OCTOBER 2010: MARKET COMMENTARY

As third quarter draws to an end, we seem to have a bit more consensus regarding the direction of the US and even global economy than we've had in a while. This doesn't mean the consensus is correct, but wider agreement usually calms markets. As we have been saying for many months, there's almost complete conviction now that we will not see a double dip recession. With recession fears subsiding substantially, the market has reacted sharply and increased nearly 10% in September.

There's another major factor that is likely playing into the recent sharp market uptick. Historical data show that **midterm elections have been largely positive for both equity** and fixed income markets. Obviously, this is only a trend, but many experts also believe that this election offers potentially larger upsides.

In early September, there were widespread expectations that the likely election results were not yet priced into the market. However, after a very strong September, **there's likely less upside potential.** It appears that investors are increasingly aware of history, and combined with growing confidence in the economy, decided to move into the market now rather than wait.

In addition, the economy is recovering, and there's data from many, many different sectors that point to gathering strength. We may not be out of the woods, but it seems that we can see past the edge of the forest. I'll run through some of many positives, but first I'll highlight some of the largest on-going drags on the economy. Most individuals still believe we're in a recession, and it's only too easy to see why this belief continues.

Housing and unemployment are two of the largest problem areas. By all measures, housing continues to be very weak. It's hard to imagine a recovery really building major momentum without reasonable strength returning to the housing market. While much was made of the recent 7.6 percent increase in August sales numbers over July's sales, the sales numbers are still very poor averaging 20 percent below the run rate for the first half of the year.

Mortgage applications are also running 30 percent behind last year's low rate. In addition, housing vacancy rates remain at record levels, and the housing glut will likely exert substantial downward pressure on prices through the rest of 2010 and into 2011.

While the recent drop in sales is consistent with the common view that the main impact of the tax credits was to pull purchases forward, it appears that the marketplace is starting to gain some equilibrium. Progress is happening, just not very fast. Yet while housing is less of a drag on the economy, it's also contributing virtually nothing to economic growth. Of course, this bad news is priced into the market and any good news will likely generate enthusiasm. At this point housing is probably heading up, but the hole is still pretty deep.

Unemployment doesn't seem to be changing much either. Earlier in the recession, unemployment trends seemed to be following previous patterns. At this point, we seem to be falling behind and trending faster in the wrong direction. Small companies create nearly 100 percent of all jobs in the US and their confidence remains very low. This isn't helping unemployment levels now and also poses challenges for the future.

However, while the news is generally poor on this front, **there is cause for optimism coming from several areas** indicating that job creation will pick up speed even if it takes longer than normal. Expectations are very widespread that the elections will slow the assault on the business community which should positively impact all of corporate America, including small businesses.

A couple less obvious trends show growing confidence in the business community. Mergers and Acquisition activity is on the rise. Venture capitalists are also returning. As mentioned in past newsletters, many big companies are holding tremendous cash balances. They've been very slow to release them, but it appears that they, along with individual investors, hedge funds and others, are again searching for promising start-ups.

Venture Capital investments are on pace to rise nearly 50 percent this year and are projected to rise more than 10 percent next year. Of course, this follows a very depressed couple years and levels are still only a third of the record set in 2000. However, this trend suggests good news for employment in the longer term as the growth of these companies routinely spur hiring.

Corporate default rates have rapidly plunged and are expected to fall below three percent by the end of the year. This would put default rates at pre-crisis levels and well below the peak in November, 2009 of 14.6 percent. Moody's reported this as a "stunning drop" and called the rebound "breathtaking". Confidence is growing that we're past the last wave of restructurings, and, if true, corporate America has reached this point faster than anticipated. The recovery is expected to help unemployment numbers as there will be fewer job losses caused by corporate collapses.

There are also various other positive signs suggesting recovery. A solid rise in retail sales in August suggests that consumers are starting to gain confidence. Excluding cars and gas, 2010 retail sales are likely to increase about four percent. All consumer spending shows a more modest increase of about two percent, and holiday sales are up about three percent from last year. With consumer spending comprising roughly 70% of the economy, increases closer to historical averages are very welcome.

A second straight month of rising consumer prices should also dampen fears of deflation. While price decreases can sound great, they're disastrous for an economy as people wait to spend hoping for further price declines. Inflation is expected to fall below 1% for the year and rise a bit next year. This should enable the US to avoid deflationary problems but also keep price increases from creating other issues.

Finally, we strongly believe that it continues to be unwise to bet against the U.S. We have the innovation, the motivation, the political structure to incent people to take risks and innovate. While sentiment at this time is still very hesitant or pessimistic, it always is coming out of a recession. Every recovery looks different, and this one is obviously very slow. However, we expect to see some very positive leaps forward in the coming years as the U.S. once again shows its ability to adapt and evolve.

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