



Monthly Investment Update

November 8, 2010

The Month in Brief

The fourth quarter got off to a positive start with gains across all equity asset classes during the historically weak month of October. Large-cap domestic stocks, as represented by the S&P 500 Index, returned nearly 4%, with mid- and small-cap benchmarks generating similar gains. Results were slightly lower for developed foreign markets, with the Morgan Stanley EAFE and Emerging Markets Indices up 3.6% and 2.9%, respectively.

As is often the case in periods with strong equity gains, fixed-income returns for October were more subdued. The Barclays Aggregate returned 0.4% for October, while municipal bonds, as measured by Barclays 7 Yr Muni Bond Index, were slightly negative (-0.1%). Fixed-income returns overseas were stronger for the month, with the Citigroup World Government Bond Index up 1.4% and the emerging markets proxy, the JPMorgan GBI-EM Global Diversified Index, up 1.3%.

Finally, commodities futures rallied strongly as well across a wide range of contracts with the broad Dow Jones UBSCI Index gaining 5%.

Domestic Economic Health

In announcing another round of quantitative easing (“QE2”), the Fed signaled its ongoing concern with high unemployment and the dangers of deflation. This somewhat controversial monetary policy decision was supported by most economists who are concerned about the relative weakness in the economic recovery. For example, the latest Commerce Department data showed personal spending up only 0.2% for September, not the 0.4% gain generally expected by economists polled by Bloomberg. Also, personal wages declined by 0.1% in September, the first reversal in personal income since July 2009, followed by a setback in the University of Michigan’s consumer sentiment index which fell to 67.7 in October, the lowest reading since November 2009. That disappointing data point was somewhat offset by an improvement in the Conference Board’s sentiment index by 1.6% to 50.2.

The Commerce Department estimated third-quarter GDP at +2.0%, mitigating some of the anxieties about a double-dip recession, although more pronounced growth is needed to make a dent in the nation’s 9.6% jobless rate. The manufacturing sector is showing slowly improving health as evidenced by the October Institute for Supply Management (ISM) report - a 56.9 reading, up 2.4% from September and marking the fifteenth straight month of growth. The ISM’s October service sector index improved as well, increasing 1.1% to 54.3.

Meanwhile, consumer inflation remained dangerously low, rising only 0.1% in September, while the more stable and predictive core inflation rate was flat, just as it had been in August. Producer prices were up 0.4% for September according to the Labor Department, with core PPI rising only 0.1%. Struggling retailers continued to keep prices low to stimulate a little demand from a deleveraging American consumer; retail sales increased 0.6% in September following a revised 0.7% advance in August.

Global Economic Health

Confidence appeared to be rebounding in Europe, as the Euro zone's October index of executive and consumer sentiment reached 104.1, the highest level since December 2007. The key German business confidence index improved along with European manufacturing growth. In the middle of the month, the International Monetary Fund forecasted a GDP increase of 1.7% this year for the euro-region economy, which would be a great improvement from the 4.1% loss in 2009. The IMF also predicted +3.3% 2010 GDP for Germany, the EU's biggest economy. The European Central Bank kept its key short term interest rate steady at 1.0%.

A Goldman Sachs analysis forecasted China's GDP at +10.1% for 2010 and +10.0% for 2011; China's 3Q 2010 GDP was officially +9.6%. Japan, which had managed a 1.5% GDP increase for the second quarter, saw the yen touch a 15-year high against the dollar in October. Manufacturing continues to gain momentum in both India and China; India's HSBC Purchasing Managers' Index went to 57.2 from September's 55.1 reading, and China's benchmark PMI improved from 53.8 to 54.7.

Financial Markets and Commodities

As mentioned above, most of the world's equities markets posted October gains, led by the 14.1% gain in the Shanghai Composite's A Shares index and the 11.5% monthly increase in Argentina's Merval. Other emerging market indices did quite well, with Brazil's Bovespa going +6.9%, Mexico's IPC All Shares at +6.4% and Russia's RTSI at +6.2%, while the Hang Seng and India's Sensex gained only 3.2% and 0.2%, respectively. In the developed markets, Germany's DAX gained 5.1% in October for the second month in a row, France's CAC 40 was up 2.6%, Canada's TSX Composite gained 3.1% and England's FTSE 100 increased 1.9%. However, Japan's TOPIX sank 4.3%, as yen strength weighed on Japanese stocks.

The bull market in precious metals showed no signs of slowing down during October. Palladium prices gained 12.9% last month, while platinum and silver prices both increased 2.9%. Gold hit another record close on October 14th (\$1,377.60 per ounce) on the way to a 3.7% October advance.

Crop futures are volatile with the seasons, and there were some big gainers as we moved into fall in the northern hemisphere. Sugar advanced 23.0% in October, cotton rose 22.0% and corn gained 17.4%. Oil had a more moderate month, with futures gaining 1.8% on the NYMEX. The U.S. Dollar Index lost 2.2% for the month, reflecting low interest rates and the prospects for another round of quantitative easing by the Fed.

Real Estate

Home sales may have reached a nadir late in the summer at least temporarily. Existing home sales rose by an encouraging 10.0% in September, while new home sales climbed 6.6% with the median price up 3.3% from 12 months ago. The August S&P/Case-Shiller home price index showed a year-over-year gain of 1.7%. However, another wave of foreclosures and persistent unemployment and underemployment still stood in the way of any pronounced housing sector recovery.

If your home was worth more than its mortgage, it was a great time to refinance. Comparing Freddie Mac's September 30th Primary Mortgage Market Survey with the October 28th edition, average rates on 15-year FRMs dropped still further from 3.75% to 3.66%. Average rates on 30-year FRMs went from 4.32% to 4.23%. By October 28, average rates on 5-year ARMs (3.41%) and 1-year ARMs (3.30%) had moved lower as well.

Looking Back....Looking Forward

It is always uplifting when we can describe a market month as the "best since ...". Following the best September since 1939, last month's performance was the best October for the S&P 500 since 2003 and the best October for the Dow Jones Industrial Average since 2006. Those results can be explained to a large extent by the anticipation of another installment of Fed easing and a shift in power in Congress that should be more business friendly.

So, what might the rest of the year hold in store for the financial markets? Generally, Presidential cycle history favors stocks in the third year of a four year term, as well as the calendar year following mid-term Congressional elections (the Dow has climbed an average of 17.1% in calendar years following mid-term elections since World War II). Of course, stocks have defied historical patterns for the past couple of years, thanks to the most severe financial crisis in the post war era.

Although the financial markets appear relieved by the dramatic shift in power in Congress and the prospects for legislative gridlock for the next two years, the economy still faces the major challenges we have chronicled in past newsletters. Shorter term, we remain concerned that some major financial and political issues probably won't be resolved until December or January (the estate tax, the EGTRRA/JGTRRA income tax cuts and health care costs), though economic visibility and political balance have certainly improved over the past few weeks. The rally in global equities is likely to continue (though with higher volatility), reflecting increasing liquidity, poor return prospects from cash, bonds and real estate and, importantly, an increasing sense of optimism and confidence in the sustainability of the recovery.

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