



## INVESTMENT UPDATE

October 2010

### **Economic Conditions & Market Outlook**

We have long cautioned investors to look warily upon prognostications based solely on what investment markets have done during the same day, month, or quarter in prior years, unless there is some underlying cause that contributes to a resulting correlating pattern or market effect. Typically there is not. For example, history may indicate that there were more times than not that stocks closed out the year in positive territory when January started the year up as well. However, suggesting that any given January's performance somehow deigns where the markets will end on December 31<sup>st</sup> is no less of a stretch than suggesting that either an AFC or NFC victory in the Super Bowl will be a harbinger of equity market movement for the year ahead.

Likewise, while pundits will note that Septembers have typically logged lackluster returns in recent years, there is nothing particularly nefarious about those thirty days that dooms the stock market to inevitable dismalness. In fact, the month end performance for the September just ended was nothing short of spectacular; with the Standard & Poor's 500 registering an 8.8% gain, its best for that month in over seventy years. Other major stock indices followed suit, with the Dow Jones Industrial Average logging an advance of 7.7% and the Nasdaq Composite finishing the month up 12.0%.

These monthly moves buoyed overall performance for the third quarter to gains of 10.7% for the S & P 500, 10.4% for the Dow, and 12.3% for the Nasdaq. Year-to-date returns for all three indices were lifted well into positive territory, registering in at 2.3%, 3.4%, and 4.4% respectively. Was September's surge a precursor for market performance through the end of the year? Were it to be so simple...but it is doubtful the remaining three months of 2010 will be any more predictable than the prior nine.

Despite this move upward, market metrics remain very mixed. On the negative side, there is significant divergence in year-to-date price performance of the individual stocks comprising the indices mentioned above, with percentage extremes at both the winners and losers end of the spectrum. This large disparity among returns is indicative of a market without strong consensus. Likewise, options traders forced to buy stock positions to cover their 'short sales' contributed to some of September's advance; a seemingly ironic scenario where those that incorrectly bet a stock's price was heading down can actually help propel it the other way.

Continued low daily trading volume will also keep price volatility heightened. As a point of reference, equity trading volume for the third quarter of 2010 was about 23% *less* than that of the same period during the prior year. This means there is still plenty of money on the sidelines that can move the market forward when it is invested but, in the meantime, short term market fluctuations can be exacerbated. This issue has been dogging the equity markets for quite some time and will likely continue until broader investor confidence is resurrected.

Conversely, stock prices look attractively valued relative to several fundamental measures. Reported corporate earnings for the second quarter of the year were surprisingly strong across most industry sectors, with the obvious exception of housing which remains plagued by excess inventory and foreclosure rates that will continue to mute new home starts and keep prices soft. Even with the earnings drag of that market segment, the Commerce Department estimated combined second-quarter profits from U.S. companies grew by 3.9% from the first quarter of 2010 and were 26.5% higher than the prior year, the largest annual growth rate *ever*.

Corporate earnings have been trending higher for the past several quarters; first receiving bottom line benefits via expense reduction and spending control, followed by profit increases resulting from increased sales and revenue growth. With third quarter corporate earnings season kicking off within the week, it is anticipated the upward trend in earnings will likely continue but at a less robust pace and with fewer upside surprises.

From our view, this leveling to more normal rates of profitability growth is both healthy and expected but how the current schizophrenic stock market may react near term to any less-than-stellar growth numbers, much less an earnings disappointment, is anyone's guess right now.

There are other positive indicators that businesses are repositioning for better times ahead and that they are indeed healthier than one might expect given the general sense of gloom and doom surrounding the economy as a whole. First, many companies that have been flush with cash for quite some time are redeploying those dollars in ways that will enhance their ability to grow their business going forward. Corporate merger and acquisition activity is one example of this trend and has been steadily on the rise throughout the year. Similarly, the pace of stock buy-back activity is once again increasing, demonstrating that companies see their shares as being less expensive now than what they anticipate the price will be going forward.

On the broader economic front, data indicating a sustainable positive turnaround has been less than convincing and certainly less than consistent. Many commentators have recently observed with a thinly veiled note of sarcasm that -according to the National Bureau of Economic Research, arbiter of economic cycles- the recession that started in December 2007 actually ended last year in June 2009. Despite the solemnity of their pronouncement, and the fact that they are indeed correct based on the most common definition of the term, most outside the NBER agree that whatever economic state we are in now sure does not feel like a 'recovery'.

Part of this is because gross domestic product (GDP) growth has remained stubbornly sluggish in 2010, after showing nice gains last winter as businesses rebuilt depleted product inventories. Revised numbers released by the Commerce Department at the end of September indicate GDP grew at an annual rate of 1.7% for the second quarter of the year. Economists are projecting third quarter GDP growth to be in the range of 1.5% to 2.0% when released later in October. As a point of comparison, 1983's rebound from a recession exemplified a typical "V" shaped recovery, with GDP expanding at 4.5% and continuing to do so for several years forward.

Other key economic indicators also vary. The widely-followed ISM Manufacturing Purchasing Managers Index showed slowing expansion during the month of September, with softening in both production and new orders. Conversely, consumer spending rose 2.5% in August, with personal income also ticking upward. The Reuters/University of Michigan consumer sentiment measure also surprised to the upside.

Perhaps it is the economic equivalent of the cautionary tale that 'the bigger the binge, the bigger the hangover' but it is clear that the U.S. economy is not going to be able to simply shake off years of excess indulgence and leverage to quickly return to the unfettered normalcy via some post-recession rebound. One of the biggest impediments to forward economic momentum has been the tepid jobs market, where new hiring has yet to significantly move the needle on the nation's unemployment figures. Weekly initial unemployment claim figures ebbed and flowed throughout the month of September, with the four-week moving average showing a slight improvement in the labor market by month end. While we have long noted that improving employment is a lagging indicator of an improving economy, it is clear that the current lackluster pace of jobs growth will continue to weigh on both the economy and markets until a definitive upward employment trend is established.

Washington's existing policymakers are finding the stubborn inertia of the nation's unemployment particularly irksome, fearing they too may be joining the ranks of the unemployed after November mid-term elections. Our public officials appear somewhat flummoxed at their inability to effectively legislate an economic turnaround despite unprecedented 'stimulus' spending. There is no surprise on our end. First, the resurrection of vibrant economic growth and sustainable job creation is ultimately the enterprise of the private sector. Second, excessive government spending is part of the problem, not the solution.

What would help is some serious government belt-tightening at the federal, state, and municipal levels before we find ourselves in the unenviable position of several of our European neighbors. While Federal Reserve Chairman Ben Bernanke is currently tapping the monetary accelerator (although we suspect a second round of quantitative easing will have the same minimal impact as the first), he is equally concerned about the fiscal brakes being applied to the ever-burgeoning federal deficit. In a speech made October 4<sup>th</sup> regarding the need to decrease government spending, Mr. Bernanke observed that 'the threat to our economy (from the federal deficit) is real and growing', 'our public finances are on an unsustainable path longer term', and 'failure to respond would endanger our economic future'.

Unfortunately, many states within the Union are doing no better at controlling costs and reducing their spending. Meredith Whitney, the analyst who rose to prominence criticizing the profligate ways of financial service companies whose practices lead to the sub-prime lending crisis, recently released a study rating the financial condition of the fifteen largest states. Only two states on the list received passing grades. Despite some political posturing to the contrary, many are skeptical state officials are prepared to address the problem.

Case in point, despite months of budgetary hand wringing and dire warnings of employee layoffs in the thousands due to our Commonwealth's serious declines in revenue and federal funding, Pennsylvania finally stepped up to the plate and reduced its current employee count. By 50 to be exact...out of nearly 77,000. That's a workforce reduction of approximately 0.065%. National unemployment would not be the problem it is today if private sector employers only needed to reduce staffing by that much to remain financially solvent.

We are not suggesting that a slash and burn approach to cutting government spending is needed or appropriate at the present time. However, if we do not proactively search for ways to seriously reign in the growing costs of our government entities, the problem's eventual fix will be much more disruptive and prolonged than any financial fallout from the recent mortgage meltdown. Just take a peek across The Pond to get a preview.

### **Our Tactical Investment Stance**

Roof Advisory Group's disciplined investment approach emphasizes adding upside value to client portfolios while controlling downside risk. Strategies include clearly defining investment policy ranges based on each client's specific investment objectives/risk tolerance, monitoring portfolio adherence to established benchmark parameters, and the ongoing evaluation of relative portfolio return.

Within this strategic investment management context, the firm makes tactical shifts to address changing market conditions and optimize client portfolio performance. Each client situation is unique but a few of the tactics presently being used are outlined below:

- The ***overall target level*** for managed portfolio allocations is currently at ***mid point*** based on each client's individual investment policy range. After a quick reduction to ***one-step below midpoint equity*** in May 2010 due to that month's market instability, the firm's target has floated between there and ***mid point*** level until the end of September. At present, ***relative risk/return*** potential in the ***equities asset class*** appears ***moderately more attractive*** than either bonds or cash, fueled to some extent by the ***higher yields*** in many quality equities relative to low short-term money market and modest intermediate-term bond interest rates. The firm's ***active asset allocation*** and ***portfolio rebalancing*** methodologies continue to add value both short and long term.

- Portfolio composition has been consistently modified to ***capture opportunity and reduce risk***. Recently, ***profits were taken*** in several equity and fund holdings due to ***notable appreciation***, with the positions being ***rebalanced to target*** if additional appreciation was suspected or ***eliminated*** if full appreciation potential was achieved or diminished risk/return characteristics were suspected going forward. The continual vetting of all existing holdings is part of the firm's ongoing active management and portfolio review process.

***Diversification remains a priority*** but unique opportunities in asset classes and specific sectors continue to be utilized to ***capture near term appreciation***. Equity exposure currently remains close to benchmark weightings for moderate balanced and growth portfolios, with some ***overconcentration in Industrial/Materials and Energy*** sectors and some ***underexposure in Financials, Software, and Media***.

***Mid-cap equity exposure*** has again been ***expanded*** but dedicated ***foreign equity*** exposure to remains somewhat ***underweighted***. That said, the firm has significant participation in the international markets via our notable ***concentration in certain large, multi-national companies*** that continue to outperform the market.

- Short-term fixed income investments remain ***significantly below target level*** due to very low yields. The ***overall average duration*** of the firm's bond portfolios remain relatively ***short to intermediate*** but slightly ***longer maturities*** are also targeted if there is an attractive opportunity to ***capture both yield and quality***.

The firm's fixed income focus is typically on cash flow and yield opportunity as opposed to appreciation potential but recently several bonds we hold have had ***extraordinary upward price moves*** and are being sold to ***lock in gains*** as opposed letting them drift back to face value as they mature.

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