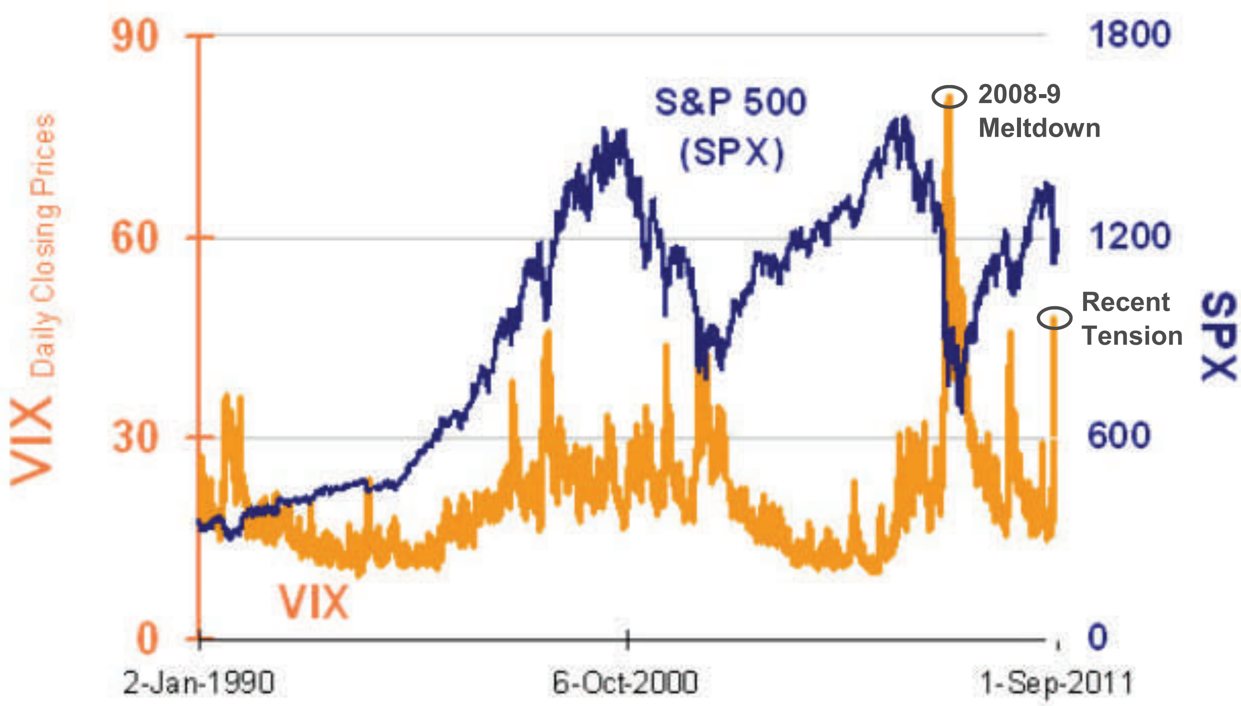
STILL PLAYING A LITTLE DEFENSE

MARKET VOLATILITY HIGHER

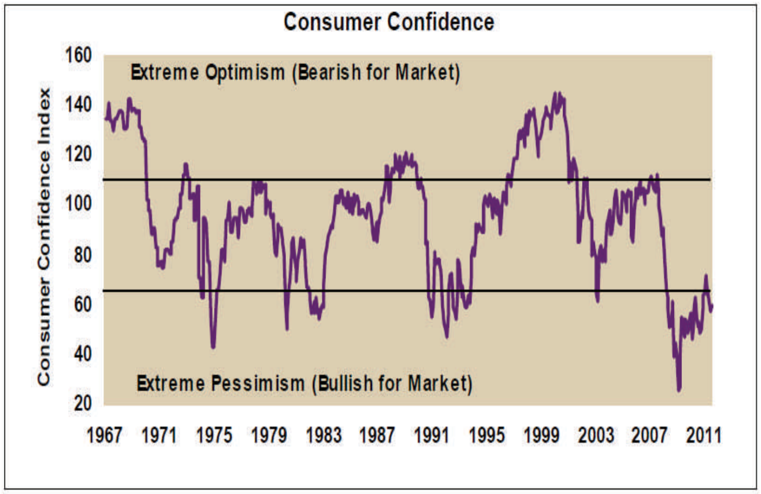
Contagion seems palpable as Europe continues to grapple with structural issues and high levels of debt within the eurozone. Meanwhile, the U.S. is flirting with the onset of another recession. Investor angst has manifested itself in the form of increased market volatility and lower equity prices. The following chart illustrates the inverse relationship between market volatility as measured by the Volatility Index (VIX) and falling equity prices as measured by the Standard & Poors 500 (SPX).



Over the longer term, lower equity prices have generally represented portfolio rebalancing opportunities, but it's difficult to embrace such opportunities over the shorter term when equity prices continue falling. So, should we be buying equities and rebalancing portfolios or are we in the midst of something more severe? Let's begin by looking at the case for optimism.

RAMPANT PESSIMISM

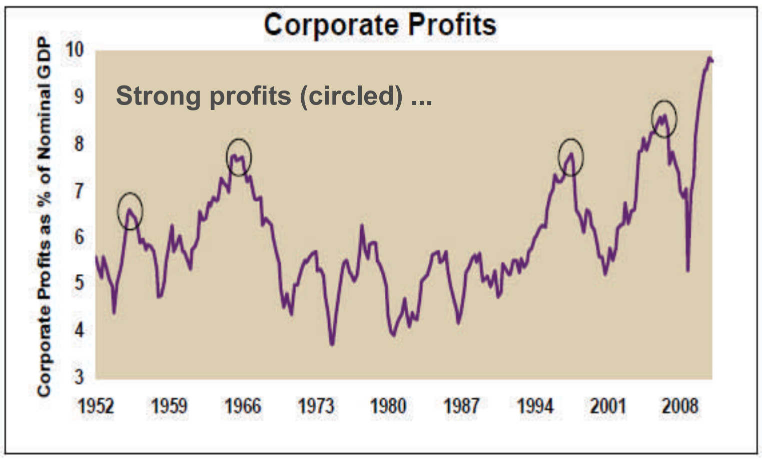
Although the premise may seem counterintuitive, widespread pessimism tends to precede stock market rallies. Since investors tend to commit funds to the capital markets as they begin feeling optimistic and withdraw funds as pessimism becomes more pervasive, that withdrawn capital provides the fuel for the next rally. Ned Davis Research publishes a Consumer Confidence Index that attempts to quantify consumer optimism. As of July, this indicator was squarely in pessimistic territory and one might assume that this index would be at least as pessimistic today. Again, pervasive gloom represents a strong positive as you can see in the grid immediately to the right.

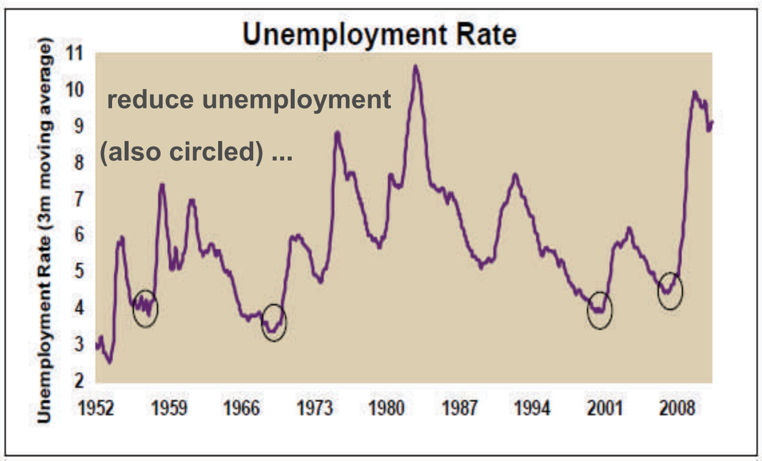


2/28/1969-7/31/2011	
Consumer Confidence	DJIA Annualized Gain
> 110	-0.2%
66-110	6.4%
< 66	14.4%

STRONG CORPORATE PROFITS

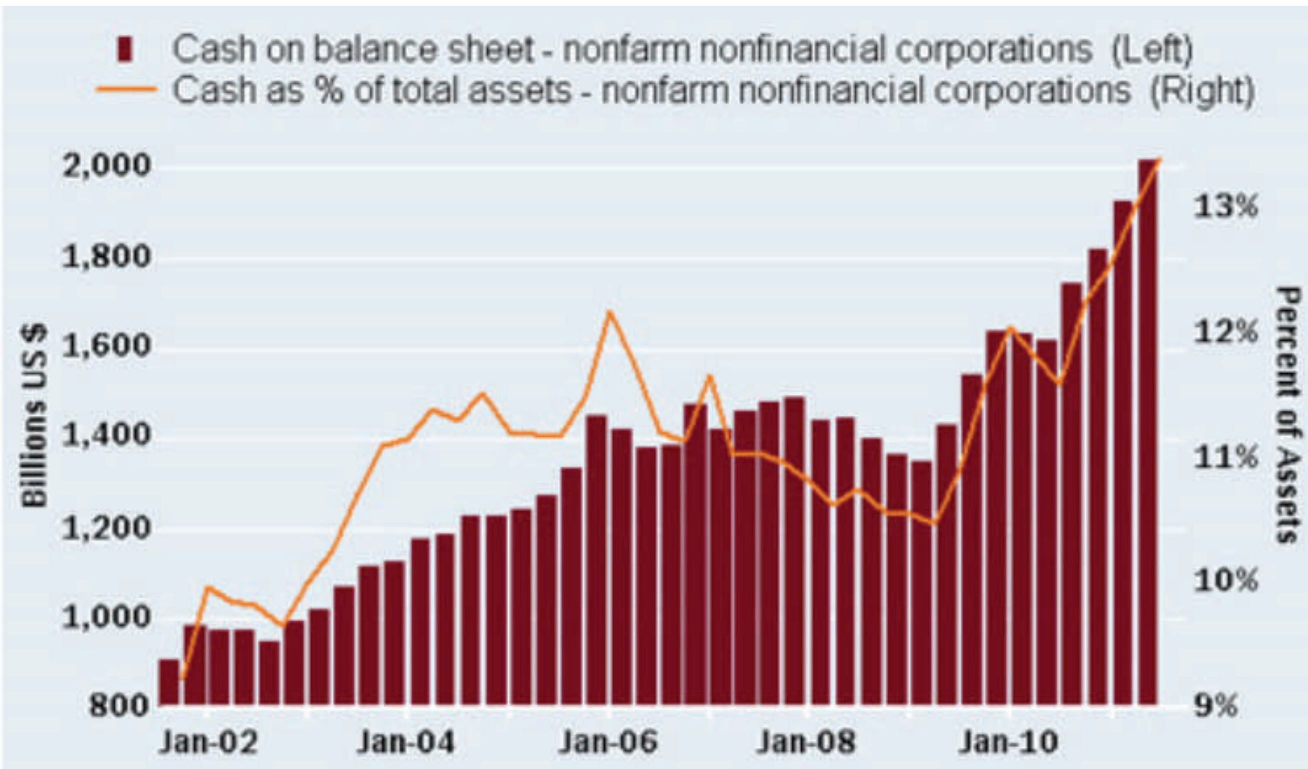
Much has been made of the persistently elevated rate of unemployment after it spiked to around 10% (nationally) during the downturn of 2008-9. It has since fallen back to about 9%, but many forecasters expect the unemployment level to remain elevated for quite some time. Nonetheless, strong corporate profitability has tended to precede meaningful reductions in the unemployment rate and strong corporate profitability is exactly what we've had. The large drop in initial unemployment claims at the end of September suggests that the inverse relationship between corporate profits and unemployment may still be intact.





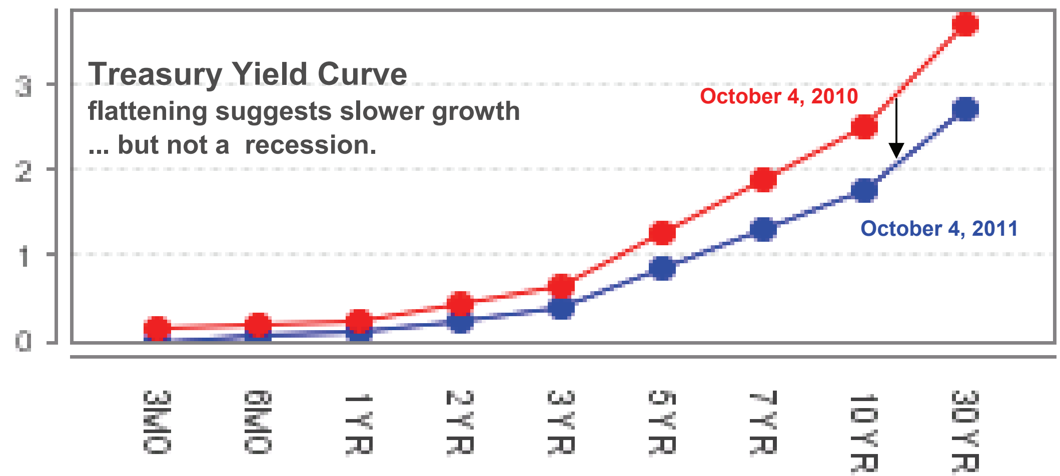
LARGE CORPORATE WAR CHESTS

Strong earnings have allowed publicly-held companies to accumulate large cash balances that represent significant financial flexibility. Although the hoarding of cash may be interpreted as a sign that corporate managers are worried about deteriorating economic conditions, this excess cash will likely be used at some point to expand operations, reduce debt, and/or to reward shareholders in the form of dividend hikes or share repurchases. All else being equal, any combination of these actions ought to translate to higher share valuations over time.



YIELD CURVE SUGGESTS SLUGGISH GROWTH ... BUT NO RECESSION

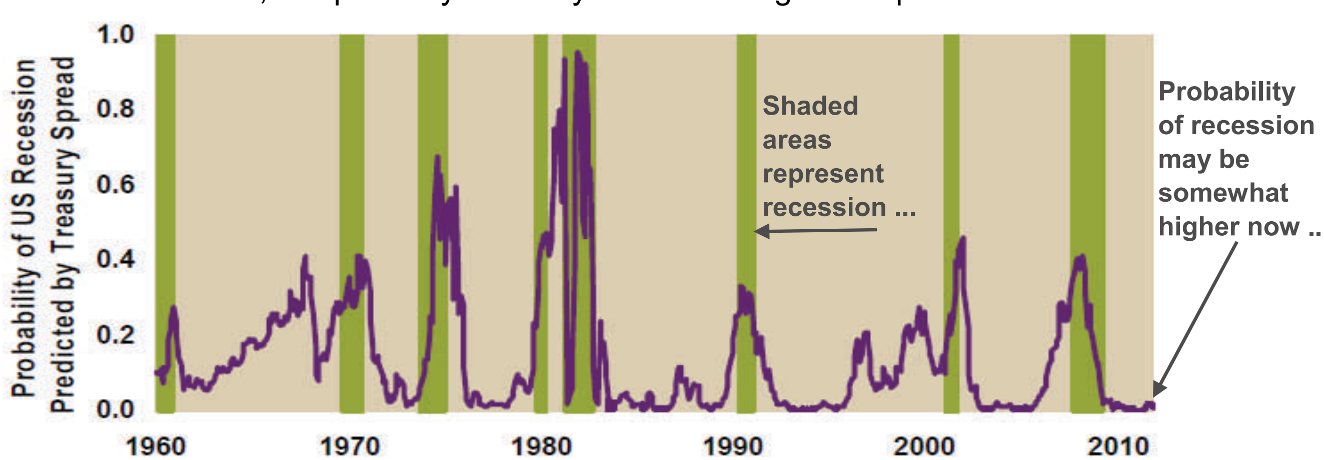
The chart on the following page illustrates how the yields on Treasury securities have changed over the past year. Because long-term yields have remained higher than short-term yields, both yield curves are said to be upwardly sloping which is considered to be normal. Without getting bogged down in unnecessary detail, upwardly sloping (looking from left to right) yield curves have historically been associated with a growing economy, not one that is in recession. Since the yield curve has flattened over the past year, a case could be made that economic conditions favor at least some continued growth rather than an outright contraction (recession).



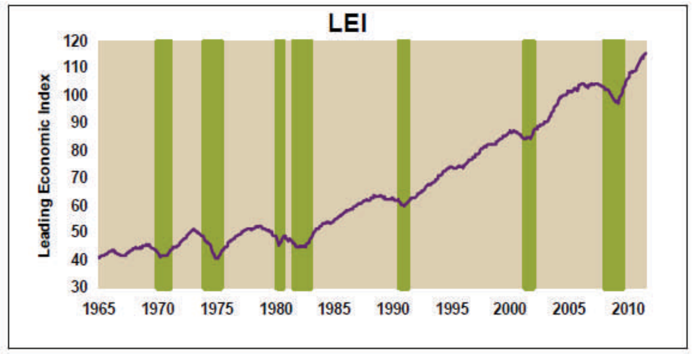
However, the fact that all types of fixed income securities are trading at yields that are near record lows may also be reflective of a so-called flight to safety due to concern that economic conditions are worsening. Therefore, the message from the yield curve is not unambiguously positive.

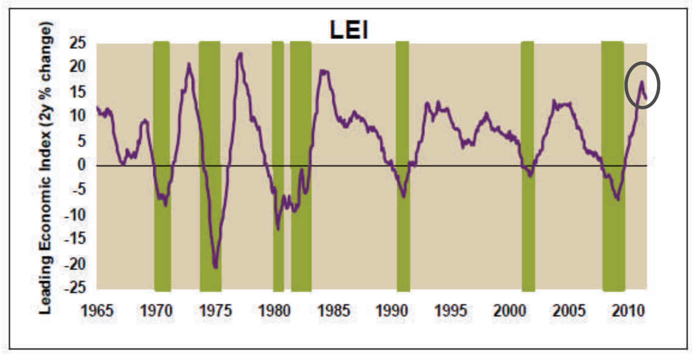
RECESSION PROBABILITY MODEL

Using the difference in yields between 10-year and 3-month Treasury securities at any given point in time, the Federal Reserve Bank of New York has developed a model it uses to estimate the probability a recession will develop over the ensuing year. Inverted yield curves (where short-term rates exceed long-term rates) have been quite predictive of forthcoming recessions, but a flat yield curve may also be cause for concern. The chart below shows how this model looked in July. The yield curve has flattened somewhat since then, but not dramatically so. Therefore, while the probability the U.S. will lapse into recession over the next year is probably higher than shown here, it is probably still fairly low according to this particular model.



LEADING ECONOMIC INDICATORS ADVANCE





The chart to the right depicts The Conference Board's Index of Leading Economic Indicators (LEI) along with an analysis of how that index has changed on a rolling, 2-year basis (the lower portion of this chart). Interestingly, it is these rolling changes that appear to be most predictive of recession (represented by the shaded areas).

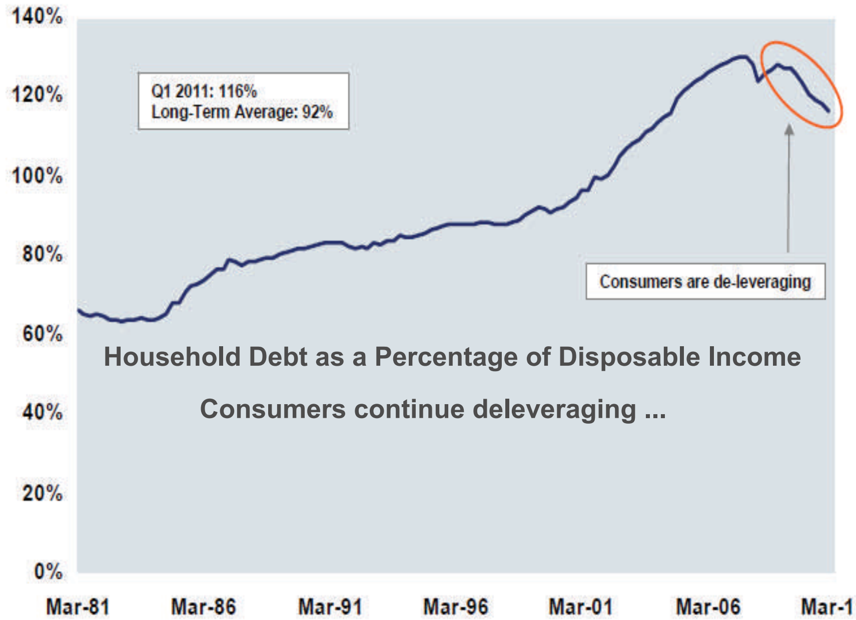
Although not shown here, the LEI has continued to advance through August, but at a slower pace. If those August figures were graphed in the lower chart, the recent momentum reversal (circled) would have been more dramatic. To quote The Conference Board in late September: "The August increase in the U.S. LEI was driven by components measuring financial and monetary conditions which offset substantially weaker components measuring expectations. The growth trend in the LEI has moderated and positive and negative contributors to the index have been roughly balanced. The leading indicators point to rising risks and volatility, and increasing concerns about the health of the expansion." Another economist on the board added, "There is growing risk that sustained weak confidence could put downward pressure on demand and business activity, causing the economy to potentially dip into recession. While the chance of that happening remains below 50-50, the odds have certainly increased in recent months." Even with a somewhat diminished outlook, The Conference Board still thinks there's a better than even chance the U.S. will sidestep a recession in the near term.

REASONS FOR CONCERN

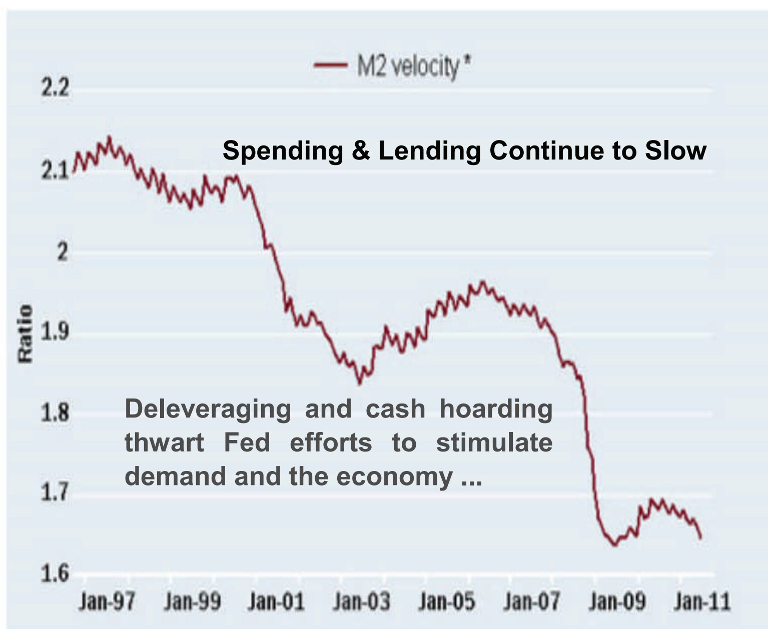
CONTINUED DELEVERAGING

Excessive debt plagues much of the developed world. In this country, the deleveraging process that began in earnest several years ago continues to plague the housing market and thwart demand, in general. The chart on the following page shows the progress consumers have made, but the deleveraging process is likely to last quite a while longer.

The chart on the bottom of this page addresses the so-called "velocity" of a particular measure of our nation's money supply. There are three such measures of aggregate money, but economists usually cite the second measure (known as M2) since the measure is broad, but not overly so.



As the Federal Reserve pumped some two trillion dollars into the U.S. economy over the past few years to stimulate economic activity, the fear was that all the extra money sloshing around the system would trigger roaring inflation. Glen Beck even aired a special broadcast that falsely stoked these inflation fears. As recently as this past spring, however, the U.S. was on the cusp of entering into a *deflationary* spiral that would have been a far more serious problem than the inflation that was feared by so many.



What Glen Beck and many other talking heads failed to understand is that large increases in the stock of money represent a potential inflation problem *only* if consumers and businesses continue to spend money at a similar pace. Of course, consumers reduced their spending dramatically and banks are still chided for being relatively unwilling to extend credit. Reluctance to spend and lend money shows up as a reduction in the velocity of money which is essentially a measure of how many times a given dollar is spent over the course of a year. To the extent the spend-deposit-spend-deposit cycle slows meaningfully, a dramatic increase in the stock of money might not only *not* trigger inflation, it might not even serve its intended purpose of stimulating the economy (and demand) adequately. In short, this is exactly what has happened and is continuing to happen. To the Federal Reserve's credit, it understood this issue and ignored charges from Glen Beck and much of Congress that it was acting recklessly. Because the deleveraging process in this country is probably not yet near its conclusion, further stimulation may continue to yield uninspiring results. This is a major negative which could linger for quite a while.

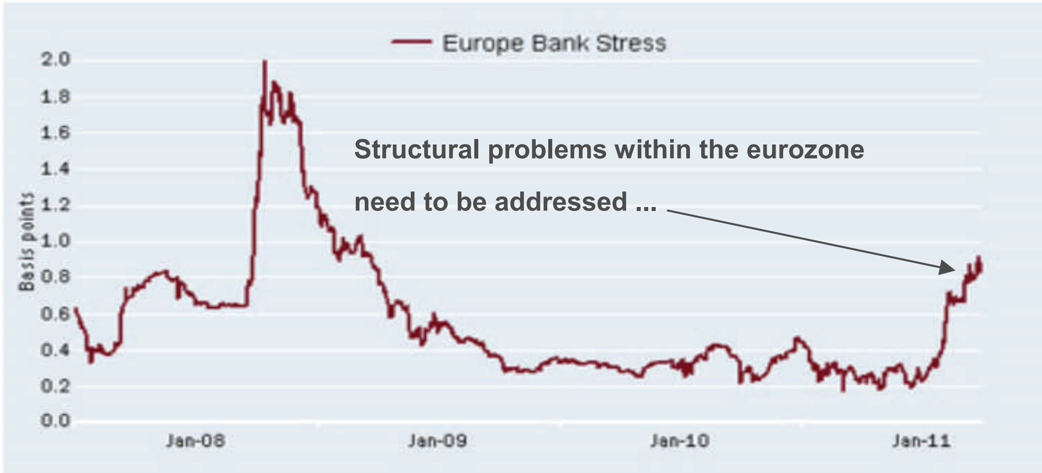
TOO MUCH DEBT & PERSISTENT DEFICITS IN THE DEVELOPED WORLD

Despite the fact that policy makers and economists cannot definitively say how much debt is too much, empirical evidence suggests that as government debt grows as a percentage of a given country's gross domestic product (economic output), economic growth tends to suffer. As the grid below illustrates, the economic suffering seems to become significantly more acute once the debt-to-GDP ratio exceeds 90%, or so. The fact that the U.S. and a number of other developed countries are already beyond this threshold (and well beyond in many cases) is another significant negative. Due to the existence of widespread budget deficits, the news here is likely to worsen.

Real GDP Growth as Level of Government Debt Varies				
Select Advanced Economies (1790-2009)				
	Central (Federal) Government Debt/GDP			
	Below 30%	30% - 60%	60% - 90%	90% and Above
Average	3.7	3.0	3.4	1.7
Median	3.9	3.1	2.8	1.9
# of Observations	866	654	445	352
Select Emerging Market Economies (1900-2009)				
	Central (Federal) Government Debt/GDP			
	Below 30%	30% - 60%	60% - 90%	90% and Above
Average	4.3	4.1	4.2	1.0
Median	4.5	4.4	4.5	2.9
# of Observations	686	450	148	113

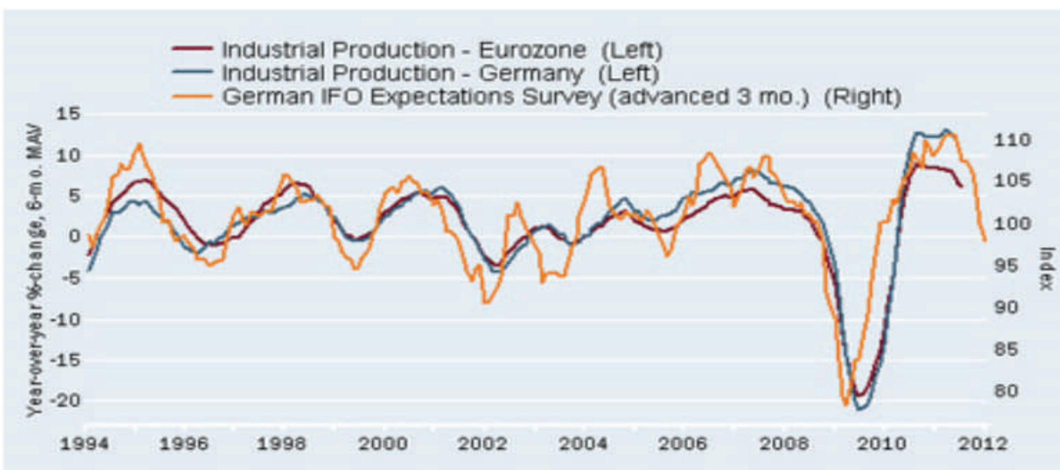
EUROPE HAS A CONTAGIOUS COLD

The old saying that when the U.S. economy sneezes the rest of the world catches a cold is on the verge of being turned inside out as Europe now seems to have the greatest potential to infect the rest of the developed world. Europe's issues have been well documented in the news, but I would like to note that Europe's banking system is under a fair degree of stress as shown in the next chart. In general, it's difficult to maintain a healthy economic environment when the underlying



Source: FactSet. As of Sept. 27, 2011. Europe Bank Stress=three month EURIBOR (Euro Interbank Offered Index Average) swap rate. Eurozone banks under stress, European recession may be next

banking system is straining. To make matters worse, industrial production in the eurozone has already slowed and expectations for future business conditions in Germany are significantly worse now than they were a short while ago. Europe may also be on the verge of a recession as is shown in the chart immediately below.



Source: FactSet, IMF, IFO, Eurostat. As of Sept. 27, 2011.

BOTTOM LINE

U.S. equity prices have been increasingly sensitive to news stemming from Europe. While a strong case can be made that equities are undervalued both here and abroad, a financial shock from Europe could alter that perception in a hurry. My preference is to continue to favor higher quality equities and to keep them somewhat underweighted versus portfolio asset allocation targets. I also favor alternative asset classes that have exhibited a low degree of correlation with traditional asset classes. I plan to discuss this more fully, later. — Glenn Wessel