



MONTHLY MARKET COMMENTARY

▼ INNOVEST September 2011

We have witnessed renewed volatility in the financial markets over the past few months. While doomsday financial scenarios from 2008 have been put to rest long ago (at least in the United States), investor fear and worry have returned to levels not seen for three years. An increasingly sluggish U.S. economy, a debt crisis in Europe and a sudden spike in global economic pessimism have led to significant financial market corrections. For the month of September the S&P 500 lost 7.03%, while Europe's MSCI EAFE Index lost 9.53%. Equity indices worldwide are now solidly negative for the year.

Keeping calm and staying the course is still the right path for investors, despite today's negative headlines. Our focus continues to be on risk control and diversification—a properly diversified portfolio will serve us well in good times and in bad. Paradoxically, it is usually the tough times when it is most advantageous to invest.

Consider investing in the U.S. stock market at two different times over the past eleven years. During the technology bubble's zenith in 2000, investor and economic sentiment were incredibly positive. The stock market was hitting new highs nearly every day. Everything felt great. Yet if you had invested in the S&P 500 in March 2000, your investment would still have losses of over 20%. In early 2009, the markets dropped to levels not seen for thirteen years. Investors were wildly pessimistic. Accordingly, an investment in the S&P 500 at the height of market pessimism in March 2009 equates to a 75% return today.

A perusal of the New York Times or Wall Street Journal might lead you to believe that our country's economy is falling off a cliff. We would like to assure you, however, that it is not all doom and gloom. The U.S. economy is growing and not likely to enter a recession in 2012. The private sector has been adding jobs each month. Stock market valuations are reasonable, if not cheap. Europe will eventually extricate itself from its current fiscal quagmire. Properly diversified investment portfolios with a long term horizon should be fine for the years ahead. We continue to urge calm and patience.

The Economy

The U.S.

September continued right where August left off, with renewed anxiety and pessimism with respect to the U.S. economy. Volatility across financial markets increased markedly for the month. Many Wall Street firms and economists of all stripes lowered their estimates for U.S. economic growth, both for the end of 2011 and for 2012. Though the underlying reasons are complex, the message is simple: the U.S. economy is recovering at a slower rate than most had predicted.

The economic news in the U.S. is actually not that bad and, in some cases, somewhat encouraging. The economy is growing. We are not currently in a recession and not likely to enter a recession in the next year. Consumer spending, which accounts for nearly 70% of the U.S. economy, is up 5.5% over the past twelve months. Manufacturing activity continues to expand in the U.S. and exports have grown for twenty seven consecutive months. The money supply is accelerating. The holiday retail season, a time when many firms make the majority of their earnings, is forecasted to be solid in 2011.

Main Street America still feels the pain: the unemployment rate remains stubbornly high, above 9% nationally. While the private sector has begun to add jobs each month, the U.S. government is cutting payrolls. The U.S. economy is adding jobs each month, but at such a low level as to not make a meaningful dent in unemployment. Corporate confidence remains an important issue. Despite having nearly \$2 trillion in cash on their balance sheets, companies are reluctant to invest and hire.

On September 21 the Federal Reserve launched "Operation Twist." The program involves selling short term U.S. Treasuries in exchange for longer term bonds. The aim is to keep long term yields lower. As a result, mortgage rates have declined to record lows. A 30 year fixed rate mortgage touched 4% at the end of the month. The jury is still out regarding the efficacy of Operation Twist, though the Fed deserves credit for trying

for accommodative monetary policy without expanding the government's balance sheet. The U.S. stock market was initially underwhelmed by the Fed's new program, though longer term the Twist could have marginally positive economic effects.

President Obama unveiled his \$447 billion American Jobs Act in September. Bipartisan opposition to the proposed bill in Congress means that the bill is most likely doomed to failure. Notably, even with its passage the bill is not likely to make a meaningful improvement for the U.S. economy. A Bloomberg survey of economists last week found that the median increase in GDP growth from the bill would be 0.6% in 2012.

In September, the U.S. added 103,000 net new jobs. The private sector added 137,000 jobs, while the public sector cut 34,000 jobs. This was a surprise to the upside. Though not a great jobs number, the report does provide solid evidence that we are not headed into a recession.

Europe

What is going on in Europe? Daily headlines about Greek bankruptcy are unfortunately all too common. Why are this country's fiscal woes impacting the entire European Union—and the world? The answer lies in the fear of financial contagion that would spread to larger European countries. The countries that are currently facing the greatest risk of default on their debt are Greece, Ireland and Portugal. Collectively, they comprise 1.9%, 1.3% and 1.4% of the European economy. They are small fish in a very large pond, though their impact on the system could be much larger.

Despite the small size of the Greek, Irish and Portuguese economies, these countries have amassed massive amounts of debt. The largest European banks own a lot of this potentially bad debt. If the countries go bankrupt, the debt on European balance sheets goes bad and many of the major European banks will face insolvency. In turn, this widespread insolvency could trigger a sale sovereign debt from both Italy and Spain. Italy and Spain also face significant financial challenges. The Italian economy represents over 12% of European GDP. The collapse of Italy and Spain would be catastrophic to Europe and world markets in general.

The financial crisis in Europe today is similar to the crisis that the U.S. faced in 2008. Excessive debt and leverage have created widespread insolvency problems. Three years ago, the U.S. provided a centralized facility with nearly unlimited funds to act as a lender of last resort to financial firms. Programs like TARP were instituted to provide for a gradual deleveraging of the system. As a result, troubled firms like Citigroup and Bank of America were able to survive.

Because of the political intricacies of Europe, a centralized solution to assisting countries and banks is far more difficult. While the European Monetary Union has provided Europe with a single currency, political sovereignty requires that all seventeen European countries approve of the steps needed handle the debt crisis in Greece. Inevitably, the result of a single currency without a fiscal union has led Europe to its problems today.

As Europe's biggest and economically healthiest country, Germany must lead any potential bail out solutions. The German Bundesbank has historically been extremely conservative, as Germans still remained scarred from the hyperinflation of the Weimar Republic in the 1930's. Germany's will to provide financial relief to Europe will be tested, though it appears that German Chancellor Angela Merkel has the political capital to do so.

Ultimately, European leaders are trying to buy time to repair the balance sheets of European banks. The deleveraging process will be long and somewhat painful, but Europe will eventually work its way out of this financial mess. In the mean time, markets will remain volatile as sentiments change on a seemingly daily basis.

The Market

September was clearly a bad month for investment returns. The S&P 500 finished the month 7.03% lower. Valuations of U.S. stocks are below



MONTHLY MARKET COMMENTARY

INNOVEST September 2011

long term averages, as the market has priced in forward-looking bad news.

Due to the European debt crisis, the European markets had a very difficult month. The MSCI EAFE Index was down 9.53%. To value investors, Europe appears absolutely cheap at these levels. On a price to earnings basis, French and German indices are nearly as low as their troughs in 2009. Still, it may not be the right time to overweight European equities. As the saying goes, just because shares are cheap doesn't mean they won't get cheaper. Emerging markets suffered as well, as the emerging market index was off by 14.58%.

Fixed income posted gains in September, as risk capital moved towards safer assets. The Barclays Aggregate Index posted a 0.73% gain. Corporate and municipal bonds both eked out gains for the month. High yield bonds tend to fare poorly in times of financial stress and September was no exception, as the high yield index fell 3.27%.

The Dow Jones UBS commodity index was down 14.73% in September, a very large move for a single month. The silver lining for the overall economy is that energy prices declined as part of this index. Cheaper energy will act like a tax cut for the U.S. consumer.

Outlook

Economists predict Europe to "muddle through" their current debt crisis. This means that the likelihood of a great outcome (quickly solving the crisis) or a catastrophic outcome (Italy and Spain collapse) are both very low. Europeans should expect a prolonged period of deleveraging and an inefficient, highly bureaucratic political process. Germany and France will likely lead a new round of capital for distressed sovereign debt, as the small steps taken so far look increasingly inadequate to solve the problems in Greece and elsewhere.

The U.S. economy should continue to grow, though the pace will remain slow. Despite all of the gloominess, the economic data support a mildly encouraging view. Consumers are gradually spending more money. Interest rates will remain low for the foreseeable future. Energy prices have come down.

Many recognize that equity markets worldwide are cheap. The natural corollary is that today could be a great opportunity to add to a position in risk assets. It is a good time to rebalance portfolios, maintaining existing strategic investment allocations. However, we think it is prudent to remain cautious. Europe still faces several major hurdles in solving their debt problems. We will continue to take a "wait and see" approach to evaluating U.S. economy, as this recovery has been more difficult than most. Recoveries from financial recessions (those created by excess leverage) typically take much longer than other recessions. This is exactly what is happening in our current recovery.

Markets will continue to remain volatile. Despite solid fundamentals, financial markets worldwide will be up and down as Europe works through its issues. In times when the markets are trading on headlines, it is important to keep a long term perspective. No one can predict the movements of the markets on daily basis. We can predict the likely movement of markets over the course of a long term economic cycle. We hope to have happier news to report next month.

Bond Rates	9/30/2011	12/31/2010
U.S. Federal Funds Target Rate	0.25%	0.25%
U.S. Two-Year Treasury Yield	0.25%	0.60%
U.S. Ten-Year Treasury Yield	1.93%	3.30%
U.S. Ten-Year Muni Yield	2.84%	3.75%
High Yield	9.51%	7.51%

Exchange Rates	9/30/2011	12/31/2010
\$ per €	1.34	1.34
\$ per £	1.56	1.57
¥ per \$	77.08	81.11

Latest Returns						
EQUITIES						
Index	Sep-11	3 months	YTD	1 Year	3 Years	5 Years
S&P 500	-7.03%	-13.87%	-8.68%	1.14%	1.23%	-1.18%
S&P 400 Midcap	-10.59%	-19.88%	-13.02%	-1.28%	4.05%	2.20%
S&P 600 Small Cap	-10.29%	-19.83%	-13.79%	0.21%	0.76%	0.27%
MSCI EAFE	-9.53%	-19.01%	-14.98%	-9.36%	-1.13%	-3.46%
MSCI Emerging Markets	-14.58%	-22.56%	-21.88%	-16.15%	6.27%	4.86%
FIXED INCOME						
Index	Sep-11	3 months	YTD	1 Year	3 Years	5 Years
BC Aggregate Bond	0.73%	3.83%	6.67%	5.29%	7.99%	6.53%
BC Muni Bond 1-10 Yr	0.14%	2.38%	5.69%	3.67%	6.37%	5.15%
BC High Yield	-3.27%	-6.06%	-1.38%	1.79%	13.83%	7.08%
BC Global Aggregate Bond	-2.31%	0.97%	5.39%	4.00%	7.89%	6.92%
CSFB Bank Loan Index	0.25%	-3.77%	-0.90%	2.38%	6.75%	3.16%
OTHER						
Index	Sep-11	3 months	YTD	1 Year	3 Years	5 Years
DJ UBS Commodity	-14.73%	-11.33%	12.73%	30.53%	3.08%	4.30%
DJ Wilshire US REIT	-11.20%	-14.54%	-5.19%	1.87%	-2.15%	-3.20%
S&P Developed World Property	-11.72%	-16.43%	-11.39%	-5.25%	0.64%	-3.90%
LPX 50 TR	-14.63%	-27.90%	-21.87%	-10.60%	-8.75%	-10.52%
HFRI Fund of Funds Index	-2.56%	-4.73%	-5.02%	-1.59%	0.22%	0.45%
3 Month T-Bills	0.00%	0.02%	0.10%	0.14%	0.22%	1.74%

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