Third Quarter, 2010

Summary
Household deleveraging has led to increased savings and lower consumption. These responses, though rational long-term objectives, are harmful in the short-term, as one person's spending is (was) another's income. As sparse sales have created an abundance of capacity, hiring trends have suffered, and disinflationary, if not deflationary, pressures have arisen.

Current financial conditions are extremely accommodative for major corporations. However, for many small businesses, which traditionally borrow from local and regional banks, liquidity remains a challenge.

In the most recently reported data by the Fed, both M2 and MZM (Money of Zero Maturity), which are monetary aggregates measuring U.S. money supply, indicate a surge in growth dating back to April of this year. As of September 30, 2010, U.S. money in circulation with no maturity (MZM) has risen to $9.6 trillion.

It has been said that the Fed does not create jobs, earnings do. So far, corporate earnings have been advancing, and as of now, indications point to a continuation of rising earnings. The Fed, concerned about a weaker than normal recovery and the prospects of deflation, appears poised for continued accommodation for an extended period.

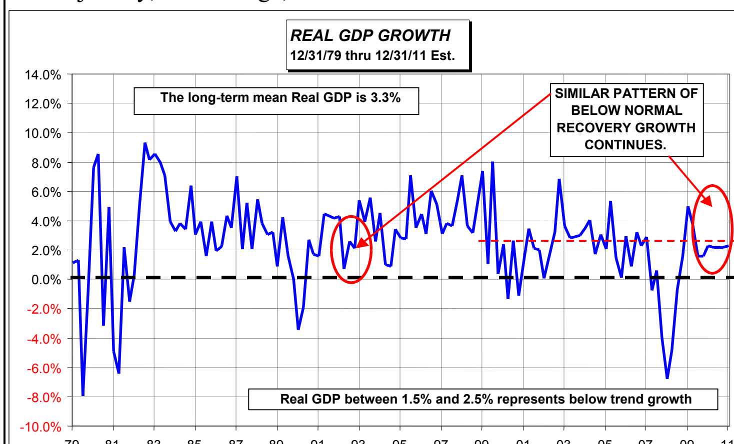
The economic recovery seems to be "bumping along the bottom" with sub-par growth. Some short-term market indicators suggest high odds for a rotation or pause, but longer-term indicators and valuation metrics remain supportive.

Bumping Along The Bottom

For the past six quarters, we have expected an unusually muted economic recovery. The September 25th edition of The Value Line Investment Survey offers a brief description of how the business cycle is different.

> *Traditionally, the transition from recession to recovery has been brief. Consumers, who account for about two-thirds of total economic activity, normally assume a lower profile as the economy tumbles into recession. They pay down debt, rebuild their savings, and defer enough spending to ensure that personal income levels again exceed personal consumption. Eventually, consumer balance sheets improve; layoffs decline; and payroll growth resumes (as employers seek to replenish inventories). Consumers then start to feel better about their present situation and become more upbeat about the future. As a result of all the above, spending levels pick up sufficiently to encourage even more private sector hiring. But this familiar and altogether comforting scenario is not playing out this time, as the employment picture, rather than brightening, has actually grown more troubled, on balance. This, in turn, is robbing consumers of the confidence needed to assume their normal leadership role in the recovery. Specifically, layoffs are still being announced in a wide range of industries, as corporations, learning that they can operate more profitably during periods of sluggish demand with leaner staffs, are opting to reduce their salaried and hourly work-forces. Obviously, such reductions are not only encouraging those directly affected to rein in their spending, but also raising cautionary flags among those workers who have thus far escaped the budget ax… In fact, over the past five quarters, each of which has seen some rise in economic output, the pace of expansion has averaged less than one-third the typical first- and second-year rate of 5%-6%. What's more, we look for only a slight acceleration in growth (into the 1.8%-2.3% range) during this year's third and fourth quarters.*[1]

Interestingly, Value Line published this commentary on September 25th, **1992**. Without question, it is eerily descriptive of current conditions. In fact, the suggested growth rates for the third and fourth quarters of 1992 mirror current sub-par forecasts for the second-half of 2010. Echoing conditions of the last century's "jobless recovery," current job growth remains weak, and high unemployment persists. Nonetheless, as in 1992, economic growth appears to be occurring, even though its trajectory, at this stage, is little better than flat.



Source: Bloomberg LP, IMVA Research

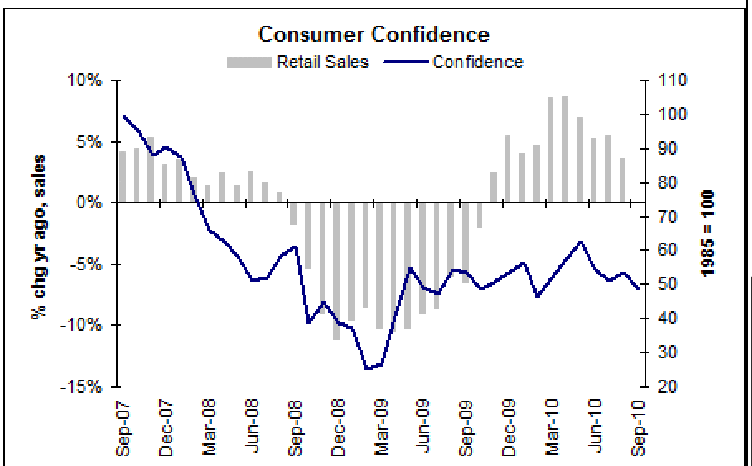
Economic Trends

On the heels of 2009's stock market rebound, this year began with great enthusiasm and hope for a V-shaped recovery. A manufacturing surge, led by exports and inventory rebuilding, accompanied by a government supported housing rebound, drove the U.S. Real GDP up a respectable 3.7% in the first quarter. This exuberance quickly yielded to fears of a second round of the financial crisis, including a possible collapse in Europe, a hard landing in China, and a double-dip recession in the U.S. Following the inventory rebuild and an end to Federal Housing

Tax Credits, growth sank to 1.7% in the second quarter. Since then, alternating releases of "below expected" and "above expected" economic reports have gradually revealed a trend of painfully slow economic growth.

Unemployment remains high at 9.6%; construction spending continues to decline at approximately 10% year-over-year (YOY); and retail sales, while growing, are advancing at roughly half the normal annual rate. According to the National Association of Realtors, stabilization in housing will be "slow and gradual," with an 11.3-month overhang of existing home supply serving as a drag. On the other hand, manufacturing continues to grow, as measured by the Institute of Supply Management (ISM), and the non-manufacturing ISM index has shown its tenth consecutive month of growth. Auto sales, while far from their peak, have rebounded, as indicated by General Motors' September sales, up 11%. After-tax corporate profits have risen nicely as well, up 38.7% YOY, with corporate tax liabilities up 82% over 2009. Even personal income is up 3.3% YOY. These data, of course, provide little comfort for the many who remain unemployed.

Most troubling, however, are the persistent low levels of consumer and business confidence. Household deleveraging has led to increased savings and lower consumption. These responses, though rational long-term objectives, are harmful in the short-term, as one person's spending is (was) another's income. As sparse sales have created an abundance of capacity, hiring trends have suffered, and disinflationary, if not deflationary, pressures have arisen.



Source: Bloomberg LP, The Conference Board

Financial Conditions
Flight-to-quality buying, particularly among Europeans, drove U.S. Treasury rates lower in the second quarter, and the demand for safety grew even more pronounced in the third quarter, sending the two-year U.S. Treasury rate from 0.6% to 0.4%, the 5-year from 1.8% to 1.2%, the 10-year from 2.9% to 2.4%, and the 30-year from 4.0% to 3.7%. Corporate bonds rates declined in a similarly dramatic fashion – and not only at the high credit-quality end of the spectrum. In fact, generic 10-year, "AAA" and "A" corporates now yield approximately 3.4% and 3.7%, respectively. More surprising, perhaps, are 4.2% yields found in "BBB" (at the low end of investment grade) securities. During the quarter, Microsoft raised $1 billion by issuing 3-year notes with a coupon rate of 0.875%, and YUM! Brands issued 10-year notes with a coupon rate of 3.875%, the lowest rate ever for a "BBB-" credit. Excluding last year, the last time that the Fed Funds rate matched current levels was in 1958. At that time, deflationary risks threatened the globe in what was viewed as the deepest downturn since WWII. In sum, current financial conditions are extremely accommodative for major corporations. However, for many small businesses, which traditionally borrow from local and regional banks, liquidity remains a challenge.

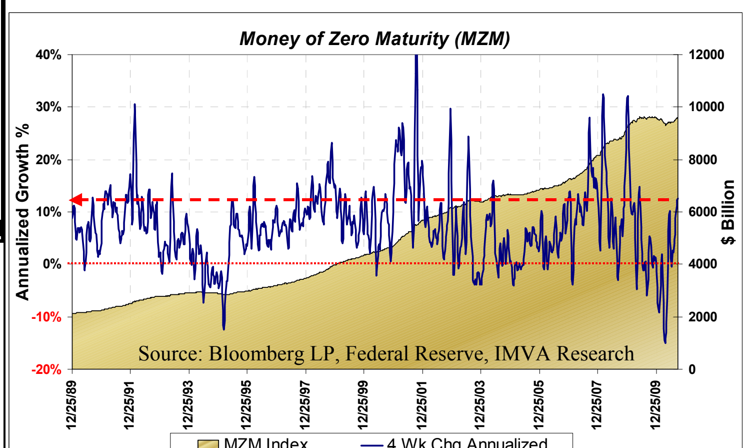
Monetary Trends
As was noted above, 1958 was the last year in which fears of systemic, global deflation dictated policy responses. Studies of news articles from the period reveal that the policy missteps of the 1930s, i.e., tightening the monetary supply and raising interest rates during an exceptionally weak environment, remained fresh on the minds of policy makers. Accordingly, authorities aggressively lowered lending rates and expanded the money supply in an effort to reflate the economy and win the battle over deflation. Today, the Federal Reserve is taking similar steps:

From the Federal Reserve Press Release of September 21, 2010:

> *"Measures of underlying inflation are currently at levels somewhat below those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability. With substantial resource slack continuing to restrain cost pressures and longer-term inflation expectations stable, inflation is likely to remain subdued for some time before rising to levels the Committee considers consistent with its mandate."*

> *"The Committee will continue to monitor the economic outlook and financial developments* ***and is prepared to provide additional accommodation if needed to support the economic recovery and to return inflation****, over time, to levels consistent with its mandate."*

In the most recently reported data by the Fed, both M2 and MZM (Money of Zero Maturity), which are monetary aggregates measuring U.S. money supply, indicate a surge in growth dating back to April of this year. As of September 30, 2010, U.S. money in circulation with no maturity (MZM) has risen to $9.6 trillion.



Source: Bloomberg LP, Federal Reserve, IMVA Research

Technical Market Trends
Following the spring correction and the summer lows of July, most equity markets have appreciated nicely. In fact, the S&P 500 Index has advanced nearly 14% since early July, recording its best September monthly gain in 71 years. While the S&P 500 still remained approximately 4% below its April 2010 high as of 9/30, it was modestly in the black on a YTD basis. Additionally, the character of the most recent surge appeared broad-based, with the cumulative measure of advancing stocks on the NYSE having

risen. Presently, many of our short-term technical readings are signaling caution. Nonetheless, longer-term market measures appear to remain healthy, albeit with implications of continued volatility.

Sentiment Indicators

Sentiment indicators, which tend to be contrary indicators, often work best at extremes. For example, during the July trough, the American Association of Individual Investors (AAII) “Bullish” indicator registered its lowest reading since the market cycle low of early March of 2009, the market bottom. Likewise, July’s “Bearishness” indicator reflected its highest mark over the same time period. Similarly, the Total Put-to-Call ratio indicated significant negative market sentiment in early July. As of the end of the third quarter, all of the measures had reversed course, indicating more positive sentiment. We would classify current sentiment measures as neutral.

Equity Market Earnings & Valuation

Following three years of earnings declines, S&P 500 Index earnings are forecast to be approximately $82.59 in 2010, up 27% versus 2009. Presently, earnings estimates for 2011 stand at approximately $94.00, up 14% versus the current year. While consensus forecasts for 2011 may be overly optimistic, we do expect modest earnings growth to continue. The direction of that trend may bode well for the market, as the high correlation between the equity market index and the direction of forward earnings estimates remains intact with a 93% correlation.[2] As of the end of the third quarter, the S&P 500 Index traded at 15 times trailing earnings, up from the extreme, low single-digit level of early 2009. The current level appears in-line with the post WWII average, making the market neither expensive nor cheap. Consequently, sustained corporate earnings growth is crucial for further advances in the equity markets.

On the other hand, equity valuations appear uncommonly attractive relative to other investment alternatives. According to Investment Company Institute data, $262 billion has been pulled from domestic equity funds since October of 2007, and $634 billion went into bond funds over the same period. More importantly, 60% of the money that left equity funds did so after November 2008, when the market had become incredibly inexpensive (it got even less expensive heading into March of 2009); moreover, 80% of bond fund additions since October of 2007 have occurred during a period in which the 10-year U.S Treasury’s yield has been below 3%, and the yield of 5-year U.S. Treasury has been below 1%. As of September 27, 2010, 157 companies in the S&P 500 Index companies have dividend yields greater than the 10-year Treasury yield of 2.39%. More significantly, and assuming corporate earnings continue to advance, the 12-month forward earnings yield on the S&P 500 Index is 6.7%.

Conclusion

It has been said that the Fed does not create jobs, earnings do. So far, corporate earnings have been advancing, and as of now, indications point to a continuation of rising earnings. The Fed, concerned about a weaker than normal recovery and the prospects of deflation, appears poised for continued accommodation for an extended period. Interest rates remain at fifty-year lows. Financial conditions are extremely favorable for major corporations, and they are gradually improving for smaller businesses. The economic recovery seems to be “bumping along the bottom” with sub-par growth. Some short-term market indicators suggest higher probabilities for a rotation or pause, but longer-term indicators and valuation metrics remain supportive. Overall, we view the pillars of the market and economy with a constructive outlook, but we do expect continued volatility.

Footnotes:

[1] *The Value Line Investment Survey,* The Quarterly Economic Review, September 25, 1992, pages 9815-9820.

[2] IMVA proprietary research sourcing data from Bloomberg, Thomson Baseline, and First Call / IBES earnings estimates since 1979.

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