

Fourth Quarter Begins With More Promise. Will it deliver?

In our June 29th message we expressed the notion that after several positive quarters in a row, the third quarter of 2011 was more likely to be a negative one for markets. That opinion was largely due to historical statistical reasoning. We also knew there were a variety of near-term issues that could impact markets. Unfortunately, those issues turned into more serious concerns and had much more of an impact on markets than what we could foresee back in the spring and early summer. This resulted in stocks falling broadly, and volatility and fear increasing. The main culprits were:

- Concerns about the possibility of a Greek debt default.
- Softening economic data in the U.S. economy, increasing fears we may be headed towards another recession.
- The inability of political leaders, both in the U.S. and in Europe, to effectively deal with serious issues leading to deteriorating confidence among investors.

The broad-market S&P 500 lost 14.3% since the start of the third quarter – the biggest quarterly drop since the three months ended Dec. 31, 2008. The Dow dropped 12.1% over the quarter ended Sept. 30, 2011, marked by swings of more than 100 points over most of the trading days this quarter.

MARKET RETURNS

Year to date thru September 30, 2011

S&P 500 Index	-8.7%
Dow Jones Industrials Index	-3.9%
Russell Small Cap Index	-17.0%
MSCI EAFE Index	-15.0%
MSCI Emerging Market Index	-21.9%
Barclays Capital U.S. Aggregate Bond Index	6.7%
Merrill Lynch High Yield Master Index II	-1.7%
S&P/Citigroup Int'l Treasury Bond Index	4.3%
Merrill Lynch U.S. Treasury 1-3 Year Index	1.4%

The 4th quarter is beginning with some significant good news

Better economic data is supportive of slower growth, not a recession

During weeks leading up to the end of September and the quarter's close, 14 of the 18 weekly economic releases came in better than expected. This trend has continued into mid October. The good news has come from a variety of sources, such as:

- an increase in existing home sales.
- initial jobless claims decreasing.

- greater than expected hiring in the private sector.
- manufacturing activity rising in September.
- retail sales figures continuing to surprise on the upside.

Raymond James Chief Economist Scott J. Brown, Ph.D., as well as other industry experts we follow continue to conclude that the evidence points towards slower economic growth, *not* another recession. Economists have, in fact, been slightly raising expectations for third quarter and fourth quarter GDP.

A potential agreement in Europe

The potential for a Greek default and increasing debt burdens of other European countries and the potential contagion effect from that has been a major worry for markets. To put the worry succinctly: If our own politicians in the U.S. can't agree on a budget for our singular country, how can leaders from several different countries, each with their own objectives, come together as a European Union to solve the severe debt problems facing a few of their member countries?

Over the past several months, the European policy response to the debt crisis has consisted of multiple components, each coming out one at a time, like a slow drip. As each new idea was delivered by European policymakers, the response around the globe remained the same - the policy response was not strong enough to truly address the severe debt problems. Markets responded by continuing the sell-off.

Recently though, the leaders of France and Germany have expressed willingness to recapitalize European banks and European leaders seem to be getting more serious about realistically addressing the debt issues. The markets are expressing some relief and hope that a more feasible solution will come.

Historical statistics are on our side

According to Ned Davis Research, since WWII quarterly losses exceeding 14% (3Q11 loss was 14.33%) have been followed by rebounds the next quarter 89% of the time.

Additionally, the 4th quarter is historically the best quarter of the year, leading up to holiday buying. With expectations so low, it is plausible to imagine a scenario where we receive more good news than expected, which is embraced by investors, sending stock prices higher by the end of the year.

Fear and bearish sentiment is extremely high, which is good for the bulls

There are a variety of indicators we continuously look to for an idea of how bearish (fearful, no willingness for risk-taking) or bullish (euphoric, willingness for high risk-taking) investors are overall. They are considered to be contrary indicators because when they are at extreme levels, they often indicate a turning point for the market (i.e. when sentiment is extremely bearish, it means everyone who has wanted to sell, likely has and upon the arrival of good news buyer are likely to enter the market).

Several data points are showing investors to currently be almost as fearful as they were at the bottom of the market March, 2009. Since that time, even with the current correction to 1195 on the S&P 500 (as of October 11th), the market is up roughly 75% from the S&P 500 closing low of 683. Considered a contrary indicator, this extreme bearishness is one factor that allows us to be more hopeful about the market making gains in future months.

Markets has held critical levels of support so far

We've discussed in previous writings about bottoming being a process. The lows near 1100 have been held on a closing basis several times now. Tuesday, October 4th the S&P 500 made a major reversal from being down below 1100 to reversing 4% and closing positive. This seemed to represent a change in sentiment for the market and for the past few weeks market technicals seems to be strengthening, at least in the near-term.

Jeff Saut, Chief Investment Strategist for Raymond James, has said he believes we have experienced the lows for the year, officially made October 4th on an intra-day basis.

The market appears to be inexpensive based on historical valuations, while dividends are attractive and growing

Doug Kass, President of Seabreeze Partners Management, Inc. has said that in looking at current data he believes one can make the case that the U.S. stock market is cheaper than it was three years ago. We have heard this opinion expressed a number of times very recently by various market experts.

Also, as stated in Wilbanks, Smith & Thomas Asset Management's 3rd quarter, 2011 newsletter, the S&P 500 index ended the quarter with a price to earnings ratio of 12, its lowest P/E since March, 2009, which compares with the 50-year average of 16.4. They also mentioned that corporate balance sheets remain pristine, with the top 1000 companies sitting on cash reserves of over \$3 trillion. Many have been increasing dividends (i.e. Microsoft increased its dividend by 25% during the quarter) that in many cases far exceed the yields available on fixed income securities. The low valuations on large blue-chip companies also provide greater likelihood for market growth in coming years.

In times of market volatility and economic uncertainty, it is easy to be distracted by day-to-day headlines. Some days you may feel like you just want to throw in the towel and go to cash. However, markets can become more optimistic as quickly as they can turn negative and we must always balance short-term issues and decision making with long-term goals. We must remain mindful of the need to manage assets ahead of inflation to realistically attain a level of comfortable living in retirement. We recently came across this interesting and disturbing statistic:

An individual living on a fixed income over the 20 years from the end of 1990 to the end of 2010 would have suffered a 39% loss of purchasing power over the 2 decades using the CPI as a gauge of his/her inflation (source: Department of Labor).

Markets are up nicely so far in October and the fourth quarter is beginning with more promise than the third quarter did. Hopefully it will deliver on that promise. We will continue watching developments closely. Please call if you have any specific concerns or questions.

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