

## 12. THIRD QUARTER MARKET OUTLOOK AND ECONOMIC COMMENTARY

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During the third quarter, market action during August and September made many investors think they were reliving some of the dark days of 2008, with the S&P 500 falling almost 14%. Many other stock markets experienced falling liquidity and skyrocketing volatility, causing returns to be much worse: the Russell 2000 Growth Index of small stocks, the MSCI Index for emerging markets stocks, and the indices for European stocks all fell more than 20% for the quarter. Stock investors were frustrated by Congressional bickering right up to the deadline to pass an increase in the debt ceiling, and which resulted in legislation that offered very little guidance on future fiscal policy. This ultimately led to a downgrade of the U.S. Government's credit rating by S&P. Eurozone politicians continued to publicly disagree on credible solutions to the European debit crisis.

Consequently, global confidence declined as consumers and corporations lost faith in policy makers, and the fear of a financial contagion grew stronger, with bond investors demanding higher interest rates from many European countries to purchase new government bonds. Purchasing manager surveys dropped all over the globe, and consumer confidence fell to nearly the lows of 2008. Global economic growth, which was reduced in the second quarter by supply chain disruptions caused by the Japanese earthquake, failed to rebound in the third quarter as much as expected. Even data from emerging market countries began to indicate that economic growth was beginning to slow. Several economies in Europe did slow to a zero growth rate, and many economists began forecasting a mild recession for the U.S., since consumer spending, the housing market, and the unemployment rate failed to improve.

Ironically, despite the downgrade of the U.S. credit rating, as investors were rapidly selling risky investments during the quarter, they sought the relative safety of U.S. Treasuries, and interest rates fell to record low levels. For a few days in September, the 10-year U.S. Treasury bond had a yield lower than 2.00%, lower than the dividend yield on stocks in the S&P 500, which led many strategists to proclaim that stocks were relatively cheap at their depressed levels at the end of September.

We think there is some validity to that point. Corporate balance sheets are much healthier than they were in 2008, with American companies holding more than \$1 trillion in cash. Many large companies in the U.S., Europe, and Japan, have multi-national sources of sales revenue. While consumer confidence plunged during the quarter, corporate earnings have generally met expectations, rising by more than 10%. Though retail sales are not rising enough to justify a strengthening GDP, they are not falling either. Americans continue to buy more cars every month, and the average American has less debt now than in 2008. However, most government entities have much more debt than in 2008, and many are now cutting spending and reducing staff levels to balance their budgets. We think the contraction in government spending will offset any increase in consumer spending throughout 2012, and we are expecting very low economic growth for the foreseeable future.

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We're growing increasingly concerned that the Greek debt crisis, and its impact on the European banking system, will not be resolved in a constructive manner for the financial markets, and create the type of liquidity crisis that engulfed the markets after Lehman went bankrupt in 2008. The European monetary union is relatively young and very complex, and is not designed to handle this much or this type of stress. Policy makers are responding poorly to developments in the financial markets. The European banking system, already weakened by the financial crisis of 2008 and 2009, is extremely vulnerable. Bond investors don't believe the Europeans can guarantee that all Greek bonds will be paid in full, and would like the Europeans to agree to formally write down the value of Greek bonds, and then guarantee the remaining principal. Unless and until this happens, we believe volatility will stay high and substantial risks will remain in global equity markets.

Lastly, global markets in both stocks and bonds will soon begin to focus on the work of the "Super Committee" appointed by Congress to recommend the spending cuts necessary reduce the budget deficit. This committee must present a plan to Congress by November 23, which must then pass legislation by December 23<sup>rd</sup>, or the automatic spending cuts approved by Congress back in August will become law on January 1, 2012. We hope that this legislation can be passed without the bipartisanship that prevailed during the previous debt ceiling debate, but we think that scenario is rather unlikely. The results on the markets of the resulting sequestration process are, at this point, fairly unpredictable.

*Sources: BlackRock Investment Directions – Fall 2011, Economic Cycle Research Institute – U.S. Cyclical Outlook, Loomis Sayles Investment Grade Bond Fund 3Q 2011 Outlook, Nuveen Asset Management 3Q 2011 Commentary, Payden & Rygel Global Economic Review and Outlook, Update on PIMCO's Economic Outlook and Total Return Strategy with Bill Gross and Doug Ongaro, U.S. Bureau of Economic Analysis.*

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