

The Oarsman Outlook

October 2010

Despite a dispiriting U.S. economy, recurrent sovereign-debt worries in Europe and a simmering trade/currency confrontation between the world's two largest economic powers, global stocks staged an impressive rally in the July-September period, recouping nearly all the losses registered in the spring quarter. Domestic stock indices advanced more than 10%, while overseas markets notched even larger gains, on average. Slowing economic growth and receding inflation-expectations pushed bond yields sharply lower for the second consecutive quarter, producing strong returns from all categories of fixed-income investments.

Among U.S. stocks, the strongest performances came from those in the Basic Materials, Communication Services, Technology and Utilities sectors; lesser, but still healthy, returns came from Consumer Staples, Financial Services and Health Care names. Small-company stocks were neck-and-neck with large-caps, while "growth" stocks modestly outperformed their "value" counterparts. Real estate securities, paced by those with predominantly non-U.S. exposure, posted double-digit gains. The prices of most industrial commodities rose; gold finished the quarter at a new record high.

Benchmark Performance – Equities

	<u>Third Quarter 2010</u>	<u>Last Twelve Months</u>
S&P 500 Index	+11.3%	+10.2%
Large-Cap. Core Mutual Fund Avg. (Lipper)	+10.9%	+8.0%
Small-Cap Stocks (Russell 2000)	+11.3%	+13.3%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	+16.6%	+8.6%

Benchmark Performance – Fixed Income

	<u>Third Quarter 2010</u>	<u>Last Twelve Months</u>
Barclays Intermediate Gov't/Credit Index (taxable)	+2.8%	+7.8%
Barclays Municipal Bond Index (tax-exempt)	+3.4%	+5.8%

Review

Compared to the April-June period, the third calendar quarter was less eventful but distinctly more enjoyable for investors. After reaching a 2010 low in early July, stock markets rallied impressively through the remainder of that month, fell back moderately for most of August, and then resumed their advance in September, closing just below five-month highs. The final month of the period notched the best one-month performance for U.S. stocks since April 2009, and the best September performance in 71 years. Second-quarter corporate profits were again surprisingly robust (up 8% from the first quarter and 51% from the same quarter in 2009), as the business sector continued to fare well despite a clear deceleration in economic growth. Meanwhile, although continuing to paint a picture of sluggish growth, economic statistics reported during the quarter, on balance, allayed fears that the recovery had reversed into a 'double-dip' recession.

What's Changed?

To provide insight regarding recent stock market performance, we can deconstruct the three-month return from stocks into three components:

- 1) Dividend Income (for three months this is the annual yield divided by four)
- 2) +/- Change in Earnings Per Share* (average for S&P 500 Companies)
- 3) +/- Change in Valuation (Price/Earnings Ratio)

= Total Return

** based on forecast earnings for next 12 months (Source: S&P Outlook)*

So, *what changed* during the recent quarter to give us the +11.3% S&P 500 total return?

Third Quarter (July - September) 2010		
Dividend Income	+0.5%	+11.3%
+ Change in Earnings	+3.1%	
+ Change in Valuation	+7.7%	
=Total Return	+11.3%	

Our read: *While earnings continued their steady advance, prices climbed even faster on prospects for lower interest rates and favorable political developments.*

While stocks grabbed the limelight, the July-September period saw another solid performance by fixed-income investments (bonds and bond funds). After reaching the seemingly absurd level of 2.95% during June, the yield on benchmark 10-year U.S. Treasury notes continued to fall, and finished September at 2.51%, having briefly dipped to 2.42%. Falling yields reflected recognition of slower growth as well as rapidly receding worries about inflation; additional impetus came from a subtle shift in Federal Reserve policy indicating the central bank would continue to keep downward pressure on yields for the foreseeable future.

On the political front, the widespread dissatisfaction and anger we commented on in our last letter seemed only to intensify. As a result, market participants appeared to discount the likelihood of a change in control of one or both houses of Congress next year. While this development likely helped propel stocks during their recent spurt, it set up a potential 'buy the rumor, sell the news' situation for the period leading up to the November election.

Overseas, there were persistent jitters on the sovereign-debt front. With the passage of time and the conduct of major European bank 'stress tests,' these concerns continued to shift – albeit haltingly – from the realm of worryingly unquantifiable to reasonably well understood. This welcome reduction in uncertainty was reflected in strong performance by both the Euro and major European stock markets. Meanwhile, the desire to score political points before the November elections resulted in an escalation of hostile rhetoric aimed at Chinese trade and currency policies, which, to their credit, the Chinese mostly ignored (to date).

Outlook

Over the next several months, financial markets seem likely to be most impacted by the trajectory of economic growth and its implications for central bank policy. The outcome and aftermath of the November elections in the U.S. as well as the tenor of U.S.-Chinese relations could be influential, as well.

On the economic front, growth likely will continue to disappoint (although the risk of a double-dip has probably receded). While much ink has been spilled bemoaning its slow pace, the current recovery actually is fairly typical of those following recessions triggered by financial crises (which tend to be distinctly slower than those following ‘normal’ recessions brought on by tight monetary policy in response to rising inflation). In the wake of financial crises, even astonishingly cheap money can fail to jump-start growth, as diminished collateral values (e.g., house prices) and tighter credit standards make obtaining credit difficult for would-be borrowers, while depleted capital impairs the loan capacity of would-be lenders. Recent research indicates a seven-year post-crisis ‘de-leveraging’ period is typical, during which growth averages around a percentage point less than during the pre-crisis decade.

The above suggests the U.S. economy may be in for several *years* of growth in the 2% to 3% range (other developed economies face similar prospects). While not negligible, growth of this magnitude would be insufficient to put much of a dent in our 9%+ unemployment rate – which is a reflection of how much slack exists throughout the economy. An economy running perhaps 10% below its potential capacity is a recipe for deflation, while persistent high unemployment will at some point become economically poisonous (risking a near-permanent loss of employability for millions whose skills become decreasingly marketable) as well as politically unacceptable.

Though economists disagree on the details, most believe additional stimulus measures – fiscal, monetary, or a combination – will be needed to help close this wide ‘output gap.’ The current political climate makes additional fiscal stimulus all but unthinkable; in fact, the winding down of existing stimulus measures, the prospect of expiring Bush-era tax cuts, and budget constraints at state and local levels all have potential to act as a substantial fiscal *drag*. Accordingly, investors have come to the view that, barring a sudden, unexpected improvement in the economy, the Federal Reserve in coming months is likely to undertake another round of monetary stimulus aimed at further lowering long-term bond yields, which will reduce borrowing costs across the economy and support profitable deleveraging in the banking sector.

As noted above, investors seem to have largely discounted substantial Republican gains in the upcoming elections. With two more years (minimum) of Democratic control of the White House, such an outcome would presumably usher in a period in which neither party could make major legislative/policy advances. While a respite from what many view as a rising tide of government meddling in the economy is likely to be welcomed by the investor/business community, the historical record for investment returns under divided government is mixed. Moreover, in the period immediately ahead, government ‘gridlock’ could spell economic disaster were it to result in the blanket expiration of Bush-era tax cuts at a time of obvious economic fragility. We suspect both parties understand this danger and will reach a compromise to avoid it; however, we are continually amazed by Congress’s capacity for dysfunction. Nevertheless, as the outcome of the election becomes clear and the nation

settles in for two years of a new political regime, we expect at least marginal improvement in the level of politically motivated angst and corporate America's drumbeat of complaints about debilitating 'uncertainty' over future taxes, regulation, health care, etc.

We are carefully watching the unfolding economic confrontation between the United States and China, which has the potential to devolve into a no-win trade/currency war. There are very substantial imbalances in the global economy, and China's (and to a lesser extent other emerging market nations') mercantilist policies are among the major obstacles to alleviating them over time. However, this is an enormously complex and politically delicate set of issues that cannot be adequately addressed via a 'quick-fix' of brow-beating the Chinese into revaluing their currency. We hope cooler heads prevail in coming weeks, and look forward in future quarters to analyzing the longer-term implications of this relationship – which will be a central feature of global economic development over the next several decades.

An environment of ultra-low interest rates, nonexistent inflation, steady growth in corporate profits and a marginally improved political back-drop should be conducive to most financial investments. Despite a modest deterioration (i.e., rise) in valuation during the quarter (see the 'What's Changed?' box on page 2), the S&P 500 Index P/E ratio remains less than 14 – below its long-term average. Moreover, a growing number of high-quality, 'blue chip' stocks sport cash dividend yields greater than the 2.5% available from 10-year Treasury notes, a relationship that has not been seen in decades. We suspect, however, that the powerful July-September rally already discounts much of this benign outlook. Combined with a marked improvement in investor 'sentiment' (usually a contrary indicator), recent strength may leave stocks vulnerable to a short-term reversal heading into the historically fraught month of October. Accordingly, we believe continued caution is prudent.