



## Financial Markets Commentary

October 2009

Investors continued to steadily expand their risk positions throughout the third quarter as the liquidity crisis passed, and the global economy moved further toward stabilization. Stocks and bonds of all shapes and sizes moved steadily higher throughout the summer. Because the technicals remain positive and the year-over-year economic and corporate earnings comparisons are likely to be strong this quarter, this rally has a good chance of continuing. But, from a longer-term perspective we believe stocks may be getting ahead of themselves. Similarly, the sharp rebound in corporate credit spreads has been profitable, but has removed much of the upside potential.

A summary of our recommendations follows:

- As the market rallies, trim back to an underweight allocation in stocks or implement protection strategies. In any case stick with the tilt toward high-quality, less levered, cash flow positive businesses, active investment managers and a globally diversified portfolio.
- Maintain allocations to bonds, utilizing active multicurrency managers and reduce the risk exposure.
- Maintain a liquidity cushion and incorporate the use of managers or funds that execute active global tactical allocation strategies as well as other alternative strategies.

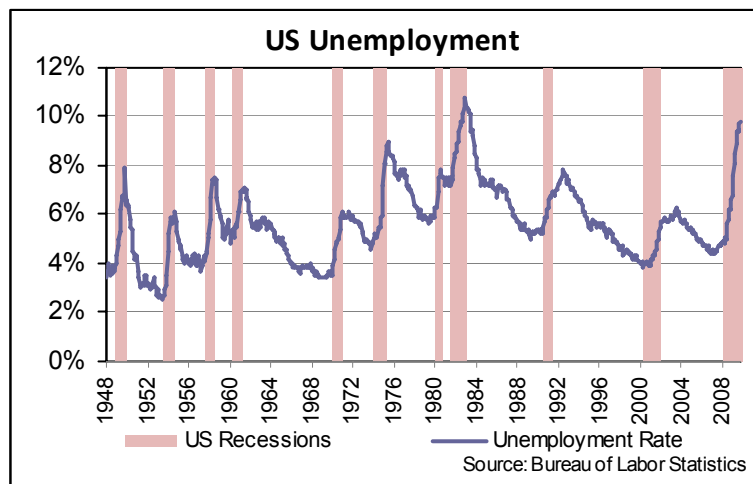
### Economy

As usual, the economy can be viewed as a glass half empty or half full. It is by no means healthy, but statistical and anecdotal evidence have moved from just plain bad to mixed. U.S. GDP was reported to have declined at an annual rate of 0.7% in the second quarter, considerably better than the first quarter's negative 6.4% performance. While it is comforting to observe this sharp "improvement," I caution that it is largely due to significant increases in government spending, without which the quarterly GDP would have been extremely weak again. The main driver of GDP, personal consumption, remained negative along with domestic investment (capital expenditures) and net exports.

Other developed market economies are suffering similar or worse growth rates and high unemployment rates. U.K. and Eurozone GDP dropped about 5% year over year in the second quarter while Japan dropped 7%. Conversely, some of the important emerging markets economies continued to grow. India GDP grew 6% year over year, while the Chinese economy grew almost 8%, clearly helped by massive government stimuli, effectively applied.

Both U.S. consumers and businesses have been very careful about spending, and for good reasons. First, consumers, on average, were clearly overextended by any historical measure. For the fifteen years ending 2008, total consumer debt outstanding grew faster than personal income by more than 2% per year. Second, after business managers were forced to quickly slash costs due to a lack of funding, many have realized that technology-based productivity increases have enabled them to operate with fewer resources.

While we can be thankful that the rate of unemployment has not continued to surge higher at the alarming pace set in late 2008, it has yet to turn the corner, continuing higher at a slowing pace in the third quarter. Lagging indicator or not, job “creation” is still in negative territory and the rate of unemployment reached 9.8% in September. History suggests that when it does peak, it will initially pull back quickly; however, where it settles not foreseeable.



Despite falling incomes, consumers have been tightening their belts. Since its peak in December 2008, total consumer debt outstanding has dropped by more than 5% through July 2009. This may not seem like much, but it is the first time consumer debt has actually fallen over period greater than five months since the early 1990s and it is by far the largest correction we have ever witnessed. This is not good news for business and therefore GDP growth in the short-term, but it is absolutely necessary and good news for the longer-term health of our economy.

Likewise the abrupt cost cutting that businesses have carried out has been bad news for the economy and employment rolls, but the resulting lean operating structures will enable any increase in demand to drive a more significant increase in corporate profits going forward.

What are the prospects for a turn? The consensus of economists expects that the U.S. economy will show positive growth in the third quarter and improve in the fourth quarter of 2009. This is dependent upon a rebound in consumer demand catalyzed by government stimulus (e.g., cash for clunkers) and enhanced by a backlog of consumer needs. As James Grant, a long time economic commentator, recently noted in a *Wall Street Journal* opinion article, “The deeper the slump, the zipper the recovery.” The historical record supports this view, and there is logic to the theory of pent up demand. So we should not be surprised to see a sharp bounce when a turn does occur; however, the magnitude and sustainability of the bounce are very difficult to discern.

Supporting the case for recovery, the index of leading economic indicators has moved higher over the last few months, capacity utilization has started to move higher, though it remains near all time lows, and the ISM Purchasing Managers Index has moved slightly above 50 which is an important delineation level between economic contraction and expansion. Conversely, the Bloomberg Financial Conditions Index remains in negative territory, but it has been recovering sharply, reflecting the vast improvement in credit and liquidity conditions. In addition, according to the Case-Shiller Composite Home Price Index, average housing prices across the country rose in June and July.

## Stocks

It was anything but a lackluster summer for stocks which would have frustrated any investor abiding by the old adage of “sell in May and go away.” All broad stock indices rose methodically throughout the third quarter after a very brief pause in early July. Foreign markets outperformed the U.S. (on average) and small capitalization stocks outperformed large-caps again. The most straightforward description of the quarter is that virtually all stocks rose.

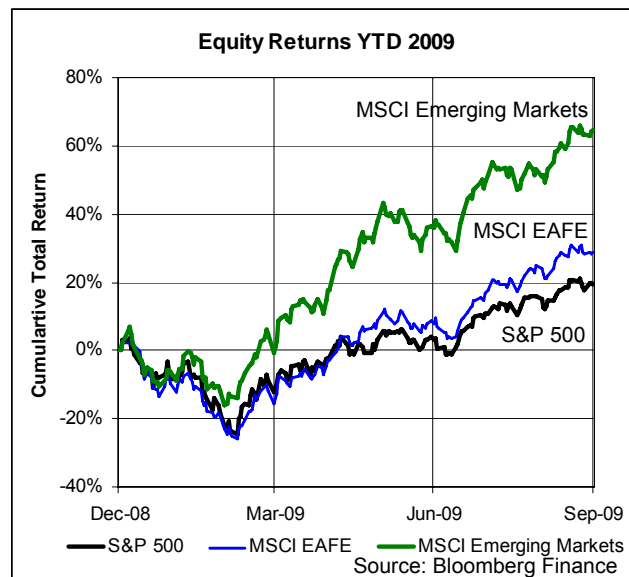
In general, second quarter corporate earnings came in at about the level of analyst expectations, but unit volume and revenues were generally lower than estimates. Again, the bottom line targets were achieved through aggressive cost cutting.

From a sector perspective, the financials sector continued to lead the pack, rising more than 25% in both domestic and foreign markets while the industrial and materials sectors provided returns in the range of 20%. The consumer discretionary and information technology sectors rose more than 17%, consumer staples and energy provided double digit returns, and in the U.S. the remaining sectors such as healthcare, utilities and telecom lagged by rising less than 10%. Across broad foreign and global indices, every sector provided double digit returns.

As in the second quarter, this quarter’s rally continued to demonstrate characteristics of a bounce off the bottom, where more risky stocks, measured in a variety of ways, outperformed less risky names. For example, companies with more financial leverage outperformed the rest of the universe by almost 600 basis points (6%). Stocks ranked with an S&P quality ranking of C and D appreciated the most while those ranked A+ significantly underperformed. Stocks with negative earnings per share significantly outperformed stocks of companies with positive earnings. Stocks with negative earnings per share growth (1 year trailing) outperformed positive growers by almost 700 basis points (7%). The same held true for negative vs. positive trailing revenue growth. Interestingly, this even held true for forecast earnings growth; that is, companies expected to deliver lower EPS over the next twelve months significantly outperformed (on average) companies that are expected to grow their earnings per share!

This may seem heretical, but it makes some sense if you recall that these are the same companies that were most likely to fail under the stress of the liquidity crisis, and thus, at the depths of the market in February and early March, were priced as such. As the liquidity crisis abated and the economy backed away from the brink of collapse, the mere prospect of their survival added multiples to their market valuations.

The S&P 500 Index returned 15.6% during the quarter, and small and mid-cap indices performed moderately better: S&P Mid-Cap 400 returned 20.0%, and S&P Small Cap 600 returned 18.7%. To put this in context, these three indices have risen 56%, 71% and 74% (not counting dividends), respectively, since the market low point on March 9, 2009. Nevertheless, these and other U.S. benchmarks remain lower than they were at the end of September 2008, soon after the Lehman Brothers bankruptcy. Notably, they remain 29%, 22%, and 26% lower, respectively, than their peaks in early October 2007.



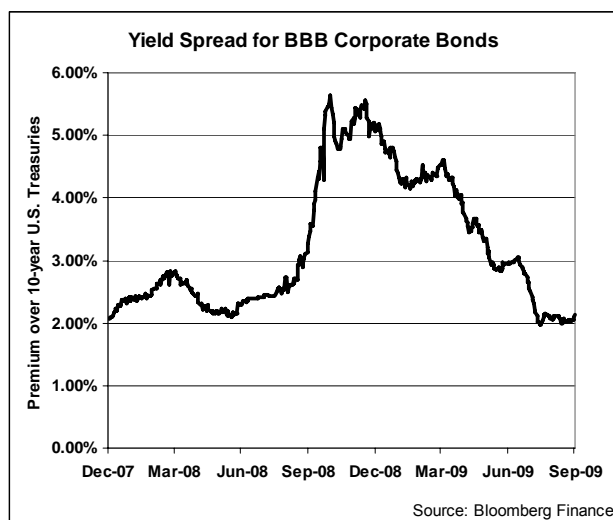
The MSCI EAFE index returned 19.5% and the MSCI EM Index returned 20.9% for the third quarter, bringing the returns for the year-to-date up to 29.0% and 64.4%, respectively.

Third quarter private equity market activity remained subdued and sharply below year ago levels. Interestingly, despite plenty of capital available in funds devoted to purchasing secondary private equity offerings, very few transactions have been accomplished due to a lack of convergence on price. According to Cambridge Associates, returns for private equity through the second quarter are approximately flat for the year.

## Bonds

Bonds also performed extremely well during the quarter as rates moved slightly lower and credit spreads continued to tighten. At the short-term end of the treasury yield curve rates remained stable at historically low levels. At the long-term end, 10 to 30 years, rates retreated by about 0.25% (25 basis points) despite the heavy issuance of more than \$560 billion in treasury securities. This was a welcome respite from the sharp rise during the first half of the year when investors reversed their flight to quality and began to worry about the treasury's deficit and inflation.

In addition, corporate credits continued to rally, also in the face of strong issuance. Investment grade companies were able to bring more than \$151 billion in bonds to the market during the third quarter. Meanwhile, the credit spread (yield premium) demanded by investors continued to shrink across the quality spectrum. For example, the credit spread for 10-year BBB bonds relative to 10-year treasuries narrowed from more than 560 basis points (5.6%) to about 220 (2.20%) basis points by quarter-end. This narrowing has been facilitated by strong net inflows into bond mutual funds and has translated into strong price rallies for bonds across the credit spectrum. Although we expected this to happen, the move has been much faster than we could have hoped, and now requires some caution and perhaps profit taking.



The Citi 10-year U.S. Treasury Index returned 2.6% during the third quarter, bringing its year-to-date loss up to -6.5% from -8.9%. In contrast, the BarCap US Investment Grade Corporate Index returned 8.1% for the quarter and 17.1% for the year-to-date. Furthermore, despite an increasing rate of defaults, the BarCap Corporate High Yield Index returned 14.2%, bringing its year-to-date performance to 49.0%.

Foreign bonds continued to benefit from U.S. dollar weakness. The BarCap Global Aggregate Bond Index returned 6.2% for the third quarter and 7.8% year-to-date.

Tax free municipal bonds also performed well during the quarter as risk aversion faded. Although there was a large amount of municipal issuance, many municipalities took advantage of the Build America Bonds Program (BABs) to issue subsidized taxable debt which comparatively limited the supply of tax free issues. The BarCap Municipal Bond Index returned 7.1% for the quarter and 14.0% for the year-to-date.

## Cash

Although the liquidity crisis has largely abated with the help of aggressive government stimuli and backing, remnants of some problems remain. For example, there are still important businesses such as CIT Group that were irreparably harmed and continue to struggle. Its falling credit quality has driven its funding rate above the cost at which it provides capital to its clients. Because CIT Group provides frictional capital to many retail businesses, its demise could have significant repercussions across the consumer sector.

On a brighter note, commercial paper markets are functioning and funding rates are low. Three month LIBOR (London interbank offered rate) continued to decline from 0.60% in June to 0.29% at quarter-end. With short-term treasury yields holding steady at a near zero, the "TED spread" (the difference in rates between LIBOR and T-Bills) has dropped to 0.15%, about the lowest we have seen or should expect to see. While this is generally good news for the economy and for borrowers, it is unattractive for investors. For instance, according to iMoneyNet, the current yield for the average money market mutual fund is 0.05%, virtually nothing.

## Alternatives

Positive results for hedge funds for the third quarter were driven primarily by the strong global equity and credit markets. Hedge fund indices have now had positive performances for seven consecutive months, and not surprisingly, industry assets have grown to an estimated \$1.9 trillion.

During the third quarter, fixed income strategies received the bulk of net inflows, outpacing equity-related strategies. Mortgage, corporate and convertible bond managers were the prime beneficiaries.

Fixed income funds also registered the best performances over the quarter. Equity funds did well too while managers using currency or commodity strategies lagged. Equity market volatility as measured by the VIX (Chicago Board Options Exchange Volatility Index) edged lower yet remains at a historically high level.

According to CS/Tremont Hedge Fund Indices (YTD through August 2009), Convertible Arbitrage had the highest gain (+35.6%) followed by Emerging Markets (+18.8%) and Fixed Income Arbitrage (+18.7%). The performance laggards were Dedicated Short Selling (-18.7%) and Managed Futures strategies (-6.79%). As you might expect, this is virtually a reverse of their relative performances during 2008.

Since we believe that most asset classes are close to fair value with high market uncertainty, we currently recommend more liquid and market neutral alternative investment strategies such as global macro, managed futures, and equity market neutral.

## Real Estate

Commercial real estate performance remained under pressure during the third quarter due to falling valuations and balance sheet pressure from the need to roll over existing debt in an unfriendly environment. Conversely, real estate securities such as REITs and publically traded REOCs performed very well during the quarter, continuing their rebound from first quarter Armageddon valuations.

## Commodities

Commodities prices rose modestly on average but varied significantly by type. The Reuters CRB All Commodities index rose 3.2% during the quarter. Oil and other energy commodities moved lower in July, correcting from a strong second quarter run after which they remained

volatile but finished slightly lower for the quarter. Crude oil finished at roughly \$70 per barrel, down about 2%.

Metals on the other hand rose sharply. Base metals, aluminum and copper rose about 20% in July and early August and then held on to those levels for the remainder of the quarter. Precious metals, such as gold and especially silver, also drove higher in late August and September. Gold moved back above \$1000, rising 8.8%, and silver appreciated 22.3%.

Various reports suggest that China has been stockpiling raw materials but we don't know how much longer this will continue. In addition, investors concerned about the stability of the U.S. dollar in the face of sharply rising money supply and rising government debt, are diversifying into precious metals.

Agricultural commodities were volatile and mixed. Soybean, corn and wheat traded lower by 5%, 6%, and 19%, respectively, while sugar ran up more than 34% during the quarter

### **Looking Forward**

Before looking forward, let me briefly review our observations and positioning advice throughout this year. At the beginning of the year I noted that the financial crisis could still develop in vastly different directions: one way with catastrophic results; the other in the direction of recovery if the various stimulus and rescue packages stabilized the global financial system and economy. Clearly there were extreme ways to position a portfolio for either one of the scenarios. We chose to counsel a positioning that would perform reasonably well in a stabilizing or improving scenario while protecting value in a catastrophic scenario. We were not swinging for the fences.

Specifically, we recommended that relative to individual long-term strategic allocations, clients should (1) maintain a liquidity cushion; (2) initially underweight equities, and tilt their stock portfolios toward high quality, less leveraged, cash flow positive companies, globally diversified; and, (3) overweight investment grade corporate bonds and/or high quality municipal bonds, including a small slice of high yield bonds, while avoiding U.S. treasury bonds.

After the first quarter our recommendations remained the same except that we encouraged clients to set up a schedule to gradually rebalance toward their long-term strategic allocations by the year-end, and where possible, begin to incorporate our recommended active tactical managers into their portfolios.

After the second quarter, as we began to worry more about eroding purchasing power, we emphasized diversification across currencies and suggested adding an allocation into alternatives and commodities. In most cases currency diversification was already being accomplished through global equity and debt managers, and commodities exposure was being implemented by the tactical allocation managers.

So far we have gotten what we had hoped for: a vastly improved liquidity situation and an economy that has not gone into a death spiral. Our investment positioning has worked out reasonably well. Investment grade and high yield corporate bonds as well as municipal bonds have provided strong gains, while treasury bonds have lost value. Stocks have rallied steadily since March, and diversification into foreign and emerging markets has been profitable as the U.S. dollar has weakened. More recently, positions in commodities have added value.

Although low quality and high volatility stocks would have been better in hindsight than the high quality tilt we espoused, these may not have survived a pessimistic scenario. One surprise has been the extremely strong performance of real estate securities, which even with their early year swoon, have been among the best performing groups for the year-to-date. Our outlook for commercial real estate remains negative, so from a top down perspective we are not attracted.

Unfortunately, despite the passage of time, the medium and longer term outlook for the economy remains as cloudy and risky as before. Recall that the liquidity crisis that occurred in 2008 was caused by a loss of confidence by virtually all market participants about the solvency of their trading partners. Although the liquidity crisis has passed, many of the inherent problems that led to the crisis have yet to be fixed, leading to the possibility of a relapse.

For example, although the enormous leverage carried by the largest financial institutions has been significantly reduced, there are many banks that remain in distress and therefore not lending to businesses and consumers. According to the FDIC, 25 banks failed in 2008 and 92 have failed so far in 2009. Institutional Risk Analytics, a research group specializing in analyzing banks, estimates that there are 900 more that could go under during this cycle. This would not be unprecedented as more than 1,600 banks closed or received some FDIC assistance in the cycle between 1980 and 1994, but it would put extreme stress on the FDIC.

The debt securitization market, often referred to as the shadow banking system, has been reduced to a fraction of its former size, further reducing the amount of credit available to consumers and businesses. In addition, the delinquency rate for consumers is at an all time high and still rising. Thus, even if consumers want to go back to previous spending habits, they may not be able to do so.

Although the residential real estate market seems to have bounced, the commercial real estate market could be a long way from its bottom. The vacancy rate for retail space is at an all time high and rising. There are many entities exposed to commercial real estate loans. Just as homeowners found it impossible to refinance their mortgages as their incomes deteriorated and the value of their houses dropped, so will building owners find it difficult to service or restructure their loans with higher vacancy rates.

While the economic outlook remains too difficult to predict, valuations over the quarter have become less attractive. Investment grade and high yield corporate bonds are no longer screaming values. They are not overpriced relative to treasuries, but the upside is now limited and they will again become more sensitive to interest rate movements.

Similarly, stocks are not cheap by historical measures. For the broad averages, trailing earnings have been so low as to make Price/Earnings (P/E) valuation nonsensical, but even on reasonable estimates for future earnings, the S&P 500 has a P/E in the range of 20 or higher. If one uses Robert Shiller's method of averaging the earnings over the past ten years adjusted for inflation, the P/E is about 19. That is not terribly expensive compared to the last 20 years, but no significant bull market has ever begun at such a valuation. One bright caveat to this is that the average dividend yield relative to treasuries is attractive.

As we mentioned last quarter, because fundamentals are so difficult to determine, the market seems to be relying heavily on technical (trend) indicators. In addition, analysts are looking to extrapolate growth rates off of last year's low earnings and revenue numbers. As Mervyn King, the Governor of the Bank of England recently declared "It's the level, stupid – it's not the growth rates, it's the levels that matter here."

For these reasons we feel that stocks have gotten ahead of themselves. That said, we also believe that many investors remain conservatively positioned in cash. With the technical trends still positive, and the prospect of improving earnings and economic trends, this rally can easily continue. Furthermore, the broad index averages mask a wide diversity of valuation and fundamental quality. As mentioned above, high quality companies with solid balance sheets and positive cash flow have not rallied as much as the broad averages.

We continue to recommend allocating to active equity managers that practice a bottom-up search for high quality companies. Foreign market and currency diversification remains

paramount. As opposed to neutral weight in stocks, however, we recommend either trimming to an underweight position or instituting some protection strategies. In any case as the stock market continues to rally, we should be vigilant to trim exposure. If James Grant's vision of a sharp recovery comes through, stocks will be very strong and we won't need full exposure to capture an attractive overall portfolio return. Your Samoset financial advisor can work with you to implement this recommendation.

We are more defensive on the bond portion of your portfolio as well, and are happy to note that the bond managers we utilize have been taking profits and moving to a more conservative positioning, mostly in terms of lowering duration. Although the Federal Reserve Bank has signaled that it will be some time before it tightens, other central banks have started this process.

As we have related all year, the global financial markets have become exceedingly complex, sensitive to government policies and short-term oriented. For this reason we believe there is a need and opportunity for skilled tactical allocation strategies in your portfolios. In most cases these will also help to gain exposure to real assets which could offer some protection against currency devaluation. We believe that clients without any tactical allocation strategies in their portfolios should add some exposure to commodities. In addition, active and alternative strategies that employ technical and behavioral factors are a constructive addition to a portfolio of fundamentally based managers or passive allocations. Finally, although the liquidity crisis seems to have passed, we continue to believe that it is prudent to maintain a liquidity cushion in your portfolio.

October 13, 2009

Thomas G. Hoffman, CFA  
Chief Investment Officer

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