



Quarterly Investment Commentary

What a Difference a Year Makes

While it was only 12 short months ago, the memory of September 2008 has grown faint for many people. The global financial system – its underpinnings eroded by the rapid deterioration of the U.S. real estate market – was in the throes of a crisis unlike any in modern memory. Several major financial institutions failed, while others reached the brink of failure before being rescued or acquired. With the prospects for a systemic failure gaining credibility, government policymakers embarked on a bold, controversial, and uncharted course of direct market intervention, combined with fiscal and monetary stimulus, with the goal of stabilizing the system and warding off the most dire of possible outcomes.

One year later, those governmental initiatives have proven mostly successful. Efforts to staunch the bleeding in the housing market, repair seriously impaired conditions in the banking industry, and restore investor and consumer confidence have helped to stabilize and improve economic activity in recent months. As a result, proclamations abound that the current recession has likely ended.

The strength of the recent recovery should not be taken for granted, however, as lingering concerns related to housing, employment, and wage growth – among other factors – may yet pose headwinds to a robust and sustainable recovery. Residual worries aside, financial markets have certainly rewarded investors with a swift and strong rally off their early-year lows.

Stocks Extend Gains

After sputtering in early July, domestic stocks rallied for the remainder of the quarter, extending their upward ascent from the March 9th bottom. The Dow Jones Industrial Average gained 15.8 percent in the third quarter – led by a bounce in financial services and industrial materials stocks – and now stands 13.5 percent higher for the year-to-date. The S&P 500 Index rose 15.6 percent for the July through September period – up 19.2 percent for the year – and the Nasdaq Composite rode a surge in technology names to a 15.7-percent quarterly gain and a 34.6-percent increase for the year.

Foreign stocks slightly outpaced their U.S. counterparts for the quarter, as the MSCI EAFE and MSCI Emerging Markets indices gained 19.5 percent and 20.1 percent, respectively. The emerging markets index has now gained a striking 61.2 percent in 2009, a testament to investors' faith that emerging economies abroad will remain somewhat impervious to problems here at home.

Incentives Spur Growth

Economic data on several fronts surprised to the upside during the third quarter, in part fueled by significant government incentives to spur consumers into action. For example, buyers seeking to capitalize on the temporary government tax incentive drove sales of existing single-family homes higher for four consecutive months from April to July, including a notable 7.1-percent monthly jump in July – the largest monthly increase in at least 10 years.

Some believed it to be a precursor to a prolonged housing market recovery. Sales in August, however, tempered those hopes with a 2.7-percent decline. With the tax credit set to expire on November 30, and with rising delinquencies and foreclosures still weighing on the market, it is reasonable to think that Congress will consider extending or reincarnating the home-buyer stimulus in the future.

Similarly, automobile sales staged a sharp summer rebound, boosted by the Cash for Clunkers subsidy. Having languished at multi-decade lows of 9 to 10 million annualized units per month for the prior six months, auto sales recovered to a more normal 11.2 million and 14 million annualized units in July and August, respectively. Absent the subsidy, which expired in late August, annualized sales in September regressed to 9.2 million, near the all-time low set in February.

Recovery Expectations

These, and other similar themes, point to an economy that is benefiting from external support as it tries to regain its footing after a rather severe shock. On the plus side, the downturn has likely run its course, and the economy and financial system have each improved drastically in recent months. In particular, the rebuilding of inventories by companies that had scaled back early in the year should provide a boost to economic growth through year-end.

But it's also likely that the recovery phase will be choppy, remaining vulnerable to continued shocks. Unemployment continues to be a concern; the September payroll report indicated that the economy lost an unexpectedly high 263,000 jobs in September, and the unemployment rate crept higher to 9.8 percent. Looking ahead, it appears that subdued growth and a tepid recovery are the most likely scenarios – and a few bumps along the way should not be unexpected.

***Disclosure:** Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. All indices are unmanaged and investors cannot invest directly into an index. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The Nasdaq Composite Index measures all Nasdaq domestic and non-U.S.-based common stocks listed on the Nasdaq Stock Market. The MSCI EAFE Index is a float-adjusted market capitalization index designed to measure developed market equity performance, excluding the U.S. and Canada. The MSCI Emerging Markets Index is a market capitalization-weighted index composed of companies representative of the market structure of 26 emerging market countries in Europe, Latin America, and the Pacific Basin.*

