

# INNOVEST MONTHLY MARKET COMMENTARY

## September 2009



W. Eric Overbey  
Research Analyst

Latest Returns						
EQUITIES						
Index	Sep-09	3 months	YTD	1 Year	3 Years	5 Years
S&P 500	3.73%	15.61%	19.26%	-6.91%	-5.43%	1.02%
S&P 400 Midcap	5.72%	19.98%	30.14%	-3.11%	-1.39%	4.53%
S&P 600 Small Cap	5.15%	18.66%	19.46%	-10.62%	-3.98%	2.83%
MSCI EAFE	3.83%	19.47%	28.97%	3.23%	-3.60%	6.07%
MSCI Emerging Markets	9.08%	20.91%	64.45%	19.07%	7.95%	17.31%
FIXED INCOME						
Index	Sep-09	3 months	YTD	1 Year	3 Years	5 Years
BC Aggregate Bond	1.05%	3.74%	5.72%	10.56%	6.41%	5.13%
BC Muni Bond 1-10 Yr	1.82%	3.95%	7.27%	10.50%	5.68%	4.45%
BC High Yield	5.70%	14.22%	48.98%	22.34%	5.31%	6.14%
BC Global Aggregate Bond	2.14%	6.23%	7.85%	13.51%	8.09%	6.11%
CSFB Bank Loan Index	3.29%	9.98%	39.78%	7.70%	1.14%	3.15%
OTHER						
Index	Sep-09	3 months	YTD	1 Year	3 Years	5 Years
DJ UBS Commodity	1.57%	4.24%	9.05%	-23.71%	-4.91%	-0.70%
DJ Wilshire US REIT	7.00%	35.45%	17.67%	-29.34%	-13.77%	1.16%
S&P Developed World Property	5.53%	25.38%	32.42%	-8.90%	-9.85%	4.00%
Red Rocks Domestic LPE	9.61%	32.44%	45.88%	-32.26%	-20.07%	-6.94%
LPX 50 TR	8.45%	30.80%	53.43%	-25.33%	-17.39%	-2.12%
HFRI Fund of Funds Index	1.64%	4.38%	9.80%	-1.24%	0.11%	3.44%
3 Month T-Bills	0.02%	0.07%	0.17%	0.39%	2.82%	3.11%

Returns provided by outside vendor. Innovest is not responsible for accuracy of numbers presented.

Bond Rates	As of	
	10/2/2009	12/31/2008
U.S. Federal Funds Target Rate	0.25%	0.25%
U.S. Two-Year Treasury Yield	0.88%	0.76%
U.S. Ten-Year Treasury Yield	3.22%	2.25%
U.S. Ten-Year Muni Yield	2.95%	3.91%
High Yield (Merrill U.S. Corporates)	9.60%	16.58%
Exchange Rates		
\$ per €	1.46	1.39
\$ per £	1.59	1.44
¥ per \$	89.23	90.65

## The Economy

The month of September marked the one-year anniversary of the Lehman Brothers bankruptcy, which resulted in the collapse of global capital markets. In contrast, September of this year offered the good news of improving economic data and several merger and acquisition deals. Walt Disney Co. announced the purchase of Marvel Entertainment for \$4 billion, and General Motors agreed to sell a majority stake in its Opel unit to Magna International and OAO Sberbank. Meanwhile, year-over-year declines in corporate revenues were largely offset by cost cutting measures and better than expected profits. Several emerging economies reported improving economic results, including Brazil's emergence from recession in the second quarter. However, Russia's economy shrank 10.9%, after substantial drops in capital investments and industrial production. The U.S. unemployment rate climbed to 9.8%, the highest level since 1983. Although the pace of job losses has slowed, hiring continues to remain idle.

Moreover, many economists contend that the real jobless rate remains much higher since many workers have exhausted their unemployment benefits.

The Federal Reserve Board extended its program to buy mortgage-backed securities through March 2010, after having purchased nearly \$850 billion thus far. The Fed continues to keep short-term rates low with no expected rate hikes until sometime in 2010 (or possibly later). With a significantly expanded balance sheet, the Fed may be setting the stage for an inflationary environment if they fail to effectively and timely execute an exit strategy. However, for now, inflationary expectations remain muted as velocity of money is low, the economy has ample slack and upward wage pressures remain non-existent. Lastly, the Institute for Supply Management's manufacturing gauge remained above 50 for the month of September, indicating economic expansion. Recent growth in inventories has come from pent-up demand and corporations having cut inventories sharply to manage costs.

## The Market

In September the domestic equity market extended its run of gains to seven consecutive months. As of the end of September the S&P 500 was up 19.3% year-to-date. Rising stock prices played out across all market cap spectrums, with the largest outperformer being mid cap stocks. While domestic equities outpaced international developed markets for the month, an 8% gain in non-U.S. currencies continued to boost returns of international equities. Emerging markets continued their rally, closing up over 9% for the month and 64% year-to-date.

On the credit front, spreads have contracted significantly since last year's credit market collapse. Senior floating rate corporate loans and high yield bonds have posted exceptional risk-adjusted returns over the past month, quarter, and year. On a year-to-date basis, indexes for these categories have posted total returns of 39.8% and 49.0%, respectively. With the exception of emerging markets equities, senior floating rate corporate loans and high yield bonds lead foreign and domestic equities on a year-to-date, one-year, and three-year basis. The performance of below-investment-grade issues has been driven by the dramatic price rebounds of the most volatile and speculative credits --those rated CCC and below. Diversified bonds, represented by the Barclays Aggregate Index, were among the lowest producers during the month of September. Although the Fed's dedication to purchasing Treasuries has successfully kept yields low, investors are becoming less risk averse, which does not bode well for total returns on long-dated Treasuries.

Commodities climbed modestly during the month, as energy and precious metal prices lifted the DJ UBS Commodity index. Listed private equity extended its gains, resulting in one of the largest outperforming assets classes on a monthly and year-to-date basis. The HFRI Fund of Funds Index was up modestly during September. Despite hedge funds having lagged equities and credit-sensitive bonds year-to-date, their low correlations to other asset classes still point to their significant diversification benefits.

## Outlook

After the equity market's dramatic climb from its lows on March 9, many investors and economists have revised their doom-and-gloom scenarios to hopeful expectations of a return of pre-Lehman economic and market conditions. From an

economic perspective, recent gains in the ISM Manufacturing Index indicate that a rebuild of inventories should start to boost economic growth. However, it is unknown how much and how fast consumer demand will recover, considering the precipitous decline in household wealth, high unemployment and a still over-levered U.S. consumer. The current steep yield curve is a positive economic sign, especially for lenders. Nonetheless, banks are more worried about preserving their balance sheets than originating new loans. Additionally, loan underwriting standards are likely to remain tight for some time, which may limit economic growth. While massive government intervention likely saved the U.S. economy from an even worse situation, the embedded problems from years of over leveraging cannot be cured overnight. This has increased the likelihood that governmental regulation and probable tax increases will challenge future growth and profitability for a sustained period of time.

The stock market has rallied dramatically since March after having discounted the next Great Depression. "The street's" expectations of corporate profits have risen, primarily due to companies' steep cost cutting measures. Moving forward, corporations and investors may not be able to rely on a continuation of cost cutting. Instead, well run businesses will likely need to rely more on revenue growth or operating leverage to meet earnings expectations. If revenue growth is the requirement for higher stock prices, then a renewal of the secular deleveraging theme would be a significant headwind. Conversely, investors have plenty of cash remaining on the sidelines, which could continue to push equity prices higher if market technicals are in favor. The low quality nature of recent rallies is also of concern. Although markets may continue to favor leveraged firms in the short-term, companies with the ability to take market share and generate organic growth may experience greater gains in a recovering economy.

As always, we advocate a well diversified portfolio as the key component for successful investing in the long-run. In the words of legendary investor, Peter Lynch, "Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in the corrections themselves."