investment update

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stocks: stocks rebound as double-dip worries fade

Economic data surprised investors on the upside in September causing the stock market to post sharp gains for the month and for the third quarter. The Dow Jones Industrial Average rose 10.4% in the third quarter and is now up 3.5% for the year. The broad Standard and Poor's 500-stock index was up even more—10.7%. Stocks were also supported by comments from the Federal Reserve to inject money into the financial markets through purchases of U.S. Treasurys. With unemployment stuck at 9.6% and inflation below its targets, the Fed was compelled to act in support of the economy.

There were no major themes in the stock market except for the financial sector, which lagged behind other sectors. New regulations, consumer de-leveraging, and investor fears about a possible double-dip in the housing market hurt financial stocks. Industrial and material stocks with exposure to strong growth in emerging markets lead the way. Caterpillar gained 31% in the third quarter and DuPont was up 29%. Bank of America, the nation's largest bank, declined almost 9%.

Lead by faster growth in emerging markets, international stocks did better than U.S. stocks. The Dow Jones World Index (excluding U.S.) rose 15.9% in the third quarter. Sri Lanka was up 60% and Indonesia and Thailand were both up more than 20%. Strong national balance sheets and better growth than developed markets have caused stocks in these countries to trade at a premium. With bank stress tests behind them, Europe recovered and was up 6.2% for the quarter. Norway and Finland, both up over 14%, were the best performers.

bonds: liquidity and quantitative easing fuels rally

During the third quarter, investors placed almost $88 billion into bond funds while pulling $43 billion from stock funds. As the economy slowed and unemployment continued to stay high at 9.6%, the Federal Reserve announced it would reinvest interest earned on bonds to purchase additional Treasurys. This liquidity and the Fed's promise to keep interest rates low for an extended period continued to support the bond market. For the third quarter, Treasurys returned 2.7%, investment grade bonds 4.9%, and high-yield corporate bonds 6.5%.

With unemployment high, capacity utilization low, and deflationary pressures expected to continue, we anticipate the Federal Reserve to maintain the Fed Funds rate near zero for some time. In this environment, fixed income should continue to offer returns superior to cash.

commodities: severe weather and printing money offer tailwind

Severe drought followed by a ban on wheat exports by the Russian government caused wheat prices to explode—up by 45% in the third quarter. The wheat price spike helped other agricultural commodity prices—corn was up 39.9% and soybeans up 16.7%. The Dow Jones-UBS Commodity Index rose 11.6% for the quarter. Dry weather in Brazil and floods in Pakistan drove prices higher for sugar and cotton. Growing demand for commodities in emerging markets, particularly China, supported industrial metal prices with copper, lead, and nickel all up 18% to 40% for the quarter.

As economic growth slowed significantly in the U.S. in the second quarter, the Federal Reserve made it clear it would engage in quantitative easing to support the economy. Investors, fearing that this would devalue paper currency, poured money into precious metals such as gold and silver. Gold prices exceeded $1,300 per troy ounce and silver rose almost 17% during the quarter.

outlook: the hangover is upon us

Over the past twenty years U.S. consumers assumed too much debt to buy too many homes, cars, and other big-ticket items they could not afford. In 2008 the bubble burst and we faced the abyss. Governments around the world stepped in with bank bailouts and fiscal spending programs. These actions helped stabilize the global economy. Credit markets began functioning again and stocks rebounded. Now, however, with fiscal stimulus fading, the economy will depend on consumer demand once again. However, consumers are reducing debt, increasing savings, and not spending. Over 20% of home mortgages are underwater and banks are hoarding capital rather than lending. Thus demand for credit and credit creation are sub-par, resulting in a sub-par recovery that cannot create sufficient jobs to bring the unemployment rate down. We are stuck in a negative feedback loop—or an economic hangover. It might take us a few years to get out of this mess.

Under these conditions inflation should remain low and might even decline. The Federal Reserve expects to maintain near zero interest rates for an extended period. Fixed income assets should continue to offer solid real rates of returns. With central banks around the world pumping money into the economy to support asset prices, we believe investors will increasingly shift to precious metals as an alternative currency. Gold and other precious metals have benefited and should continue to benefit from this trend.

Investors with longer time horizons, however, should consider risk assets that offer value. Housing prices are down 30-35% from their peak and interest rates are at historically low levels. We believe 2010 could prove to be a good time to buy a new home or trade up to a more expensive home. In many parts of the country, housing prices have stabilized and many homes are selling below their replacement costs. We also like large, high quality U.S. multinational companies with strong balance sheets, cash flows, and significant exposure to high growth emerging markets—companies such as IBM, McDonalds, Colgate, Abbott Laboratories, and United Technologies.

Sources: Wall Street Journal, Bank of America Merrill Lynch, Goldman Sachs