Global Economic Slowdown, Below Trend U.S. Economic Growth and High Liquidity Environment Persist; Central Bank Backstops Drive Rally in Risk Assets; U.S. Recession, Market Consolidation Risks Increase

The stock market has everything going for it…except the economy. Global policy makers from Washington to Brussels and Tokyo to Beijing piled on additional accommodative monetary policy in the third quarter, at least temporarily taking the worst case economic scenarios off the table and creating a "sugar high" for risk assets. The broad stock market in the U.S., as measured by the S&P 500 Index, rallied nearly 6.5%, to the highest level in almost five years. The yield on the 10-year U.S. Treasury note, which moves inversely to price, moved up to as high as 1.87% in September, from 1.39% in July, before ending the quarter at 1.63%. Inflation expectations, measured by the difference in yield in 10-year notes and similar maturity Treasury Inflation Protection Securities, reached 2.49%, the highest in over a year. Broadly however, investors remained unconvinced by the recent move higher in equities. Based on data from the Investment Company Institute, August 2012 marked the 16th consecutive month of stock mutual fund net redemptions, besting an 11-month period in 2007-2008. On the other hand, bond mutual funds experienced net additions of over $77 billion in the quarter, indicating fear, not greed, is the prevailing emotion motivating investors.

Due to the lack of meaningful job creation and sub-par global economic growth, central banks were forced to deliver new rounds of quantitative easing (QE). In the U.S., Federal Reserve (Fed) Chairman Ben Bernanke unveiled the third bond purchase program (nicknamed QE3). The Fed will add $40 billion a month in mortgage-backed securities to its asset purchase program in an open-ended move, with no predetermined end-point in time or amount, designed to stimulate economic growth by keeping interest rates low and to address the employment situation which it described as a "grave concern". The Fed said that without the additional policy accommodation, economic growth might not be strong enough to generate sustained improvement in labor conditions. The Fed also said it will hold interest rates near zero "at least through mid-2015", a six-month extension from its previous guidance, and that "a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the economic recovery strengthens."

While the open-ended QE move was well-received by the markets, driving risk assets higher and safe-haven bond prices lower, we would argue that there is a level of diminishing returns at work with each incremental accommodation initiative, especially in the U.S., and that we are rapidly approaching the point where the costs of additional accommodation, in the form of higher inflation, outweigh the benefits. Despite the Fed having moved to near-zero interest rates in December 2008 and having increased its balance sheet from less than $1 trillion before the financial crisis to almost $3 trillion today, the U.S. unemployment rate has been above eight percent for 43 months. Moreover, in August the labor force participation rate fell to the lowest in over 30-years. We believe the core problems in the U.S. labor markets are structural and will therefore be difficult if not impossible to solve with counter-cyclical measures such as the Fed is undertaking. We do believe the Fed's QE program improves the fiscal debt funding arithmetic. If real (inflation-adjusted) bond yields were close to the historic average of 3%, rather than the current environment where they are actually negative, the U.S. government would have to undertake additional fiscal restraint to stabilize the debt-to-GDP ratio. By keeping rates low, QE also lowers the cost of capital of corporations, reducing the incentive to hold cash. Moreover, it increases the opportunity cost of investing in safe assets and reduces incentives to save by raising inflation expectations.

Central bankers in Europe were also active with policy of their own in the third quarter. On July 26, European Central Bank (ECB) president Mario Draghi said he would do "whatever it takes" to save the 17-nation monetary union. On September 6, in an announcement aimed at containing interest rates and reducing the level of systematic risk in Europe, Draghi announced that the ECB would enter into an unlimited bond purchase program by buying bonds with maturities as long as three years on the secondary markets for countries that ask Europe's bailout fund to buy their bonds in the primary market. The Outright Monetary Transactions (OMTs) which follow the ECB's earlier bond purchase program, the Securities Market Program (SMP) which began in May 2010, will be only for countries that secure assistance from the European Stability Mechanism (ESM), the Euro-zone permanent rescue fund. On September 12, the German Constitutional Court sanctioned Germany's participation in the ESM.

The ECB's move had a favorable impact on Euro-zone debt markets, and in time will hopefully mark the beginning of the end of the euro crisis; however the Euro-zone will have its work cut out for it to integrate further, much less stay together. While the market's initial reaction to the OMTs was favorable, given the conditions, additional shocks may be needed to spark action from politicians. The European welfare states began as basic safety nets but over time turned into cushions, leading to welfare dependency. This has led to unsustainable levels of sovereign debt and the current recession across the continent. Economic conditions in Spain remain in near-depression-like territory, Italy's economy is fragile and Greece continues to be at risk of a least a second default without more aid and potentially an outright exit from the Euro-zone. Given the high-level of ongoing uncertainty, we remain significantly underweight direct financial and cyclical exposure in Europe, choosing only more defensive positions in the healthcare and telecommunications industries.

While not open-ended, the Bank of Japan policy board joined the Fed and ECB by increasing its asset-purchase program, its main tool for easing with interest rates near zero, by ¥10 trillion ($126 billion) in a surprise move on September 19. These purchases will take place until the end of 2013. Japan's aging population and prolonged deflation are weighing on demand for goods and services in its economy, the world's third largest.

Officials in China, which cut interest rates in June and July, have refrained from undertaking an aggressive stimulus plan similar to the one announced in 2008 that led to large local-government debt. However, Chinese officials are working to stabilize declining growth rates near the current 7.5% in order to avoid a so-called hard landing. In early September, China's central government announced a policy easing/stimulus plan to boost infrastructure spending on urban rail transit and road projects in 19 cities totaling close to 900 billion yuan (~$143 billion). The recent measures should boost fixed asset investment, an important measure of government spending, and represent an attempt at stabilizing its economy. In an effort to boost lending, the People's Bank of China also increased short-tem bank reserves by 365 billion yuan (~$58 billion). While Chinese policy makers are using preemptive measures, they are not expected to enter into a stimulus program near the size of its 4 trillion yuan plan from 2009 – 2010.

Back in the U.S., Congress must address the more than $600 billion in tax increases and spending cuts equivalent to 4.0% of gross domestic product (GDP) due to go into effect on January 1, often referred to as the fiscal cliff, to avoid a return to recession. In August, the Congressional Budget Office said that if Congress fails to maintain current tax rates and prevent deep cuts to federal spending, U.S. economic growth will decline by 0.5% in 2013, with an unemployment rate near 9%. If the fiscal cliff is not averted, about 88% of households would see an average tax increase of almost $3,500 in 2013, according to the Tax Policy Center, as tax rates on income, capital gains, dividends, and estates would all rise, with the alternative minimum tax spreading to 21.7 million households, up from four million. When the temporary payroll tax holiday ends, the tax increase would be about $95 billion in 2013. Independent analysts estimate that its expiration alone could reduce economic output by as much as one percent and cost the economy as many as one million jobs. According to the National Federation of Small Businesses, the related "uncertainties over economic conditions" and "uncertainty over government actions" are already weighing on optimism. Small enterprises normally account for almost half of private-sector GDP and more than half of private-sector employment.

In September, Moody's Investors Service warned that it could downgrade the U.S. government's credit rating next year if measures to reduce the national debt do not occur by early in 2013. Moody's placed the U.S.'s Aaa rating on a negative outlook in August. Standard & Poor's downgraded the U.S. on August 5, 2011, and has said political and fiscal risks may lead to another downgrade. The crux of the problem lies in the fact that U.S. Treasury takes in ~$2.5 trillion in revenue and spends ~$3.6 trillion every year, leading to this year's fiscal deficit which was $1.164 trillion. Even though the Fed's super low interest rates are lowering the cost of government borrowing to well below the historical average of the last 30-years, these imbalances are unsustainable.

The biggest problem with a stall-speed economy is that it is vulnerable to exogenous shocks, whether natural disasters like drought or man-made ones like the fiscal cliff. In late September, multiple reports signaled the increased possibility of a U.S. recession. The Ned Davis Recession Probability Model rose to a one in four chance of recession, its highest reading since May 2009. In addition, in a report released in late September, S&P's Deputy Chief Economist Beth Ann Bovino said, "Our expectation for the chances of another U.S. recession is about 20% - 25%. Chances of a quick turnaround are about 15%." She added, "The global economic slowdown, plus poor visibility on how things will turn out politically, both here and abroad, will likely keep the recovery at a crawl."

Second quarter U.S. GDP growth was revised lower to 1.3%, marking the slowest rate since the second quarter last year. Potentially even more troubling, the manufacturing sector, which tends to be a leading indicator for the overall economy, is stalling. In August, new orders for durable goods fell by 13.2%, the most since January 2009. Reinforcing concern, industrial production decreased 1.2% in August, the most since March 2009. Moreover, business activity, as measured by the Chicago Purchasing Manager's Index, unexpectedly contracted in September for the first time in three years, to 49.7, from 53.0 in August. A reading of 50 marks the dividing line between expansion and contraction. It unfortunately appears that the manufacturing sector, which has been the main driver of the recovery from the 2007 – 2009 recession, is running out of steam in the face of headwinds from a slowdown in China, the recession in Europe and domestic policy uncertainty.

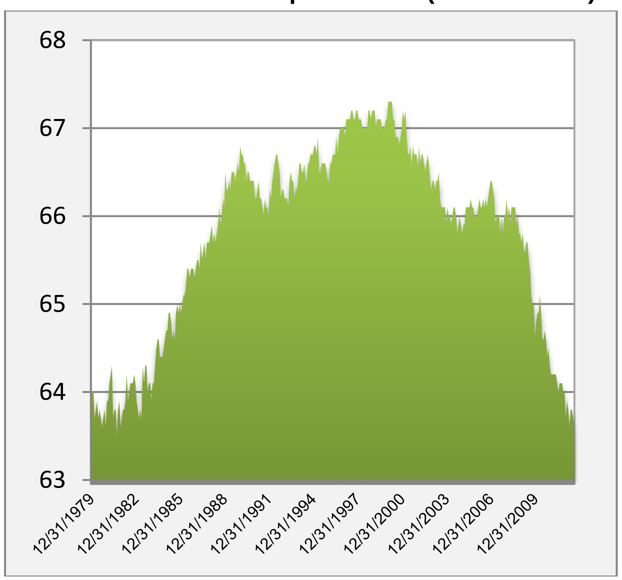
Housing remains one bright spot with multiple positive indicators signaling that participants are dipping their toes back in the water. Home prices increased 2.2% in the second quarter, the best performance since the fourth quarter of 2005, and have increased 5.9% through the first seven months of 2012. In August, construction of single-family houses climbed 5.5% to a 535,000 rate, the fastest since April 2010. In addition, home builders are as confident as they have been in six years. Moreover, existing home sales rose to a two-year high in August as attractive levels of affordability and record-low mortgage rates continue to drive results. Housing will likely add to economic growth this year for the first time in seven years.

Vehicle sales in the U.S. are also showing signs of strength. In September, carmakers sold 14.9 million cars and light trucks, at a seasonally-adjusted annual rate, the best pace since March 2008 (before the Lehman Brothers collapse). Although unemployment remains stubbornly high, auto sales have picked up as Americans are replacing older vehicles. Smaller, more fuel-efficient cars led the gains, up 50%, due in part to gas prices near $3.75/gallon.

For companies in the S&P 500 Index, quarterly profit growth in the third-quarter is expected to contract which would be the first such slide since the third-quarter of 2009. The recession in Europe, the slowdown in China and anemic levels of growth in the U.S. are all putting pressure on earnings growth. After hitting four-and-a-half year highs in the quarter, it is our view that the broad stock indices have decoupled from the underlying macro conditions and fundamentals due to aggressive central bank policy action. In the ongoing tug of war between liquidity and earnings, we believe the equity markets may be vulnerable to a consolidation in the near-term. With stock prices up and fundamentals weak, valuations are becoming more difficult to justify.

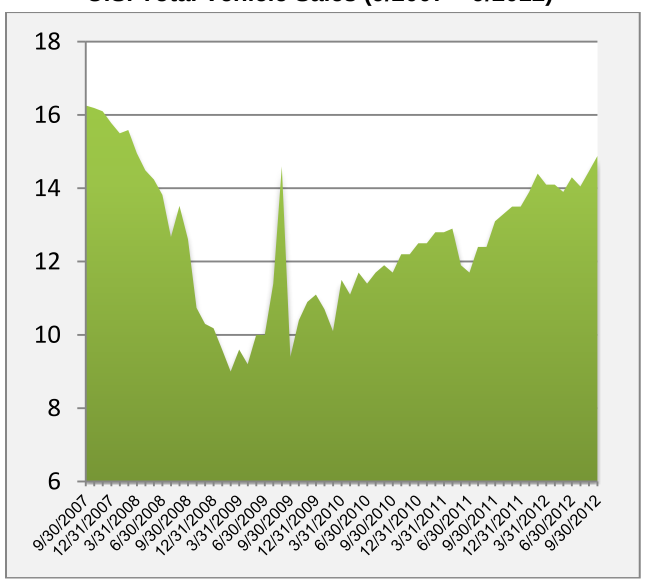
We believe this environment lends itself well to a risk-based focus on individual stock selection. As we attempt to balance the positive impacts of the recently announced monetary policy accommodation from global central banks with the uncertainties of a slowing global economy, declines in earnings, modest expectations for near-term economic improvement given the risks associated with the fiscal cliff and a wide divergence between the stock market and the real economy, we remain relatively fully invested but maintain a conservative tilt, focusing on high-quality stocks with generous and rising dividends. In fixed-income, we are avoiding Treasuries, and are instead emphasizing short-to-intermediate high-grade corporates and mortgages.

U.S. Labor Force Participation Rate (1980 – 9/2012)



Sources: Bloomberg, Bureau of Labor Statistics

U.S. Total Vehicle Sales (9/2007 – 9/2012)



Sources: Bloomberg, Ward's Automotive Group

Top Federal Tax Rate on LT Cap Gains (1967 – 2013)

Sources: Bloomberg, Department of Treasury, Office of Tax Analysis