/business/la-fi-1001-markets-quarter-20101001,0,2854846.story

Best September since 1939:
http://www.sfgate.com/cgi-bin/article.cgi?f=/n/a/2010/09/30/national/a121755D84.DTL&type=business
Rosenberg on the idea that the recession never ended: http://www.businessinsider.com/never-ending-recession-2010-8

Death of Equities article:
http://www.businessweek.com/investor/content/mar2009/pi20090310_263462_page_2.htm

Time magazine quote: http://www.time.com/time/magazine/article/0,9171,976602,00.html

S&P 500 data set: http://www.econstats.com/eqty/eqea_mi_1.htm

Equity Clock: http://www.equityclock.com/2010/09/12/stock-market-outlook-for-september-13-2010/

Investopedia: http://www.investopedia.com/ask/answers/06/putcallratio.asp