

The Dog Days of Summer?

If one only looks at the results of the 3rd quarter, it appears that it must have been a mild boring summer indeed. The reality was a bit different as we did experience some sharp volatility at times, but the final result was a modestly higher market. Most major indices increased by 3 – 6% during the quarter. That brings the year to date result back into positive territory with the market averages up by approximately 2.5%.

The old Wall Street adage, “Sell in May and go away until Labor Day” was particularly accurate this summer as the market was virtually unchanged during that period. As usual the devil was in the details as the market experienced sharp corrections in June and August. Both of these moves were greater than 6% and created a negative year to date return of nearly 10% at the lows. Therefore investors had to endure a bit of a roller coaster to benefit from the slight gains the market delivered in the 3rd quarter.

The Tug of War Continues

We continue to have a substantial tug of war going on in the market. On one side of the rope are corporate profits and low interest rates. Pulling against those forces are anemic employment growth, sovereign debt concerns and wishy-washy economic indicators. Which side will win? It is still a toss-up and when one side seems to get close to the mud pit, it finds a way to pull back from the abyss.

Corporate profits continue to positively surprise as managers continue to do an excellent job “squeezing blood from the turnip”. In spite of flat revenue numbers, or at best modest increases in revenue, companies continue to maximize cash flow via expense controls. We are pleased with the results we are getting from our companies. The negative is the lingering issue that the expense controls are coming at the price of new hiring, which gives us a blasé outlook for employment....and the cycle continues.

One of the things we mentioned a year ago was how the market needed to simply take a breather and let valuations catch up with stock prices. There are two ways this can happen, a market pullback or extended sideways action. While we have seen some pullbacks in the nine months, to counterbalance the rallies, the market has really made no progress since January of this year. We are only 2% higher than we were in January. This is a positive development. While that may seem counterintuitive it is very true. The longer the market goes sideways, if cash flows continue to improve, the less expensive the market becomes. This provides for a higher level of safety and comfort for investors. After the strong year of 2009, we could not have envisioned a more favorable year to date result than what we have experienced.

Does this mean we are now bullish? No, but it means we are more constructive than we have been in a long time. The long term issues we have written extensively about have not gone away, and some would argue they are getting worse, but they are not at the forefront of investors’ minds right now and so the market continues to hold its own. We maintain our cautious long term outlook but as of right now the

government is succeeding in “kicking the can” down the road and this enables us to be a bit constructive for the near term.

The Final Stretch of 2010

We find ourselves in the final months of the year and we are ecstatic that the market has risen ever so slightly? Yes. Valuations are better, psychology is better and stock prices have given us decent returns this year. So what does the last few months look like? Barring a big surprise, we think the last few months could be more of the same. We have a couple of catalysts that may allow us to lift a bit more and give us a fairly decent year end result. The first catalyst we foresee is the resolution of the November elections. We will talk about the expected results in a moment but the very fact that the elections will be over is a positive. The uncertainty of swings in congressional power, regardless of the direction, are always cause for anxiety. The resolution of this uncertainty removes one item for investors to fret over. The second catalyst we expect is to hear from the Federal Reserve that they are STILL willing to do whatever it takes to stimulate the economy. It seems that policy makers are fully committed to raising the “animal spirits” from the grave, no matter the long term cost. Additional quantitative easing by the Federal Reserve eliminates additional worry for investors that the Feds will become less accommodative. The combination of these catalysts, along with the normal allocation of cash that tends to occur at year end, could give us a bit of strength as we finish out the year.

The elections themselves appear to be lining up to be consistent with what we expected. It appears an almost certainty that the Republicans will regain control of the House while the Democrats will retain control, albeit by a thin margin, in the Senate. (A few key races can swing the Senate, but based on current poll numbers, this is the likely scenario) What is the result of this occurring? Gridlock! To some this might be concerning, but for those that believe that the less the folk in Washington do, the better, then gridlock is apt to be viewed as a positive. Based on what we are being told the results of gridlock will possibly result in the following:

1. The Bush tax cuts will NOT be extended and income tax rates will rise.
2. Some resolution will be reached and the estate tax lifetime exemption will be set somewhere between \$2mm and \$4m.
3. No earth shattering legislation is likely to be passed in the next few years.

As always, ones perspective will determine if the items above are a positive or a negative, but the very resolution and clarity (albeit foggy) that they create may end up being welcomed by corporate planners and investors. Naturally if the election results are substantially different then what the current consensus believes to be the case, all bets are off!

Of Bonds and Bubbles

Is there a bond bubble? Yes, we believe there is. A ten – year Treasury bond yield of less than 2.5% is hard to fathom. But until we see real economic growth and pricing pressure, it may be the norm for a bit longer. Make no mistake, the “no brainer” that we see in the market today, is that interest rates are

going to go up a LOT from these levels. We have to get thru deflation first but when we start to see inflation it will shock people how quickly it ramps up and how hard it is to control.

When this does happen, the Federal Reserve will start scrambling the tools it has at its disposal to slow the rate of inflation and interest rates will begin to rise quite dramatically. Like all bubbles, if investors wait until the signs of the bubble bursting show up they will be late and will suffer as a result.

So what should a bond market investor do? Invest in short term maturities, buy TIPS (Treasury Inflation Protected Securities), buy floating rate debt instruments and be patient with cash. The most painful mistake an investor can make right now is to chase an extra 50 bps of yield by buying long dated bonds. Be patient and be prudent.

Sometimes Boredom is Desirable

After the roller coaster experienced by investors in 2007 – 2009, an unexciting period of time is not necessarily a bad thing. We know that investors who feel like they are “running out of time” as they prepare for retirement are getting anxious. Don’t let that anxiety cloud a person’s judgment and cause mistakes. It is tempting to throw “caution to the wind” and chase prices but we know that the rules of investing never change. Buy what is not expensive and sell what is expensive. Don’t focus on price alone, look at value. That is the way to deliver consistent results and never forget that sometimes the best investment decision one can make is to sit on our hands and stay the course.

We continue to examine the landscape to find opportunities that we believe will be fruitful and as the economic cycle ebbs and flows there are attractive investments to make. With careful evaluation and consideration, we will continue to help our clients participate in those situations. Please don’t hesitate to let us know what questions you have and how we can serve you better. We appreciate the confidence you have in us.