NOVEMBER 2010: MARKET COMMENTARY

Elections will obviously be the big story of this week, and really, the next two years. The U.S. stock market appears to have priced in large Republican gains in Tuesday's midterm elections. The S&P500 had its best September since 1939, and October also produced sizable gains.

Republican control of at least the house and possibly the senate is widely viewed by corporate America and investors as more favorable for business and nearly any type of risk asset. Business doesn't like an unstable legislative environment, and the last two years have been especially tumultuous.

Investors also don't like change and uncertainty at any time. Since 1965, when Congress has been in session, the S&P500 has gained an average of 0.9%/year versus 16.0%/year when Congress is out of session. While there's many positive changes that government can make, investors seem to believe that gridlock is preferable to nearly any type of activist government.

The other major event of the week is the Federal Reserve meeting which ends on Wednesday. The Federal Reserve continues to pump billions into the economy through Treasury debt purchases. Qualitative Easing Round 2 (or QE2 as it's "affectionately" called) is widely expected to continue to throw money into the system to stimulate growth. Investors like this in the short term although there's considerable doubt regarding its long term effectiveness.

Given all the activity of the week, it's likely that markets will be fairly volatile. And, this could continue for a while. Election results will not be fully known for weeks, and it will take investors a while to determine how much they really like the Fed's plans regardless of what they are.

While these two issues will get the major attention in the short term, obviously many other factors will continue to play into market returns. **The economy grew at a 2 percent annual rate in third quarter.** While this is hardly a torrid pace, it's also solidly positive. The annual rate for the year is expected to average around 2.8 percent. These are pretty anemic numbers for coming out of a recession, but they're also well above zero growth that could result in a double dip recession. Projections for next year's growth numbers target about the same growth level – again, solid, but not particularly strong.

As a result, it's going to take awhile to see major impacts in the jobs market. While private enterprise is adding jobs, growth has been slow. Recent job gains for October's non-farm payrolls showed only 60,000 jobs added. Net job creation needs to average 130,000 a month to keep up with growth in the labor force though immigration and new workers entering the labor force. We've had few months even approach this number, and obviously much higher numbers are needed to actually increase employment. It usually takes a while for hiring to pick-up, but the pace of hiring out of this recession has been particularly slow. Less legislative uncertainty may result in increased hiring, but we're not going to see massive employment increases overnight. It will probably be the middle of the next year before unemployment really declines.

Housing also continues to present challenges. Higher unemployment, much tighter credit and regulatory changes are all continuing to dampen housing prices. The market appears close to the bottom and may even be past it. However, rather than a V shaped housing price curve, it

appears prices may follow a U shaped curve in which values linger at lower levels for quite a while before increasing.

Europe appears to be quite serious about making fiscal changes. While this is great for longer term growth and economic health, it is likely to create challenges in the short term. Tighter budgets will crimp spending and slow growth. While this is expected to negatively affect the European economy in the short run, it's also likely to spill over to the US. US exporters will feel European tightening the most. The weaker dollar may help a bit, but probably won't offset economic weakness. While this won't create major problems for the US, it won't help either.

All these various weaknesses probably mean that growth will continue to be slow and unsteady. A more business friendly government will likely help, but it's not going to magically transform the economy.

However, even with all these various issues and possible challenges, there's enough strength building in various areas that it still appears that growth will continue, fear will continue to subside, and risk assets of any type will become more valuable.

Corporate profits are strong and cash levels are enormous. Obviously, this is highly positive for the stock market as corporate profits are the primary driver of the market. Corporate profits can't keep increasing at recent rates, but they are likely to remain strong.

The cash on balance sheets will eventually be deployed in some manner. The average firm's cost of capital tends to be around 10 percent while the cash on the balance sheet earns only 1 percent. Obviously, this is a big negative spread. While companies have been very hesitant to spend money, growing confidence and decreased fears will likely result in increased spending. Mergers and acquisition activities are picking up as firms put some capital to work.

In addition, cash is cheap and firms can access short term cash very inexpensively. Throughout history, when short term rates are much lower than long term rates (a steep yield curve), growth has been solid. Even with the special circumstances of this last downturn, this overwhelming accurate indicator strongly predicts that growth will continue.

Lastly, valuations are still very reasonable. While stocks are no longer incredibly undervalued, by numerous measures they're still relatively inexpensive, even with the recent run-up in prices. As confidence continues to return to various areas of the economy, it's likely that prices will increase to reflect a reversion to mean valuation levels.

The combination of strong corporate profits and cash levels; cheap and readily available capital; and reasonable valuations usually creates a very positive environment for stocks. A more favorable political environment should also calm both business leaders and investors. While on-going challenges are likely to temper market increases and ensure continued volatility, the recent increases appear warranted for various reasons and are likely to continue.

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