Monthly Investment Update

December 8, 2010

The Month in Brief

November turned out to be a mixed month for broad asset classes, with most of the positive news coming from domestic equity markets. A new round of worries over debt in the European Union, an artillery attack on South Korea by North Korea and concerns about tightening in China changed the mood and sent both developed and emerging foreign stock markets into negative territory for the month. On the fixed-income side, domestic returns showed small losses for the month, but global fixed-income markets fared worse. The losses for U.S investors in both foreign stocks and bonds were largely explained by a strengthening dollar.

Stateside, the midterm elections were an obvious bonanza for Republicans. Also, the Federal Reserve unveiled another round of monetary easing ("QE2"), creating a new round of media hysteria about inflation and the potential insolvency of a few larger states. Mortgage rates also edged up, but remained very low on a historical basis; still, home sales fell and home prices were weak. The dollar and gold both enjoyed a good month, as fear came back into fashion as primary driver of investment flows.

Domestic Economic Health

Wall Street was comforted by the Republicans winning control of the House, as prospects increased for less reform and regulation and a more business-friendly environment. Capitol Hill was poised for a negotiation over the expiring Bush tax cuts and estate taxes; the question was could a lame-duck Congress make up its collective mind before the end of 2010?

The Fed announced plans to purchase $600 billion worth of Treasuries over an eight-month period, including their intentions to buy as much as $900 billion in debt by the end of September 2011. The message to the markets was clear; interest rates will remain suppressed for at least several more quarters until the Fed is confident that deflation has been avoided. Some thought QE2 was a wise move to promote lending, inflation and the overall economy; others argued the announcement effectively invited a trade war and warned the Fed's actions would lead to asset bubbles in equities (especially emerging markets) and commodities bubbles.

The economy seemed to need more encouragement, as the Commerce Department forecasted 3Q 2010 GDP to grow by more than 2.5% -- not bad, but low for this stage of a recovery from a deep recession and hardly what was needed to make a dent in the jobless situation. Unemployment was at 9.6% in October and in late November the Fed estimated it would stay well above 7% through 2012. It also forecast growth of 3.0-3.6% for the economy in 2011, down from prior projections. However, the Commerce Department brought us word that personal spending was +0.4% for October. Additionally, personal wages were +0.5% for the month, and the personal savings rate even ticked up a tenth of a percent to 5.7%. In October, real disposable income was 2.5% above year-ago levels, the best 12-month gain registered since June 2008.

Consumer prices (at least as gauged by the Consumer Price Index) had risen just 0.2% in October, and the core CPI didn't go up at all – it was flat for the third consecutive month. Retail sales were not flat – the Census Bureau said they were up 7.3% in October compared to 12 months before, and the monthly gain was 1.2%. Finally, the manufacturing sector expanded for the sixteenth straight month in November, though the pace of production did slow down a bit in November while stockpiles and supplier deliveries increased.

Global Economic Health

Ireland, Portugal, Spain and Greece were the economic hot spots in Europe in November, saddling the European Union with trying to put out either embers or full-fledged fires. Ireland was the latest nation to adopt austerity measures and accept a bailout; the European Central Bank and the International Monetary Fund arranged to offer as much as 85 billion Euros of direct assistance to recapitalize banks and aid its punctured bubble economy. Economists feared Spain was next, based on their astonishingly high unemployment, a stock market swoon, and the collapse of its real estate market. The bad news was that Spain's debt was at about 64% of its GDP; the good news, so to speak, was that the majority of it was domestically financed. There hadn't been much growth in the Eurozone in the third quarter. Germany's economy expanded just 0.7%, and the Eurozone as a whole grew just 0.4%.

The People's Bank of China twice set new capital ratio requirements for the nation's lenders in November, following its first interest rate hike since 2007. This decision came after China's consumer prices rose 4.4% in October. Japan's economy showed surprising signs of emerging growth with a GDP rise of 3.9% in the third quarter.

Global Financial Markets

It was generally a poor month for stocks worldwide. While large-cap domestic stocks, as represented by the Vanguard 500 Index, were flat for the month, mid and small caps fared better, with gains of 3.5% and 1.8%, respectively. Looking abroad, equity returns were down across developed and emerging markets, with developed markets losing 4.8% and emerging markets declining 2.6%.

On the fixed-income side, domestic returns were negative for the month, and global fixed-income markets fared worse. The Barclays Aggregate and the Barclays 7 Yr Muni Bond Index fell 0.6% and 0.9% respectively, while the Citigroup World Government Bond Index and the JPMorgan GBI-EM Global Diversified Index each dropped close to 5%. All financial asset classes we follow are in positive territory year to date.

Commodities

The key precious metals mostly advanced last month with only platinum declining 2.4%. Gold gained 2.1% on the COMEX, ending November at $1,385.00 per ounce and making its gain 26.5% YTD. Silver rose 14.9% last month and palladium gained 9.0%. As for energy futures, oil advanced 3.3% to close the month at $84.11 per barrel, ending November up 6.0% YTD. Natural gas futures rose 3.5% in November and gasoline futures gained 6.3%; heating oil futures gained 3.6%. In crops, sugar grabbed headlines with its first negative month since May, as those futures fell 5.4%.

Real Estate

An 8.1% drop in new home sales in October left some pundits wondering if perhaps the home buyer tax credit needs to be reinstated. The existing home sales rate was 25.9% below October 2009 and the new home sales pace was 28.5% below that of a year ago (but that was when the initial deadline for first-time buyer tax breaks was approaching). Existing home prices were down 0.9% from a year prior, according to the National Association of Realtors; the Commerce Department said new home prices were down 8.2% from October 2009.

The bright note was in pending home sales where October's pending sales rose 10.4% for the largest one-month jump since the NAR began tracking that statistic in 2001.

Mortgage rates went up at least for the short term. Comparing Freddie Mac's October 28 and December 2 Primary Mortgage Market Surveys, average rates on 30-year FRMs went from 4.23% to 4.46%. The movement was similar in 15-year FRMs: 3.66% to 3.81%. Over the same period, the average interest rates on 5-year ARMs went from 3.41% to 3.49%; average interest rates on 1-year ARMs actually diminished a bit from 3.30% to 3.25%. In summary, rates are at historic lows and are not a deterrent to home purchases.

Looking Back….Looking Forward

November was the first down month for the Dow Jones Industrial Average since August, but the losses were minor for blue chip domestic stocks and positive for smaller company stocks. Losses in foreign markets were mainly currency related, as the global economy also appears to be picking up momentum and visibility. The losses in fixed income were not a surprise, as retail investors have been on a two-year buying binge that has driven prices too high and yields too low. Absent a deflationary spiral, fixed income rates have no place to go but up from current rates; translation, we expect capital losses to continue for unwary bond and bond fund investors.

December tends to be a bullish month for stocks. According to *The Stock Trader's Almanac*, since 1990 the S&P 500 Index has gained an average of 1.8% in December, posting monthly gains in 16 of the past 20 years. Of course that is simply past performance, and no guarantee of future results, but December has gotten off to a good start. Global markets have reacted positively to assurances from the ECB about controlling EU member debt, there has been a big rebound in pending home sales, and retail sales numbers from Black Friday weekend were encouraging. Extension of the Bush-era tax cuts (and finally settling on a reasonable estate tax system) for 2011 and beyond could give the December rally further impetus.

As we look into the prospects for the coming year, we remain optimistic the economic recovery will continue to gain strength, encouraging investors out of bonds and cash and into higher risk assets – basically stocks and commodities. We still believe that economic growth will be subdued in this cycle and the potential for economic policy errors and geopolitical shocks present wild cards that call for the more intensive risk management approach we have instituted with our Adaptive Risk Management process.

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