

## THIRD QUARTER REVIEW

Global equity markets performed very well during the third quarter. The summer months were very lackluster for equities, but thanks to one of the strongest Septembers in recent memory, the broad averages all finished sharply higher. This move back to assets perceived as more risky came at the expense of lower volatility securities. Asset classes like Bonds and U.S. Dollars sharply underperformed during the third quarter.

Despite reasonably good economic data, consumers are still remarkably pessimistic. The University of Michigan's Index of Consumer Sentiment showed a drop in expectations over the past year, even as consumers report that current conditions have improved. It's true that high unemployment affects consumer sentiment, but unemployment is categorized as a lagging economic indicator. It tends to improve only after a recovery is well underway. A few weeks ago, the National Bureau of Economic Research indicated that the recession ended in June 2009 (no, that is not a typo!). Not surprisingly, the stock market reached its low in March 2009 and had a rally well underway by June—one of the reasons that the S&P 500 is included in the Leading Indicators Index.

The pervasive negative consumer sentiment has had a dramatic effect on where investors are allocating their capital. Investors continue to pour billions of dollars into bond funds. Despite record low yields, the pain of several bear markets continues to drive investors to areas they view as safe. There is much debate as to whether we are in a "bond bubble" right now similar to the "real estate bubble" or "technology bubble." Whether we are or aren't is always open to debate, and will only be known with hindsight. What does worry us is how managers are allocating capital in this environment. It is not uncommon for a high yield bond offering to have no covenants and still be oversubscribed! These types of deals are being done because they can be done—they are good for the issuer, and if the public will throw dumb money at that type of deal the smart money will gladly pick it up. That is generally

what you find when professional investors have a lot of money to invest, and very few good ideas to invest the money in. That should worry all bond investors.

Equities, on the other hand, are suffering from years of neglect. This has caused the valuations of many high-quality companies to fall to very attractive levels. One example of this are the dividend yields on common stocks. There are quite a few stocks that have a current dividend yield higher than the interest rate on their 10-year corporate bonds. In other words, an investor can collect more current income owning the business than he can simply lending money to the business. That hasn't been the case for many, many years. The brightest spot in the equity markets has been in Emerging Markets. Flows to Emerging Markets have been positive, and the returns have been very good the last couple of years. This indicates investors haven't totally given up on equities, and we believe when domestic equities can show some sustained leadership versus other asset classes there is plenty of cash on the sidelines waiting to move back into the market.

When that sustained leadership will come is difficult to determine. The market does face headwinds—most noticeably uncertainty about the business climate. Investors hate uncertainty. But as the mid-term elections draw closer some of that uncertainty should be resolved as the political landscape becomes more clear. Nobody can predict what effect the elections will have on business and the economy in the coming years, but we do know there will be winners and losers. Some companies will adapt to the new rules and fare well. Other companies will not be able to compete. A systematic relative strength investment process is designed to adapt to a changing landscape, and find the companies that can thrive under the new conditions. As always, we remain confident our process will adapt and find the new leadership in these dynamic times, and we remain very optimistic about the last three months