

October 2012

ECONOMIC OUTLOOK

Summary

The economy started to show some signs of life in September, as there were positives reported in corporate America and with the consumer. The Institute for Supply Management (ISM) factory index rose above the important 50 level following three months of contractionary readings. This was a welcome reading as it contrasts with weakness in other parts of the world. For example, manufacturing in the eurozone contracted in September for the 14th consecutive month. The ISM non-manufacturing index rose to its highest level in six months.

As the manufacturing and non-manufacturing sectors expanded, the consumer felt better about present conditions and especially about the future. The Conference Board's Consumer Confidence Index rose sharply to its highest level in seven months. Even though consumers face the uncertainty of the "fiscal cliff" at the end of the year, as previously enacted tax-law changes expire, the low interest rates and commitment of the Federal Reserve to do whatever necessary seem to be helping. The announcement that the Fed will purchase \$40 billion of mortgage debt on a monthly basis has been a positive for mortgage rates and contributed to stability in the housing market. The improvement in the labor market has also been a positive for consumers. There has been a steady increase in the nonfarm payroll numbers and the decline in the unemployment rate to below 8% should help solidify the positive consumer views.

Challenges remain for the economy, as the world situation has not improved materially. The consumer faces higher energy and food prices and is not able to spend as much on many other items. Low interest rates and further accommodation by the Fed should provide needed support until the labor market sees sustained improvement and the economy shows more consistent and higher levels of growth.

POSITIVES

- ❑ Consumer confidence rose sharply in September
- ❑ Housing market shows more signs of stability
- ❑ Labor market appears to be improving as the unemployment rate drops
- ❑ ISM manufacturing and non-manufacturing indexes show economic growth

NEGATIVES

- ❑ Rising food and gas prices squeeze households, as savings rate falls
- ❑ Durable-goods, factory orders fell in August; industrial output down

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- ❑ Resolution of "fiscal cliff" and election outcome

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EQUITY OUTLOOK

Summary

The Federal Reserve's endorsement of continued monetary support for the U.S. economy (QE3) pushed equity markets higher in September. After gaining 2.6% during the month, the S&P 500 is ahead 16.4% for 2012. The best-performing sectors in September were telecom services (+3.9%) and health care (+3.8%). Consumer staples (+1.1%) and utilities (+0.89%) lagged. So far this year, the Nifty Fifty (top 50 market cap companies) lead the market as a whole by a margin of 2.4% in price performance.

The strong surge in stock prices in the past 12 months has pushed up valuations dramatically. The price-to-earnings ratio on forward 12-month estimates is now 12.9 versus 10.8 a year ago. When considering growth, the P/E-to-growth multiple of the market is now 1.7 versus 0.8 last year. Only the dividend yield on the market has remained somewhat comparable, as corporations have accelerated payout ratios.

While short-term opportunity may be muted as the market digests the gains of the past year, we argue that the weight of evidence still favors the equity market for several reasons. First, interest rates remain at generational lows, and policy makers have signaled an accommodative stance stretching to 2015. Second, based on historical measures, stock valuations are not excessive. Third, a continued corporate policy of dividend increases to shareholders, especially in a "zero-interest rate" environment, is likely. Finally, common stocks as an investment class are under liquidation, as evidenced by the continued shrinkage of equity mutual funds and ETFs. From a contrarian's viewpoint, the resulting rush into bond funds during a period of extremely low rates of interest suggests opportunity in select equity styles.

POSITIVES

- ❑ Global monetary policies accommodative
- ❑ European Central Bank continues to forge support
- ❑ Valuations still reasonable

NEGATIVES

- ❑ Corporate earnings likely muted in third quarter
- ❑ Austerity in Europe affecting earnings
- ❑ "Fiscal cliff" still unaddressed

UNKNOWNNS

- ❑ Election outcome and impact

October 2012

FIXED INCOME OUTLOOK

Summary

Coinciding with an advance in global equity prices, U.S. bond yields rose and prices fell in the early part of September. These moves were primarily driven by the increasing belief that the latest plan to limit the debt crisis in Europe would be successful and that a full-blown crisis involving Spain and Italy would be diverted. Additionally, domestic economic indicators were mixed with a slight bias to the upside, and there was even a hint of inflation in the manufacturing survey's prices-paid component. These factors reduced the likelihood that the Federal Reserve would embark on a new round of asset purchases, but the release of an alarmingly weak payroll report for August cemented the case for further action. On Sept. 13th, in addition to stating that it expects to maintain the exceptionally low level for the fed funds rate into mid-2015, the Fed announced an open-ended asset purchase program that will continue until the desired results are achieved.

Rates temporarily moved even higher and the curve steepened in the first few days after this announcement, but then reversed to end the month just 8 basis points higher on the 10-year Treasury. Corporate credit continued to perform well, as the removal of alternatives in the investment-grade universe is creating a scarcity of bonds. In aggregate, corporate credit delivered about 1% more in return as spreads narrowed. Finance-sector bonds led all others, as the Fed's actions further reduced the risk of a significant economic contraction. QE3, or QE-Infinity as it may become known, trumps everything. As long as the Fed is sucking up a significant portion of the investable bond universe, yields should not increase significantly on Treasury debt or corporate bonds.

POSITIVES

- ❑ Global economic growth is moderating
- ❑ Inflationary outlook is benign, measures well within target ranges
- ❑ Fed is still scheduled to make significant additional asset purchases

NEGATIVES

- ❑ Current yield levels lower than expected inflation; negative yields on TIPS
- ❑ Bond yields reflect significant "flight to safety" and manipulation by the Fed

UNKNOWNNS

- ❑ Uncertainty in European financial crisis and path to resolution
- ❑ U.S. election cycle, policy uncertainties and "fiscal cliff"
- ❑ Investor flight from and appetite for riskier asset classes