Investment Newsletter

Third Quarter 2009

Executive Summary

The recession that began in December of 2007, the longest since the Great Depression, likely ended in the third quarter of 2009. Expectations are for 2.5 to 3.0% growth in each of the remaining quarters of the year.

Reflecting back on the second quarter, the capital markets responded favorably to the avoidance of financial Armageddon along with the hope and anticipation of economic improvement. During the third quarter, the market rally continued although hope and anticipation were displaced by more concrete evidence of economic stabilization and hints of economic growth.

In hindsight, investing into a market stricken with fear in an economy that could hardly get worse proved highly profitable. Be that as it may, the current environment is neither ravaged by fear nor supported by an economy without downside risks. In short, as challenging as it may have been to stay invested during the year's early days, today's reality is that at these levels, market opportunity is diminished while risk is now elevated.

Progressing into 2010, expectations for the economy and capital markets become more varied. Those in the "V" shaped recovery camp generally look for a repeat of historical post-recession recovery patterns. The rally cry here is the deeper the decline the more dramatic the recovery. The S&P 500 Index's total return of 58.2% from the bottom on March 9th through the end of the third quarter certainly lends credibility to this group since markets tend to be leading indicators of the economy.

Those in the "U" or "W" shaped recovery camp counter with the facts that we face an unsustainably overleveraged economy with many critical segments showing stabilization and/or improvement based on little more than government provided life support.

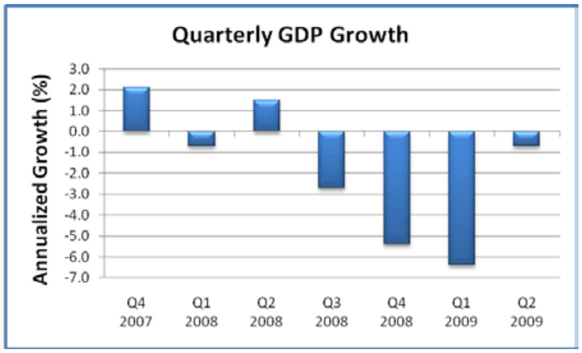
The economic discussion that follows unpacks various elements of the economy with a particular focus on the consumer. There are a great number of moving parts to the overall economy, but at 70% of overall GDP, personal consumption is one you need to get right in order to call the big picture correctly. The market is in agreement with this thesis as information flow regarding the consumer has led to heightened periods of market volatility. Indeed, a nearly straight up move in the stock market has shown the most noticeable retrenchments when consumer related economic releases came in below expectations. Labor reports, retail sales, consumer confidence, and the like are the most impactful reports du jour, and rightly so.

While waiting for the economic future to unfold, the ever present capital markets' scoreboard is here today. The third quarter was about as close to a repeat of the second quarter as one could imagine. Fixed income segments were up mid to high single digits and equity categories rose at mid to high teens percentage rates. International securities outperformed their domestic counterparts and precious metals shined. A common theme to each was a move away from the U.S. and its challenged currency.

Economic Review and Outlook

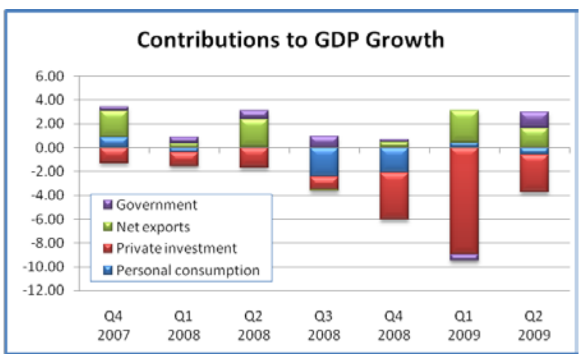
Economic Growth

On an annualized basis, gross domestic product (GDP) declined 0.7% in the second quarter of 2009 after a drop of 6.4% in the first quarter of the year.



Data Source: U.S. Department of Commerce

As with previous quarters, the primary driver behind economic contraction was weakness in private domestic investment. Fortunately, this component of GDP, depicted in red in the following chart, proved less of a drag than in the first quarter.



Data Source: U.S. Department of Commerce

The phenomenon of things getting worse at a slower rate has been a major theme in many areas of the economy for several months. Indeed, this so called second derivative effect is perhaps the most significant factor behind capital market gains in the U.S. and across the globe.

On a more granular basis, the pullback in private investment reflects well known challenges in residential housing, significant declines in the purchase of automobiles, a very material drawdown in business inventories and decreased investment in industrial and transportation equipment.

As we look forward, each of these economic segments are migrating from a negative to a neutral and in some cases a positive. Specifically:

- Housing has been in a bottoming process for several months.
- Automobile sales have been below basic replacement levels for some time. This cannot last indefinitely.
- Inventory declines overshot on the downside. Simply maintaining current levels would be an economic boost. Actual restocking, the more likely scenario, would be even better.
- Businesses reacted aggressively to right-size their business models. They are well positioned to invest as economic ambiguity subsides.

It is with these factors in mind, along with stimulus spending such as the government's cash for clunkers program, that most economists expect a resumption of growth to be reported for the third and fourth quarters of this year. Expectations are for 2.5 – 3.0% growth in each of these quarters.

While most forecasts are in general agreement in the near term, opinions regarding the sustainability of this growth become more diverse as the calendar progresses into next year.

Important considerations, many of which are discussed in the following sections, include:

- The consumer's economic health and willingness/ability to spend in light of weak labor markets, tight credit, decreased household wealth, high debt levels and corresponding increased propensity to save.
- The U.S. government's ability to provide appropriate levels of economic stimulus within the constraints of deficit spending, inflationary forces and growth expectations.
- A continued progression of positive signs in the residential real estate market and containment/management of increasing strains in the commercial real estate space.

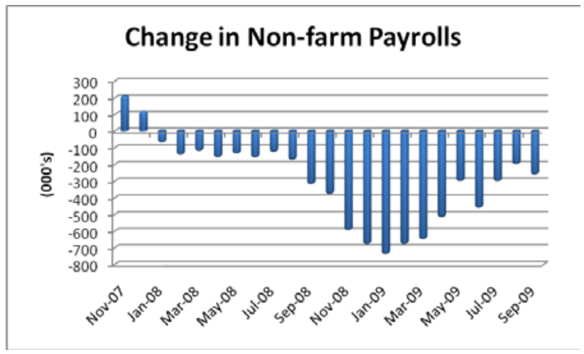
The Consumer

The U.S. consumer accounts for 70% of domestic economic activity. As a result, changes in the consumer's inclination and ability to spend have material impacts on the economy. A few of the key considerations in this regard are:

- Employment and labor conditions
- Consumer debt
- Savings rates
- Other factors such as household wealth, consumer sentiment, demographics, social safety nets, availability of credit, home equity and tax rates

Many now believe the recession ended during the recently completed third quarter. During this challenging period (12/07 through 9/09), 7.8 million jobs were lost and the unemployment rate doubled from 4.9% to 9.8%. There are currently 15.1 million people without work and another 11.1 million individuals have either given up searching or have accepted part-time work. That translates into a so-called U-6 underemployment rate of 17%. The long-term unemployed (over six months) have risen fourfold from 1.3 million at the start of the recession to over 5.4 million today. *Clearly these statistics do not support strength in consumer spending.*

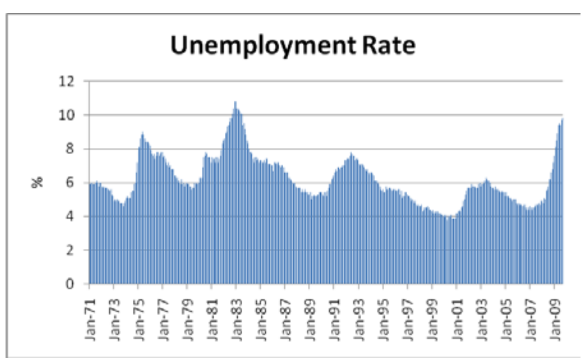
Where does the labor market go from here? The changes in nonfarm payrolls, indicated below, show a steadily improving trend from peak losses in January of this year.



Data Source: U.S. Department of Labor

To put payrolls into perspective, the creation of 150,000 new jobs per month is required to keep pace with population growth and thus avoid increased unemployment. The corollary is that job growth in excess of that number will translate into decreased unemployment.

As is evident in the following graph, the economy is in strong need of the aforementioned "excess" job growth.

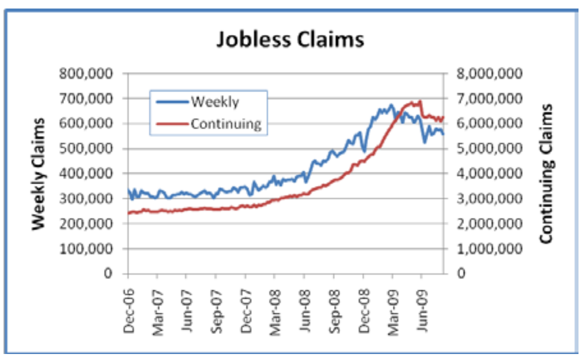


Data Source: U.S. Department of Labor

As shown, the unemployment rate continues to drift higher and is approaching post World War II highs. Despite the recession's end, this metric lags the economy and will continue to move higher into 2010.

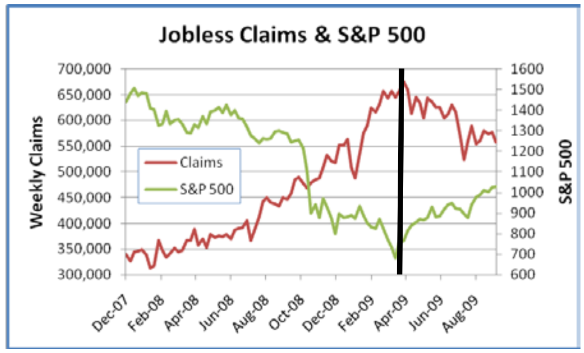
Interestingly, although the unemployment rate provides little value in forecasting the overall economy, it does prove to be particularly enlightening when it comes to anticipating monetary policy. It is rare for the Federal Reserve to reverse expansionary policy prior to a peak in unemployment. Indeed, after its most recent meeting on September 23rd, the Federal Reserve Board indicated the federal funds rate will remain low for "an extended period."

The labor statistic that tends to be the best forward economic indicator is jobless claims. These peaked in March and have shown progressive improvement since that time.



Data Source: U.S. Department of Labor

The following graph overlays weekly jobless claims and the S&P 500 Index as a proxy for the stock market. Each reach their respective peak and trough within days of the other.



Data Sources: U.S. Department of Labor, Yahoo Finance

This makes sense as the stock market, as a discounting mechanism, is also widely viewed as a leading indicator.

To summarize the labor market, payroll declines are diminishing but have a way to go. Unemployment is trending higher, but would be expected to for some time past the end of a recession. Weekly jobless claims, the best economic indicator, reversed a negative trend back in March along with a concurrently positive reversal in the stock market. Continued positive trends in each would suggest economic improvement going forward.

Employment is only one of several important factors that influence consumer behavior. From the beginning of the economic crisis through the end of the 1st quarter of 2009, U.S. households experienced a $13.3 trillion reduction in wealth.

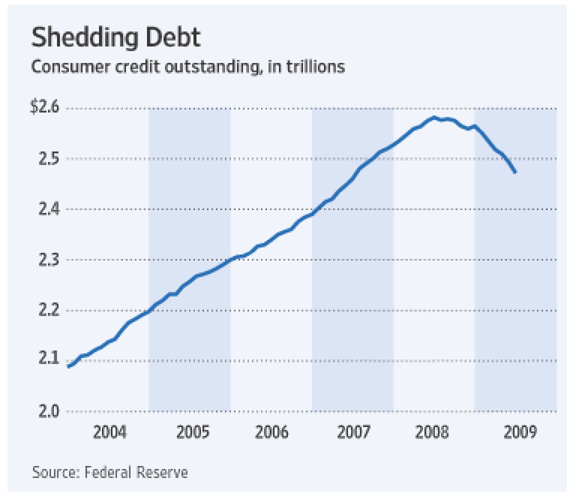
Owing to a rebound in housing and the capital markets, consumers clawed back $2 trillion in net worth during the second quarter. This represented a 3.9% increase and was the first advance in almost two years. Continued market and housing gains in the third quarter portend further improvement.

Although good progress has been made, the consumer's wealth is still likely down on the order of $10 trillion. A phenomenon known as the wealth effect describes changes in consumption patterns as a result of gains and losses in wealth. Using the midpoint of the wealth effect's 3 – 5% range, one would expect a drop in consumer spending of $400 billion, or 4%. Considering the consumer's 70% share of the economy, this translates into a 2.8% drop in GDP. The actual peak to trough drop in real GDP through the second quarter was 3.5%. Short of a dramatic improvement in household wealth, this factor suggests a permanent downward step change in consumer consumption and debunks a common belief that the economy will bounce off its lows in a similar manner to that experienced in past post-recession periods.

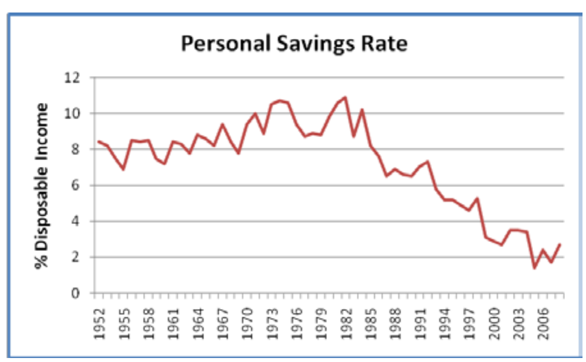
Wages and wealth are not the only sources of fuel for consumption. Indeed, U.S. consumers are highly adept at tapping home equity and consumer debt vehicles to drive spending. Where do these sources currently stand?

Nearly one third of home owners owe more in mortgage debt than their homes are worth. Some believe this percentage will climb in coming quarters to nearly 50% of homeowners being "upside down" on their homes. Clearly the notion of the home as an ATM machine has run its course.

From a peak of 136% in the 1st quarter of 2008, total debt to disposable income has dropped to 129%. Considering the credit card default rate recently hit a record high of 11.5%, a further decrease in borrowing is warranted. No one knows how far the consumer will take the deleveraging process, but economists believe this metric may return to the 80% average seen in the 1990's. The following graph confirms the consumer is working in the right direction.



The shift to thrift is also showing up in the personal savings rate. Consumers saved 3% in July and 4% in August after hitting a 14 year record of 6% in May. If it were not for the government's cash for clunkers program, which temporarily encouraged borrowing, savings rates would have been even higher. Where might the savings rate gravitate to over time? If history is any guide, the following graph would suggest an 8 to 10% level, which was prevalent prior to declines starting in the mid 1980's.



Data Source: U.S. Department of Commerce

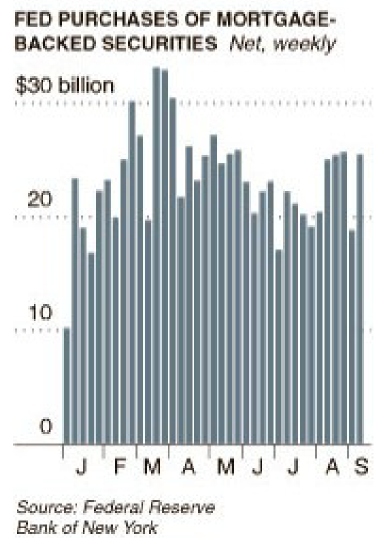
In the final analysis, the U.S. is at the end of a 25 year secular credit expansion where individuals effectively borrowed consumption from future periods. Consumer debt levels rose from 64% of GDP in 1995 to a current level of 100%. As a percentage of disposable income, debt rose from 61% in 1984 (the start of the debt accumulation run) to a recent peak of 136%. The result is today's need for debt reduction. Savings rates are up, consumption will remain below normalized levels and the mathematical reality is GDP growth rates will be much lower in the future.

The transition thus far has been painful. Government intervention has certainly helped to stabilize the economy, but the government's work, although sizable, is not yet complete. As fiscal and monetary policies wind down over coming months and years, successful investing will be more dependent upon maintaining a sound understanding of changes in the economic landscape.

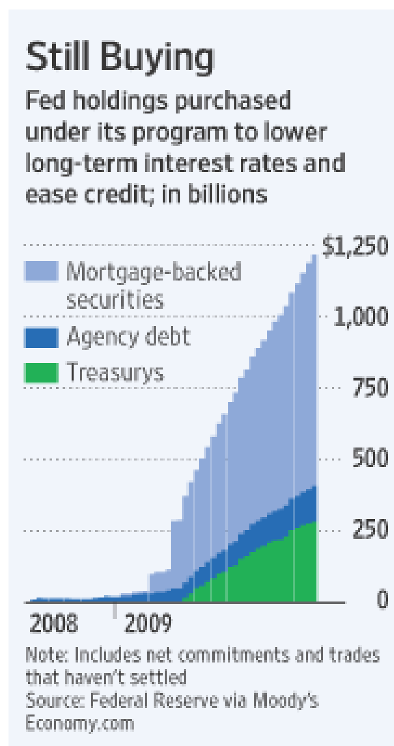
The Government

In the deleveraging economy, the Federal Government is providing both credit and credit support. Treasury backed entities have guaranteed 85% of new mortgages and The U.S. Government, for its part, is borrowing more while others borrow less. Federal debt increased at a 28.2% annual rate in the second quarter. This is not sustainable.

Among other governmental programs, the Federal Reserve, as part of its quantitative easing initiatives, has purchased 80% of newly issued mortgage backed securities this year to the tune of $20 – 25 billion per week.



This is not sustainable either as the Fed's balance sheet is getting bloated.



The Federal Reserve is scheduled to complete Treasury purchases at the end of

October and to cease buying mortgage securities at the end of March next year. Judging by the Fed's recent discussions with bond dealers, other quantitative easing programs are moving closer to completion as well. The goal of these talks was reportedly to explore strategies to facilitate draining the unprecedented amount of liquidity from the system.

In the meantime, the Fed recognized in their latest meeting that economic activity has picked up, financial markets have improved, housing activity has increased and household spending seems to be stabilizing. That being said, the Board anticipates a slow recovery and will maintain interest rates at a low level.

On the fiscal side of government, the $787 billion fiscal stimulus program had deployed $151 billion, or 20% of targeted funds, through August. Notable programs have included a $3 billion effort to spur auto sales and an $8,000 tax rebate for new home buyers. Nearly 700,000 autos were sold under the cash for clunkers program and an estimated 40% of housing transactions benefitted from the housing rebate for a total of $15 billion in Federal aid.

Of note when it comes to fiscal policy, there is a gradually emerging strain between the Treasury and Congress as the U.S. is approaching the current maximum debt ceiling of $12.1 trillion. Lawmakers are growing increasingly nervous about U.S. public debt and budget deficits while the Treasury seeks ways to continue funding the government. It will be interesting to watch the progress of this debate.

The quarter's economic grab-bag……

To round out the quarter's economic discussion, we introduce a new section to touch upon interesting, if not important, facts and events from the preceding three months.

The Good

- Existing home sales in August were 3.4% higher than in the previous year period
- The OECD indicated the global economy is emerging faster than it forecast last quarter
- Foreigners bought $207 billion in long term U.S. Treasuries in the 1st half of 2009, up from $110 billion in the prior six months
- The spread between 10 year yields and inflation is the highest since the 1980's
- Consumer sentiment hit 70.2 in early September, up from 65.7 in August
- The Federal Reserve's Beige Book consistently reported a moderating decline and indications of economic stabilization
- Pending home sales hit their highest level in 2 years and new home sales rose in 5 of the previous 7 months
- G20 nations agreed to boost capital requirements for banks
- The Case/Shiller home price index showed increasing home prices
- Federal Reserve Chairman Ben Bernanke was nominated for an additional term

The Bad

- The U.S. dollar hit the lowest level in a year
- 46.3 million people in 2008 lacked health insurance up from 45.7 million in 2007
- The Treasury's money market backstop ended in September
- Major retailers reported consumers are hunkered down and do not expect conditions to improve until next spring
- Banks charged off commercial mortgages at the fastest pace in 20 years

The Ugly

- The IMF estimates there will be an additional $1.5 trillion of bank losses by the end of 2010 for a grand total of $3.4 trillion from '07 through '10
- After 94 bank failures this year, the FDIC insurance fund is running out of money and considering options to bolster funding
- There are 416 "problem" banks, the highest level in 15 years
- Corporate defaults hit a record at 201 borrowers comprising $453 billion in debt
- Mortgage foreclosures this year are anticipated to reach 3.4 million versus 2.3 million last year
- The portion of homeowners either delinquent or in foreclosure (13.2%) rose to the highest level in at least four decades during the second quarter
- The U.S. Postal Service has experienced record breaking losses with a $7 billion deficit expected in 2009

Economic Summary

The longest running recession since the Great Depression likely ended during the third quarter of 2009. Economic growth in the back of the year is anticipated to come in at a 2.5 – 3.0% rate.

To some extent, this growth is predicated upon the restocking of depleted business inventories and continued government stimulus.

Moving into 2010 and beyond, economic progress will be highly dependent on the willingness and ability of the consumer to spend. The weak labor market and drag from a negative wealth effect will be headwinds. Additional challenges will be the necessity to reduce debt and the inability to tap previously available sources of capital, such as home equity.

While we suspect the economy has begun to move in a forward direction, the challenges noted will cause GDP growth rates to be lower than in previous economic recoveries. The government's unprecedented involvement in managing and supporting the economy may also cause bumps in the road as these efforts wane over time.

Capital Markets Review and Outlook

Overview

It seems the capital markets took their third quarter cues from the second quarter. With very few exceptions, the quarterly performance for each investment subcategory was strikingly similar across the periods.

Considering the phenomenal run in the second quarter, déjà vu in the third quarter was not a problem. Where the two periods did experience a difference was in the driving forces behind the rallies.

Second quarter performance was driven by relief that the economy and financial system were backing away from the precipice of calamity. The rally was born out of relief and accentuated by glimmers of hope. Indeed, a cottage industry nearly sprung up to identify and record "green shoots" springing up across the globe.

Despite comparable return results between the second and third quarters, the backdrop fueling these returns was much different.

The third period was kicked off positively with reports of strong corporate earnings. Nearly three out of four companies in the S&P 500 Index exceeded analyst expectations. Economic releases carried the torch from there by providing confirmation that hopes from the prior period were transforming into reality.

During the quarter, for example, the pace of job losses declined and housing prices began to tick up after falling continuously for nearly three years. The ISM manufacturing index continued an 8 month trend of monthly increases culminating in the first expansionary reading in 18 months. Progress was made in industrial production and the capacity utilization rate bottomed and began to move higher.

Despite these favorable developments, there are still concerns. The market has advanced tremendously and, as such, poses more downside risk than it did six months ago. Corporate results were driven more by cost cutting than revenue growth. Not all economic releases were positive and temporary government assistance is certainly impacting the data.

Closer to the capital markets, insider selling picked up to the highest absolute level in over a year and the ratio of selling to buying hit 29 to 1 in August. That can be compared to the ratio of only 2 to 1 at the market bottom. Warren Buffet labeled the economy as "remaining deeply troubled"

Capital Market Returns

	3rd Qtr 2009	YTD
U.S. Treasury Bills	0.1	0.3
Barclays Aggregate Bond	3.7	5.7
S & P 500 (Equities)	15.6	19.3
Wilshire 5000 (Equities)	16.1	21.3
Dow Industrials	15.8	13.5
NASDAQ (Equities)	15.9	35.6
Russell 2000 (Small Cap)	19.3	42.6
EAFE (Int'l Equities)	19.5	29.0

and his value-driven company, Berkshire Hathaway, decreased stock purchases to the lowest level in 5 years.

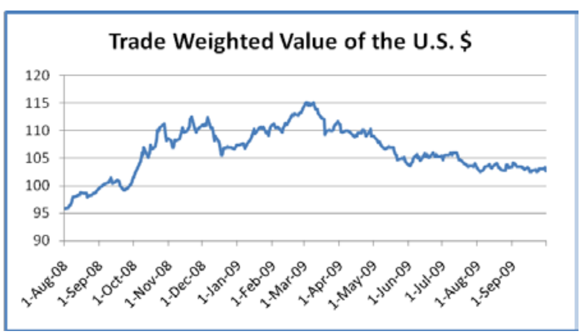
Equity Markets

Domestic

The S&P 500 delivered 15.6% for the quarter and is now up 19.3% for the year. In terms of sub-categories, smaller capitalization securities slightly outperformed while value stocks outperformed their growth counterparts by 5 to 6% across the entire capitalization spectrum during the quarter.

International

International markets delivered the strongest returns in the equity space. Emerging markets continued to be the market stalwarts, rising 21.1% for the quarter and are now up 61.3% for the year. Developed markets were up 19.5% for the quarter and have risen 29.0% for the year. As the following graph depicts, the dollar declined marginally during the quarter, although not as significantly as it did in the previous period. Nevertheless, U.S. dollar investors received a slight benefit during the quarter and a big boost from the market bottom in March.



Data Source: U.S. Federal Reserve

Fixed Income Markets

The U.S. aggregate bond index was up 3.7% for the quarter and is now up 5.7% for the year. The credit side of the market outperformed with lower credits outperforming higher rated companies. Investment grade corporate bond funds were up 9.9% with high yield funds rising 13.1%. Of note, high yield funds are now up 38.9% for the year and the high yield market has erased its market losses from 2008.

Strictly from a yield curve perspective, there was little variation between the beginning and end of the quarter. Rates at the short end of the curve remained near zero while the 10-year treasury finished the quarter with a yield of 3.30% versus 3.55% at the start. We continue to believe this yield will remain in a trading range, over the near term, between 3 and 4%. Going forward, the Treasury has very material funding requirements that must be met by new issuance. This raises the likelihood of excess supply and may eventually push yields higher.

Municipals delivered strong performance for the quarter with spreads widening against taxable bonds. While there are challenges to state and local government budgets, a dearth of new supply drove this segment of the market. Investor concerns over higher tax rates in the future also pushed, and will continue to push, investors to seek tax sheltered investments.

Alternative Assets

Anticipating inflation and dollar weakness from U.S. fiscal and monetary policies, investors pushed into inflation safe havens. The poster children here were gold and other precious metals. Funds in this category rose 19.8% for the quarter. Among other investment strategies and segments, precious metals and other commodities such as energy remain valuable tools to help combat inflation and portfolio volatility.

Capital Market Summary

In our previous quarter's piece, we suggested positive incremental economic data and good corporate earnings would be necessary to drive further gains in investment markets. This came to pass. While risks remain, our prescribed recipe for continued market gains was whipped up into quite a nice soufflé. Equities across the board delivered mid to high teens returns and bonds were up mid to high single digits. Favorable spread movement benefitted municipals and lower quality corporates.

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