OCTOBER 2011 MARKET COMMENTARY

Historically, September is the single worst month of the year for U.S. stocks and the only month in which stocks have produced negative returns. Unfortunately, this September stayed on trend. There seems to be something inevitable about investors returning from summer holidays and diving back into the realities of investment and economic challenges that pushes sentiment down.

If you were looking for bad news in September, it was easy to find. This month highlighted our previously mentioned concerns regarding European challenges. I've been asked several times why all the fuss over Greece? It's only a little country and their debts are paltry compared to others in the E.U. Well, the real worry isn't Greece but concerns regarding the ability of Europe's leaders to fix sovereign debt issues that will also face Italy and Spain.

If Greece and E.U. leaders can't figure out a solution for Greece, investors jump to the conclusion that Italy and Spain will follow the same path, bankrupting many financial institutions as they default on massive loans. The result could be a credit crisis in Europe similar to the U.S. recent meltdown. Hence, seemingly trivial issues are roiling markets as investors extrapolate small movements as a likely future direction for the continent.

Yet even with all the dire warnings, we believe it's likely that Europe will agree to a financial solution that avoids Armageddon. The agreement reached this week on yet another bail out signals the on-going willingness to move forward. As much as Germans don't want to keep bailing out their reckless cousins, they'll likely continue to do so in order to keep the family from falling into ruin. Future relationships will change, and the Euro's future remains cloudy, but failure now remains too costly for too many.

For the U.S., progress in Europe likely avoids many possible problems, but doesn't solve our on-going weakness. Even without Europe's mess, the U.S. economy continues to struggle. September markets also suffered from the Federal Reserve's comments regarding on-going weakness in the U.S. economy.

Yet, we continue to believe that domestic projections are overly pessimistic. Our biggest concern for the U.S. continues to be Europe which I already covered. The economy is slow in the U.S. and will remain weak for some time, but a recession remains unlikely. We've never had a recession with a steeply positive yield curve (ultra-cheap borrowing for corporate America) and strong corporate profits.

Corporations' cash stockpiles are also huge at over $2 trillion and growing. Banks froze lines of credit even to the safest and best managed companies. Corporations are still managing defensively. Corporate leaders and managers continue to maintain cash-heavy balance sheets as in-house insurance policies against possible future problems.

July's trade gap shrank offering more encouragement that economic growth may increase rather than slow. New claims for jobless benefits hit a five-month low last week, and second quarter's economic growth was slightly stronger at 1.3 percent versus the previous estimate of 1.0 percent. Third quarter GDP projections are low at 2.0 percent, but are still well above recessionary numbers. Consumer spending has also picked up a bit.

Uncertainty on multiple levels will continue to keep money on the sidelines and unemployment will stay high for the foreseeable future. Yet, circumstances are entirely different than they were at the start of this downturn. Even if we were to enter a recession, I believe it's unlikely we'd experience a crisis similar in scale to the last meltdown. Too much has already changed.

Moreover, investor fears have led to a cheap stock market. By various measures, individual investors' market sentiment remains very low. This past month, another measure, the gauge of consumer expectations, fell to its lowest level since May of 1980. Many individuals have abandoned the market. Historically, this is great news for the market's future as current valuations and sentiment suggest much future opportunity. As we recently said, the market will likely remain volatile and may continue down, but in five years, we believe these prices will look very attractive.

Equities look attractive on multiple levels. They offer returns in three different ways: investors pay more for a dollar of earnings, earnings grow, and dividends increase. All look good going forward. The Standard & Poor's 500 Index's price-earnings ratio sank to a 28-month low of 12.2 last month, and then recovered to 12.5, according to data compiled by Bloomberg. The inverse of that multiple, known as the earnings yield, shows income represents 8 percent of the measure's price, or 6.1 percentage points more than the rate on 10-year Treasuries. That's the biggest gap since 2009, when the level was the highest in Bloomberg data going back to 1962. The dividend payout is exceeding bonds for the second period since the 1950s.

Unlike stocks, we're much less optimistic regarding bonds. Thirty year treasury bonds offer the dubious combination of three percent yield and an enormous potential downside. As risky as that sounds, millions of investors are moving money into Treasury bonds as a "safe haven." Many savvy money managers are steering clear of the Treasury minefield. The risk is obvious – the possibility of a sustained rise in interest rates. When rates go up, bond prices fall. The longer the term, or maturity, of the bond, the greater the interest rate risk.

With yields so low, an inflationary shock of any sort would be devastating, as rates would spike in response. The math is compelling. If yields on 10 year Treasury bonds rise three percentage points, we estimate losses of 23.5 percent for the 10-year Treasury and a 40.7 percent for the 30-year bond. While we don't expect a big jump in inflation in the near term, some form of inflationary shock seems extremely likely within the next three to five years. We've moved much of our bond portfolio into international bonds and inflation protected sectors.

While famous stock and bond investors Warren Buffett and Bill Gross disagree strongly on many issues including the recent S&P downgrade of U.S. debt, they, along with most financial professionals, agree that government policies will lead to inflation. Bond holders need to be particularly cautious going forward.

While markets usually reward good strategy over the long term and punish those who panic, there are times when investor actions – or inaction – make bigger impacts. Given recent volatility and on-going challenges, investors can be tempted to panic or act rashly. We believe times like these reward smart investors with good strategies focused on the longer term. Turmoil nearly always creates opportunity, and we believe this time is no different than many past opportunities.

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