Quarterly Market Update

September 30, 2011

Whereas investment returns for the second quarter of 2011 were characterized as remarkably stable amidst the ongoing tumult of natural disasters in Japan and the United States, third quarter returns can be characterized as volatile, albeit not weather related.

Arguably, in 2011 the United States had its most disruptive time of weather induced disasters in many decades. (Just ask the property/casualty insurance industry about covered losses this year!) The effects of the East Coast earthquake were felt for hundreds of miles, Hurricane Irene was the first hurricane to reach the Mid-Atlantic and New England regions in at least 15 years, and heavy rainfall from Tropical Storm Lee washed away many towns in New York and Vermont.

In addition, record drought conditions in Texas provided the fuel for the worst fires in Texas history. Record snowfall this past winter combined with an unusually heavy Spring rain in Montana, led to flooding along the Missouri River that devastated farmland and overran levees, leaving many residents dislocated for months. This was also a record year for tornadoes, and tornado damage, as the devastation in Joplin, Missouri attests. It is no wonder that the Federal Emergency Management Agency (FEMA) almost ran out of available funding before the end of the Federal fiscal year on September 30.

This is not the launch pad for a discussion of climate change, but rather an observation that with all these disruptions to everyday American life, the economy overall is still resilient and growing. In spite of this resiliency, U.S. markets fell more than 14% (S&P 500) and 12% (NASDAQ). Why? The primary reason is the ongoing economic problems in Europe, which demonstrates how greatly the U.S. is affected by our financial and trade connections with them.

Greece may be the poster child for these problems, but the list of problem countries now includes Italy, the third largest member of the European Union, along with Ireland, Portugal and Spain. Europe is China's largest trading partner, and the Shanghai Market's price decline this year has reflected the potential economic problem. The prospective size of the European bailout problem is far greater than the current capacity within Europe to deal with it.There is justifiable concern that somehow the United States Federal Reserve will become the banker of last resort to the world, inflating its balance sheet beyond any current expectation by anyone in any monetary agency around the world.

Even as the U.S. stock market is poised to decline into bear market territory (the S&P 500 is down more than 19% from its April peak), the determinants of value within the equity markets have grown substantially more attractive. With long term interest rates at record low levels, the discounting mechanism for capitalizing corporate earnings should be at the high end of its historic range, say 18-20 times current earnings. Instead, corporate earnings are currently being valued at 11-12, a clear indication that fear of the future economic course within our country dominates all other factors.

Corporate balance sheets, including banks, are at their strongest and most liquid levels in at least 50 years. Dividend yields on blue chip companies exceed the yields on U.S. Treasury securities, last seen in the 1950s. While there have been a few companies that have pre-announced a slowdown in their earnings growth, the surprise is how few have announced a significant reduction in projected earnings. In spite of these positive indicators, economists and market strategists are forecasting a 40% probability of a "double-dip" recession. Consequently, commodity prices, including gold, long a safe haven in this volatile economy, have either declined or stalled. Truly there has been no safe place, aside from U.S. Treasury Notes, during the past three months.

As we go forward, our own forecast, less based on fear, is a more positive one. We expect continuing decent growth in corporate earnings, no recession, some resolution (at least partial) of Europe's messy problems with sovereign debt issues and no change in partisan politics in Washington. We expect a good final quarter of 2011 and we are fully invested in equities currently.

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