



## Third Quarter 2011 Market and Economic Summary

### Overview/Introduction

The ambivalence that took root in the spring bloomed into outright fear in the third quarter as the combination of the euro zone's decaying fiscal situation and a contentious U.S. budget debate left global investors sickened by risk. While stock and commodity markets retreated, money crowded back into the relative safety of Treasury debt—despite the high-profile downgrade of U.S. credit—and by quarter's end, the Federal Reserve was forced to “twist” its strategy of intervention in the Treasury market.

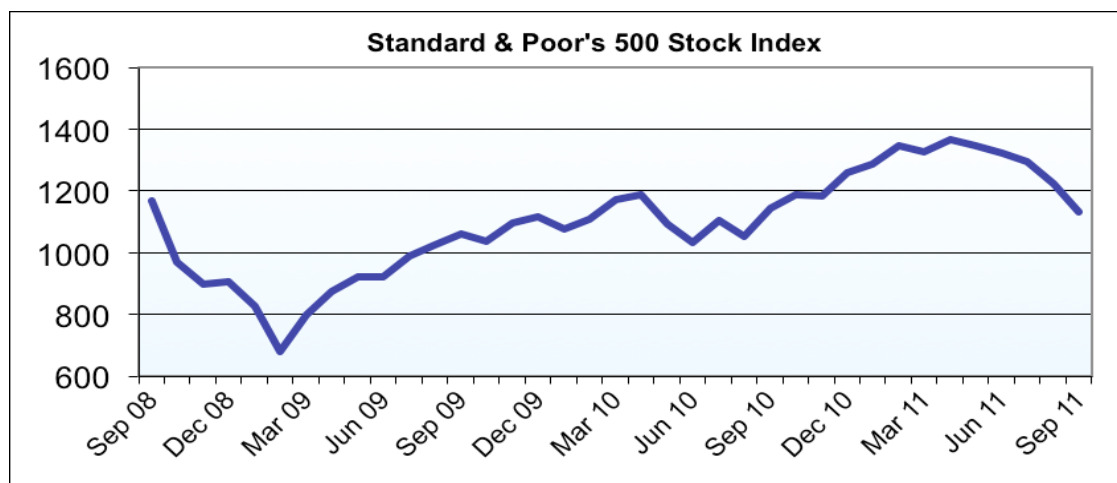
### Equity Markets

#### **Overview**

After a spectacular two-year rally, U.S. stocks may have been due for a correction, but the somewhat mild selling that began in May turned savage by August. With volatility gauges spiking, global equity benchmarks delivered their worst three-month performance since late 2008, in the wake of the harrowing Lehman Brothers collapse.

#### **Major Indices**

The Dow Jones Industrial Average, based on the performance of shares in 30 top U.S. corporations, sank a stark 13.26% during the quarter on a pure price basis, or 11.49% when helped by dividend payments. The broader market, as represented by the Standard & Poor's 500 stock index, shed 14.32% of its value in raw terms and was down 13.87% after dividends. The technology-rich Nasdaq Composite also suffered, dropping 12.91%.





While these losses almost entirely erased the market's gains for the year, long-term investors took some comfort in realizing it could have been worse—such as during the fourth quarter of 2008, when more than 20% of the value of the entire U.S. market evaporated. Moreover, despite the reversal, most of the accumulated appreciation from the 2009-2011 rally remained intact.

The S&P 500, for example, ended the quarter with a scant 1.14% gain to show for the trailing 12 months, but remained 67% above its 2009 trough and “only” 27% below its record high of 2007. The Dow, too, held on to a 3.83% gain since September 2010, leaving the blue-chip index up 66% for the previous 2½ years. The Nasdaq, having soared 90% above its low in 2009, ended the quarter just 15% below its 2007 high (though still vastly below its all-time pinnacle of 5,048, attained on March 10, 2000).

### **Russell**

A palpable sense that the U.S. and global economies were slowing drove investors out of recession-sensitive small-cap shares in disproportionate numbers. The small-cap Russell 2000 Growth Index, considered especially vulnerable to a decline in new commercial activity, plunged 22.25%, while the slightly more defensive Russell 2000 Value Index sank 21.47%. Once again, the nation's largest corporations held up slightly better, but with the Russell 1000 Value Index dropping 16.20% and the Russell 1000 Growth Index down 13.14%, even the bluest of blue chip companies were in retreat.

### **Sector**

Sellers, on the edge of panic, fled almost every market sector. Of the 10 industry groups that Standard & Poor's tracks, nine lost ground, with only the traditionally placid utility group ending the quarter about where it started, edging up just 0.40%. Pressure on commodity prices sent energy and materials stocks down another 20.85% and 24.95%, respectively, while new doubts about the health of the nation's—and the world's—banking system heaped fresh losses of 23.11% on the still-battered financial sector.

### **Earnings**

Remarkably, U.S. corporations kept finding ways to squeeze additional profitability out of existing businesses even as the economic outlook clouded. Final results from the second quarter saw members of the S&P 500—which accounts for more than 70% of the total capitalization of the U.S. market—report 18.92% higher operating profits per share, a bit above the 16.40% growth they had delivered three months previously. Still, compared with the 27% growth U.S. corporations enjoyed during the final quarter of 2010, the trend pointed downward, and analysts suspected the summer's numbers would show still slower growth.



Profitability remained a sore spot for financial companies, whose earnings were expected to rise less than 1% during the third quarter amid increased regulation and stagnant lending. Signs of weakness also emerged in telecommunications, while volatile energy prices continued to strain the profit margins of utilities. But energy producers should benefit, seeing their earnings expand by as much as 50% when third-quarter numbers are released later in the year.

### **Dividends**

Investors might have spent the quarter's darkest days worrying that a repeat of the grim winter of 2008-2009 was coming, but the massive amount of cash U.S. corporations are generating—and passing on to shareholders—should put those fears in perspective. Another 350 publicly traded companies expanded third-quarter payouts while only 23 cut dividends. The aggregate increase came to \$9.6 billion for the quarter, one bright spot for income-hungry investors.

### **Global**

#### **Equity**

Once again, developments overseas were both the source and the primary symptom of much of the quarter's angst. Western Europe's worsening debt situation generated endless speculation that political inertia could doom at least the region's weaker economies to a deep recession. At the same time, though, hints of persistent inflation in emerging markets led to worries that central bankers in Asia might be losing control of their recently booming economies.

While the United States spent much of the quarter reeling from its own eroded credit rating and faltering economic climate, its risks must have seemed less dire than most to the investors who flooded into the perceived relative safety of dollar-denominated assets.

Against this backdrop, the MSCI EAFE Index, a leading gauge of blue chip stocks in the developed markets of Europe, Australasia, and the Far East, plunged 15.68% on a local currency basis, or 18.95% when repatriated into dollars.

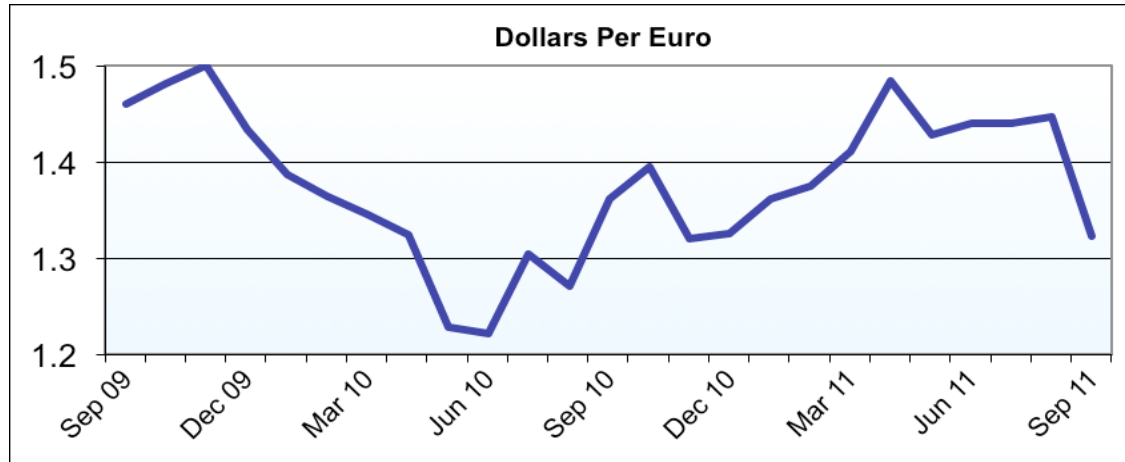
The long-dreaded prospect of fiscal decay spreading from Greece and other debt-weakened members of the European Union finally came home to the industrial superpowers of Western Europe. In dollar terms, the third-quarter losses of European equity benchmarks ranged from 16% to a nightmarish 46%, with only Switzerland and the United Kingdom—the strongest economies on the borders of the euro zone—falling less than 19%. Even in once-stable France and Italy, sovereign credit ratings began to deteriorate and stock markets in those nations lost almost a third of their value.



As nation after nation scaled back its targets for consumer spending and growth, capital poured out of the emerging world, leaving key markets in Asia, Latin America, Eastern Europe, and the Near East down by as much as 45%. While relatively robust growth saved Chinese and Indian stocks from the worst of the selling, those governments' increasingly desperate efforts to contain inflation unnerved investors, pushing down the nations' markets by 25% and 20%, respectively. In Brazil and Russia, whose economies are tied closely to the plight of commodities, the retreat was even more pronounced, with stocks ending the quarter 27% and 31% lower, respectively.

### Currency

Thanks to the long debate in Washington over raising the Treasury's borrowing limit, the U.S. dollar spent much of the quarter on the defensive. However, while Standard & Poor's elected to strip the United States of its cherished "AAA" credit rating, investors soon flocked to the dollar anyway. By September, currency markets had priced in the likelihood of at least a technical default in a euro zone country, and Europe's shared currency was on the run. The Japanese yen, Swiss franc, and the dollar surged in value, and the greenback fared particularly well, ending the quarter up 5.6% against a basket of other monetary units.



### Commodities

Amid falling targets for global economic growth, estimates of how much oil, metal, and other raw materials the world's industrial consumers would need also dropped. The widely quoted CRB commodity index sank 11.8% in the quarter, led by much larger declines in copper and other key industrial materials. Oil prices continued their retreat, falling another 17% to \$79.20 a barrel for West Texas Intermediate crude as supply disruptions in war-ravaged Libya were resolved.



Gold, considered the ultimate hedge against currency weakness, political instability, and inflation, fared much better. Amid the downgrade of the U.S. debt rating and ensuing market turmoil, bullion soared an almost unprecedented 27% in a matter of weeks to a new peak of \$1,908 an ounce on August 22 before quickly giving back much of that surge. By quarter's end, gold was still up 7.8% from its price at the end of June, reflecting the depth of investors' desire to protect themselves from risk.

## **The Bond Market**

### **Overview**

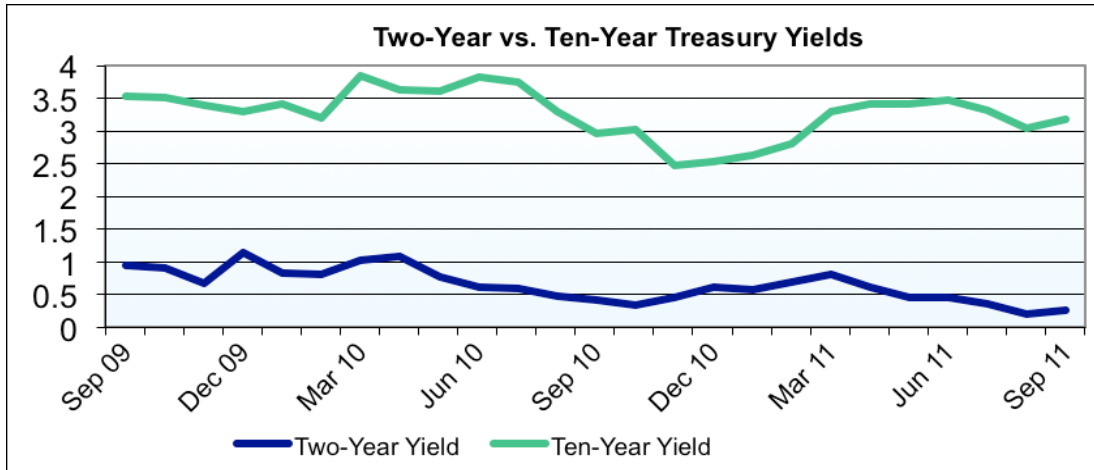
Amid heightened worries that Greece would have to default on its obligations, even downgraded U.S. debt was much in demand, leading to the best performance for U.S. bonds since the extreme risk aversion of late 2008. By comparison, the Federal Reserve's decision to shift \$400 billion of its U.S. government bond portfolio to longer-term securities—the controversial “Operation Twist”—was at best a sidelight to the flight of capital to Treasury debt.

### **Rate policy**

Once again, with scant progress in the housing and labor markets, no one expected that the Federal Open Market Committee would raise its target for overnight interest rates. Indeed, Fed chair Ben Bernanke and his colleagues hinted after their August meeting that short-term interest rates could effectively stay at zero or otherwise “exceptionally low levels” through at least mid-2013. Investors looking for other hints about the economic outlook scrutinized the language in Fed statements, noting that “deterioration” in the job market in August gave way to “continued weakness” in September, although consumer spending shifted up from “flat” to “increasing at a modest pace.” But inflation, remained stable throughout the quarter, and by September, the Fed confessed that with foreign markets unsettled and commodity costs waning, pricing pressure was actually too low—too deflationary—for comfort.

### **Treasury**

As represented by the Barclays government bond index, the total return on Treasury securities was a breathtaking 24.66% during the quarter—higher than in any three-month period since Lehman Brothers' messy demise generated unprecedented demand for U.S. bonds. While the market greeted Washington's long stalemate over the federal budget with trepidation, not even the resulting downgrade of the Treasury's credit rating dampened global hunger for these securities. By late September, short- to mid-term Treasury yields were back at record lows, with the Federal Reserve's decision to buy longer-term bonds actively depressing yields of bonds of all maturities.



### **Corporate**

Investors avid for Treasuries had little room in their portfolios for most other fixed-income investments. Even high-grade corporate bonds generated only a 2.9% total return in the quarter, while rapidly sinking demand for high-yield or “junk” debt pushed its returns into negative territory in September. Despite high-profile warnings of a looming meltdown in the tax-advantaged municipal bond market, there was no wave of state and local government defaults and munis rose 3.81% for the quarter.

### **The Economy**

#### **Overview**

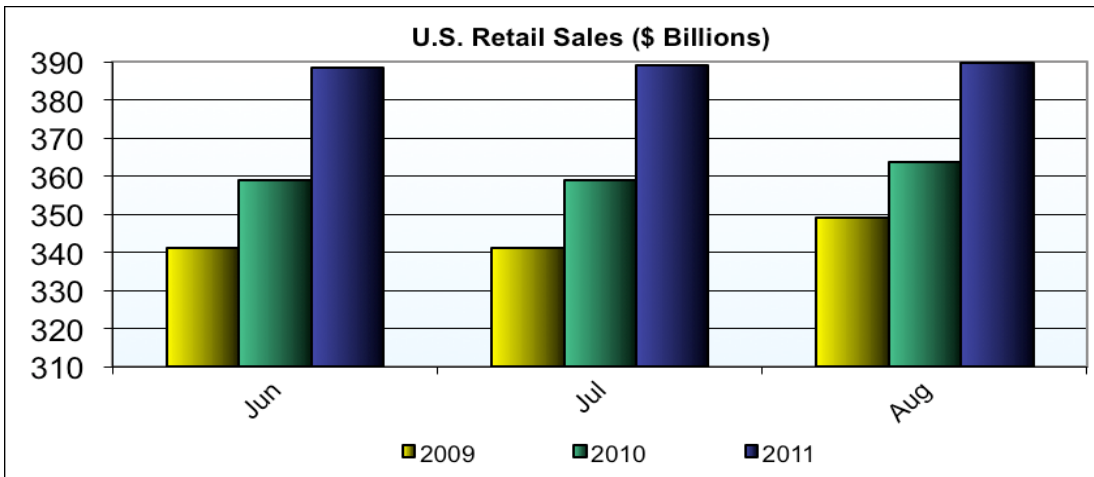
Whether investors took their cues from the Federal Reserve or regularly scheduled data releases, their outlook on the U.S. economy cooled in the third quarter. While the data failed to support claims that an outright disaster was upon us, hope that trillions of dollars of government stimulus would trigger a robust expansion faded, leaving fear of a period of stagnation or outright recession.

#### **GDP**

Gross domestic product, the widest gauge of U.S. economic strength, expanded at a lower-than-expected annualized rate of 1.3%, and earlier estimates of “real” first-quarter growth were revised down to a scant 0.4%. Despite scattered bright spots—notably a surge in exports, business investment, and corporate profits—few economists anticipate that the third quarter’s numbers will be much better as government spending slows.

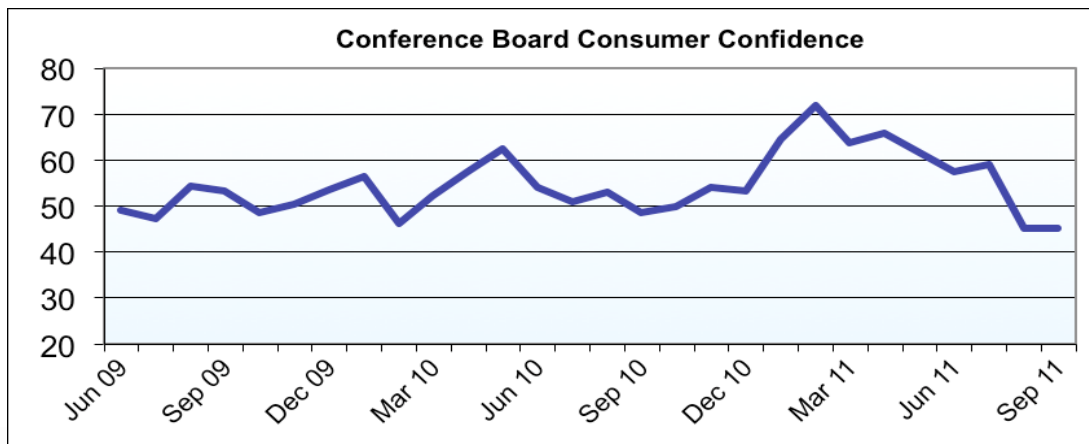
**Retail Sales**

As the Federal Reserve noted in its monetary policy decisions, U.S. household spending leveled out in the third quarter. Retail sales kept edging upward, reaching a record \$390 billion in August, but while that figure represented a 7% year-over-year improvement, month-to-month gains were negligible. Gas prices remained high and spending at filling stations soared 19%.



**Consumer Confidence**

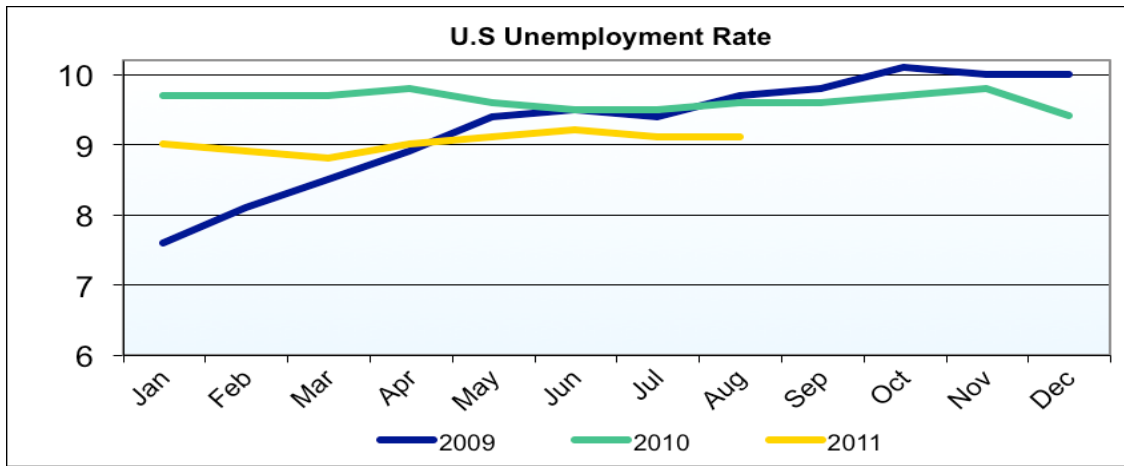
Gloomy headlines translated into a steep decline in the U.S. public’s take on economic conditions. By August, one key gauge of consumer confidence had retreated to 45, the lowest level since April 2009, when the global economy was still recovering from the credit crunch. The Conference Board, which tracks this statistic, attributed the decline to a combination of unease over lawmakers’ fragile compromise over the federal budget and ongoing angst in the job market.





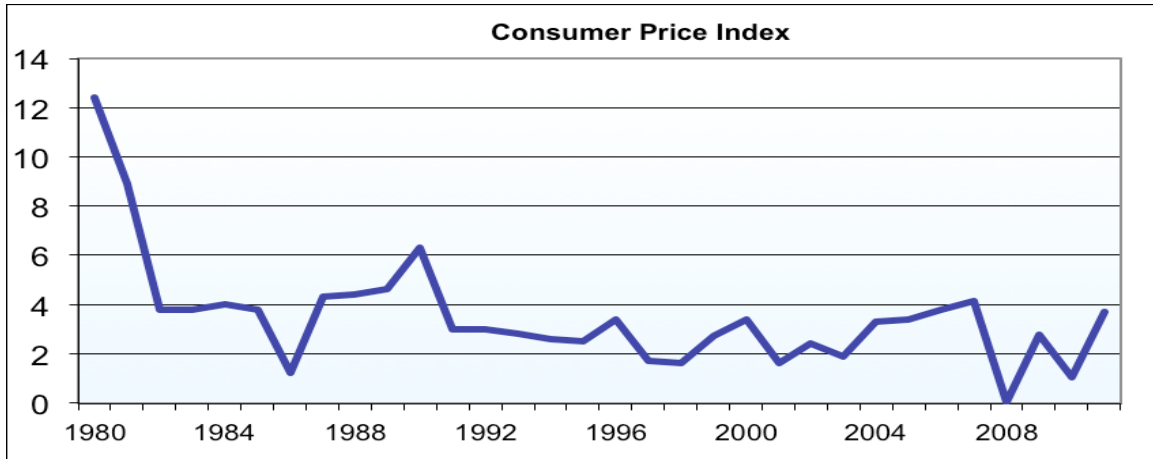
## Unemployment

The pace of U.S. job creation continued to slow during the third quarter, with companies filling a scant 287,000 new positions from July through September. Meanwhile, as even extended unemployment benefits expired for many workers, they returned to the difficult job market, leaving the broad unemployment rate elevated at 9.1% in September.



## Inflation

Even though wage increases proved elusive, the cost of living accelerated during the third quarter. As manufacturers and refiners passed along higher commodity prices, retail inflation increased to historically normal levels, rising 3.8% in August on an annualized basis. But most of the gain was fueled by an 18.4% year-over-year increase in energy costs. Not counting energy and food, prices edged up 2.0%, feeding the Fed's argument that if anything, inflation remains too weak to help fuel economic growth.



### Summary/Outlook

Ultimately, investors with a long-term perspective managed to take some comfort in the knowledge that while the third quarter may have disappointed, it was far from disastrous. Though the economic picture dimmed, the primary engines of wealth creation remained active, albeit at more subdued levels. U.S. businesses hired fewer people, but the mass layoffs that plagued the economy and unnerved the public in 2008 and 2009 haven't returned. Housing markets continued to drift, neither rebounding nor worsening appreciably. In early October, the euro zone's finances were fragile but intact. And perhaps most importantly, the long-dreaded downgrade of U.S. credit failed to trigger the apocalyptic consequences that market commentators had eagerly predicted. On the positive side, corporate profits remained resilient, the Federal Reserve was still poised to intervene aggressively if the situation worsens, and as always, life in America goes on.



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