

**Quarterly Market Commentary**

**9/30/2011**

*The Economy*

In the absence of signs that the economy is about to improve on its own, policymakers have intervened. The Federal Reserve recently announced a new program dubbed Operation Twist. The intention is to effectively swap \$400 billion of short-term Treasury bonds it owns for longer-term bonds in order to squash interest rates even further. If successful, the reduced borrowing costs for businesses and consumers could stimulate economic activity. The accompanying hope is that both mortgage holders and potential homebuyers might be enticed to take advantage of historically low rates. For those current mortgage holders, refinancing would reduce interest payments, freeing billions of dollars for incremental spending into the economy. In the meantime, the President announced a plan to create jobs, since net employment growth has slowed materially in recent months. Given the partisanship of today's Congress, there is only a remote expectation that much if any of the proposal will be enacted.

In the meantime, European Union officials continue to debate the solutions to the sovereign debt issues of its members. Even if an answer to stem the immediate concerns is found, the austerity measures required to return recipients of bailouts and rescue packages back to good health will leave an imprint of sluggish economic growth across the continent for some time. On the other side of the world, China is maintaining its diligent effort to tame inflation and property price escalation. The fear is that the tightening could slow the economy more than anticipated at a time when many other nations are relying on its torrid pace of growth to pull along the global expansion.

Collectively, these macro forces that are buffeting markets are creating tremendous uncertainty for businesses and investors alike. While governmental authorities are attempting to satisfy the problems each of these important economic regions are facing, it likely means the aversion of a disaster rather a recipe for a markedly improved economic climate looking forward into the next year.

*Equity Markets*

Equities posted declines across global bourses for the quarter. Escalating woes about Greece's solvency and what or who might be next, along with global growth paring its comparative pace, pushed values down into bear market territory in some European and developing markets. While U.S. equities did not go unscathed, the 14% decline by the S&P 500 index was far less than that of the EAFE or Emerging Markets indices, which were down 19% and 22%, respectively.

As prices have fallen, valuations have been compressed to levels that demand attention. Based upon earnings expectations under all but draconian conditions, many equity markets are selling at or below historical norms. Were the fog of uncertainty to begin lifting, equity prices could stage a healthy advance. Still, caution is warranted given the complications that could arise from a disorderly event in Europe, a recession in the U.S., or a hard landing in the Chinese economy. A diversified portfolio of quality equities, along with select commodity-related instruments, represents a prudent approach to holding risk assets at a time when volatility will probably remain high.

*Fixed Income*

High quality bonds performed exceptionally well in the quarter, as the risk-free trade was in full bloom. The Barclays Aggregate Bond index rose 3.8%, helping to push its total return for the year to 6.6%. What is truly remarkable is the return of the Barclays Government Long Treasury index that jumped 25% in the quarter! The flight to safety overlaid by the Fed's checkbook caused prices to soar. As a consequence of these events, however, the 10-year Treasury yield reached near 60-year lows. At less than 2%, while inflation is running north of 3%, a negative real rate of return would hardly make these instruments appealing to a long-term investor.

The Federal Reserve recently stated that economic conditions will likely warrant keeping short-term rates exceptionally low well into 2013. Unless the domestic economy experiences an unexpected burst of positive activity, instruments like money markets, CDs, and savings accounts will continue to pay savers near zero for the foreseeable future. Therefore, other means of producing income, such as corporate or municipal bonds, foreign bonds, convertible bonds and preferred stock should be considered.

*Concluding Comments*

Economic conditions will probably remain subpar for the remainder of the year. The headwinds will be relieved only when a European-led solution is found for the Greek debt crisis, domestic job growth returns, and confidence is restored. These challenges can be met and overcome, but it will take great political will and cooperation. We suspect such collaboration will take place in time and markets will respond favorably in due course.

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