

# Market Review & Outlook

August 2010

The market continued its 2010 Jekyll and Hyde performance during the course of the 3rd quarter. If you recall, stocks hit the high mark off the March 2009 bottom back in late April with the S&P 500 trading above the 1200 level for a number of sessions. From there, the market corrected and then traded up and down in a narrow trading range for nearly 5 months, seemingly driven by whatever the headline economic news was for that particular day or week. Though stocks have not yet surpassed April levels, they did break out to the upside of this trading range late last month as fears of a double dip recession subsided and positive sentiment gained some traction. While September has historically been the worst month for stock market performance, the S&P 500 recorded a total return of 8.9% last month, making it the best September for the market since 1939. For a more detailed look at how the stock and bond markets have performed so far this year, please refer to the following table:

On September 20th, the National Bureau of Economic Research (the official arbiter of when recessions start and end) announced that the recession that began in December 2007 officially hit a trough in June of 2009. That means the aptly named Great Recession lasted 18 months, making it the longest recession since World War II and much longer than the average of 11 months. In addition, the NBER did not conclude that economic conditions since then have been favorable or that the economy is operating at normal capacity, it merely stated that this is when the recession ended and the recovery started. Indeed, growth in the U.S. and most of Europe is still very weak though the economic indicators continue to point to a slow recovery. And if we use history as a guide, the average economic recovery is 59 months long, meaning that we could still be in the early stages of a multi-year economic expansion.

In contrast to the developed nations, the emerging market countries are enjoying robust growth – these countries did not have near the amount of bad debt as the developed world going into the financial crisis, they

did not roll out massive stimulus packages in response to the crisis and did not bail out companies with public funds. And although these countries have already enjoyed nice stock market returns over the past 5-10 years, most analysts continue to predict that the next 20 years will be transformative as these markets continue to develop and comprise a larger and larger share of global GDP and stock market capitalization.

There are other factors that have played into the recent rise of stock prices and a continued chance for gains through the end of the year. One could make a strong argument that the market is positively anticipating that the Republicans will make significant gains in the upcoming mid-term elections. Most investors clearly favor the GOP position on extending the Bush tax cuts as they relate to dividends and capital gains. From a

Index	September 2010	3rd Qtr. Performance	YTD Performance	Description (what the Index is comprised of)
S&P 500	8.8%*	11.3%	3.89%	Large Cap Stocks
DJ Industrial Average	7.7%*	10.4%	5.57%	Large Cap Stocks
NASDAQ Composite	12.0%*	12.3%	4.4%	Large & Mid Cap Tech Stocks
Russell 1000 Growth	10.7%	12.9%	4.4%	Large Cap Growth Stocks
Russell 1000 Value	7.8%	10.1%	4.5%	Large Cap Value Stocks
Russell 2000 Growth	14.2%	12.8%	10.2%	Small Cap Growth Stocks
Russell 2000 Value	10.7%	9.7%	7.9%	Small Cap Value Stocks
MSCI EAFE	9.8%	16.5%	1.5%	International Stocks
Lehman Aggregate Bond Index	0.1%	2.5%	7.9%	U.S. Government Bonds
Lehman High Yield	3.0%	6.7%	11.5%	High Yield Corporate Bonds
3-month Treasury Bill	0.0%	0.0%	0.1%	

Returns are estimates as of September 30, 2010. \*Does not include dividends

simple economic perspective, the higher capital gains and dividends taxes are, the less stocks are worth.

Also, the Federal Reserve has indicated a willingness to take further steps to stimulate the economy. In September, Fed chairman Ben Bernanke stated that “the Fed is prepared to provide additional accommodation if needed.” What he is referring to specifically is that the Fed may engage in additional quantitative easing, which is just a fancy term for printing more money, or increasing the money supply by increasing the amount of excess reserves in the banking system. Central banks have historically engaged in quantitative easing when normal methods of controlling the money supply have failed, i.e, short term interest rates are already at or near zero. The fact that the Fed is willing to be more accommodative should be viewed as positive in the short to

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intermediate term, but there are many pundits who believe too much of this risks high inflation down the road – perhaps in the second half of this decade. This is a key thesis the gold bugs posit as the metal continues to hit record nominal highs (to hit real inflation-adjusted highs, gold would need to trade up to around \$2,100/oz., which is roughly 60% higher from current levels).

Another net positive is that corporate profits continue to recover strongly, powered by cost-cutting and growth in emerging markets. S&P 500 profits are still below peak levels, but Barron's reported that corporate profits as a percentage of GDP are near a 40 year high, and these earnings have pushed corporate cash balances to record levels. The Wall Street Journal reported that current cash balances of companies in the S&P 500 Index equals a record 11.6% of those companies' market value, about twice the level for the period 1980 to 2007. This cash can be used enhance shareholder value by paying dividends, buying back shares, or making acquisitions.

Although there are a number of reasons to remain constructive on the stock market in the short term, there are some serious headwinds that could present challenges. For one, the unemployment rate remains stubbornly high at 9.6%, and this official number does not include those folks who have stopped looking for work or who desire full time work but are only working part time. This appears to be constraining the rebound in consumer spending that would normally accompany a recovery. Major domestic industries such as automotive and construction remain at depressed levels and governments at home (local, state, federal) and abroad face large budget deficits and increasing debt burdens. In addition, there is considerable uncertainty surrounding new regulations (financial and healthcare) and future tax policy in the U.S. Finally, there is the housing market, which is what got us into this mess in the first place. Some experts have predicted that the market is bottoming out, but because the residential real estate market is so fragmented, this is a difficult assessment to make. While it's true that home prices have risen in some areas of the country over the past year (the SF Bay area for instance), the data for the most part is more supportive of the view that the housing market nationally will continue to struggle over the next year or two and possibly see some more downside.

What part will investor sentiment play into how stocks perform going forward? Many pundits believe that a large percentage of average retail investors have lost confidence in stocks as a long term investment vehicle, similar to how many in the Great Depression era lost faith in stocks. Given that we have experienced 2 painful bear markets in just over the past 10 years, it's hard to discount this view. Since the beginning of 2009, mutual fund investors have pulled out \$100 billion from stock funds and added \$620 billion to bond funds. The trend has continued through recent months despite 19 months having elapsed since the market bottom and thousands of points gained on the Dow. However, research has shown that negative investment sentiment is strongly correlated with rising stock prices, so if stocks continue to go up, don't be surprised if the retail investor jumps into the market and helps continue the positive trend.

We are mildly constructive on stocks in the short term for the reasons previously mentioned but acknowledge that there are any number of shocks that could derail the current positive trend. It's difficult to say how much of the recovery has been because of massive monetary and fiscal stimulus on the part of policymakers, but we will find out as that support is removed. One last tip - we are currently about 19 months into this bull market move and during past bull markets, small cap stocks have outperformed large cap stocks by a wide margin during the first year and to a lesser degree the second year. On average, during the third year the large cap stocks will begin to outperform. Please remember to stay diversified in your portfolio.

**If you have a general question about your account, please contact our customer service at 800-535-4253 extension 152. If you need investment advice, please contact me or your firm's designated consultant. You can reach me at extension 178 (510-740-4178) or at [john.w@wespac.net](mailto:john.w@wespac.net). John Williams, Manager of Advisory Services – WESPAC**