

October 2011

4th Quarter Outlook

PICKING UP THE PIECES

Looking back at our third quarter outlook, we were concerned that stocks might have difficulty as summer was unfolding. Unfortunately, that turned out to be the case. Sure, stocks typically limp through the summer months, a seasonal phenomenon that has been somewhat predictable over the years, but we were also concerned about the ending of QE2, the looming budget battle and the continuing troubles in Europe.

The end of QE2, which was occurring in early summer, was a concern because basically it was the beginning of the Fed taking the punch bowl away. Stocks had been buoyed by easy monetary policy for two years and we had insisted for some time that you don't want to fight the Fed. It surely made sense that if you bought stocks when the Fed was providing the punch, you might want to sell a few things when the Fed stops providing the punch.

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Also, we were concerned that the game of chicken that was Congress' budget debate could lead to concerns in the market. Wow, that was an understatement. The budget mess was a disaster for consumer and investor confidence and left us all just exhausted and frustrated. Oh, and by the way, Standard & Poor's downgraded the debt of the United States of America for the first time. As the Church lady used to say, "now isn't that special?" (Did we just date ourselves?) Finally, the debt crisis in Europe continues to get worse, and more and more it looks like the only solution is a restructuring of sovereign debt (default) and recapitalizing European banks. Of course, they are fighting tooth and nail to determine who takes the haircuts on the debt and who pays to capitalize the banks.



The result was a disastrous quarter for stocks with the S&P 500 down more than 14%, and down about 10% for the year to date. Many market participants are now anticipating that the economy will slip back into a recession, or at the very least, will experience a prolonged period of extremely slow growth. Now as the fourth quarter has begun, markets continue to be extremely volatile as traders react to each piece of news that comes out of Europe. In addition, traders are concerned with a possible slowdown in China and other emerging markets. We have continued to see investors take money out of stock mutual funds (approximately \$400 billion since 2007) and pour money into bond mutual funds (approximately \$800 billion). Sentiment has turned decidedly negative over the past three months as investors have become disenchanted with the massive volatility in the markets and the deteriorating political climate.

THE ECONOMY

With the employment rate remaining stubbornly at 9.1%, the economy continues to struggle, and at the core of that struggle is the lack of available jobs. We have preached for a few years now that until we start creating jobs in this country, we are going to continue to struggle with consumer and investor confidence. The problem is that with the lackluster growth that the economy is experiencing, if indeed, it is experiencing any growth at all, it is very difficult to generate the economic activity that is necessary to create jobs. Economists suggest that it takes GDP growth of 3% or more before any real job creation would be realized. With GDP predicted to be no more than 2%, if that, over the next several quarters, it is likely that unemployment is going to be a concern for quite some time.

The global concerns continue to be concentrated in sovereign balance sheets as the developed world finds itself weighed down with a tremendous debt

burden. Europe, Japan and of course, the U.S. have debt burdens that have finally become unmanageable. When addressing the debt burden, developed countries turn to austerity which stifles growth and leads to potential political unrest. Citizens don't particularly like when the government take things away from them, regardless of whether they are affordable or should even have been provided in the first place. With the likelihood of austerity in the developed world being the norm for quite some time, a prolonged slow growth environment is the most likely outcome. The accumulation of debt over the past 30 years will simply take a lot of time to work off. U.S. Corporations and U.S. citizens have been in the process of cleaning up their balance sheets for a few years now, and now sovereign nations will be the next to do so, and it will be painful.

What does prolonged slow growth translate into? Most likely we will be struggling to achieve 1% to 2% GDP growth for many quarters to come. Unfortunately, that makes job creation very difficult which could surely affect the political climate as we enter 2012.

PROTECTION

FIXED INCOME

Nothing has changed in our approach to our protection bucket. In terms of fixed income, we will remain short in duration and in the best credit quality. Municipal bonds continue to hold their ground, despite predictions to the contrary, and we are comfortable holding the best municipal credits.

We continue to be concerned that the solution to the debt burden in developed countries around the world seems to be printing money. Someday, in the future, printing money will lead to inflation which is the greatest threat to long term maturities.

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GROWTH

STOCKS

As mentioned earlier, stocks had a miserable third quarter with each of the major averages in negative

territory. As we mentioned, we were concerned as we entered the third quarter that stocks would be running into many headwinds, not the least of which was the ending of QE2. As we enter the 4th quarter, Europe still seems to dictate the direction of the market on a daily basis, as each rumor or piece of news on the macro front sends traders into a "risk on" or "risk off" mode each morning. Until we get some direction as to what a long term solution looks like in Europe, stocks will remain susceptible to quick declines, even if on a domestic front the news gets better.

Getting the direction of stock prices right for the next 6 months will be directly tied to whether we go into a recession or not. It is difficult to expect stocks to advance if we are going to have negative GDP for the foreseeable future. On the contrary, if we have positive GDP growth (even if it is anemic) stocks could be perceived to be good value at these prices. Value is not a catalyst for higher prices, but it is a good starting point when deciding what the next major move in a market might be. It is easier to see stocks rise from lower levels if the anticipated environment ends up being better than expected.

We continue to favor stocks of companies that pay good, sustainable dividends in this environment where capturing yield is dearly desired. Getting the economy call correct will dictate what parts of the market are likely to do best over the next few quarters. If we avoid recession, then materials, industrials and energy would likely be the outperformers. If recession is unavoidable, staples, health care and utilities will rule the day. This upcoming earnings season and economic calendar will provide the clues to the answer as to whether we are recession bound or not. We will remain cautious about committing additional monies to our growth bucket until a verdict can be rendered. In the meantime, we are content to hold our dividend paying stocks and will look to add to our growth bucket if a) prices become more attractive or b) momentum changes course to the upside.

We are entering a season that is typically good for stocks, and with negativity as high as it is, and money managers as underinvested as they seem to be, there is potential that with some good economic and corporate profit news, stocks could advance towards year end. Of course, global macro events can at any moment change the direction of stocks, regardless of the domestic outcome.

OIL AND GOLD

Oil prices dipped to \$75 a barrel in early October but recently bounced back to near \$85 a barrel. We would suspect that this may become the new trading range for oil and could at least provide some relief at the pump. Lower gasoline prices would be a help to consumers as the holiday season arrives.

After reaching the \$1900 level, gold fell back in early October to near \$1600 an ounce. With the likelihood that any solution to Europe's debt problem will include "printing money", gold seems likely to be desired by investors wanting protection from "fiat" currencies. It would not surprise us to see gold back up towards the highs later in the year, if indeed, bailouts explode in Europe. If on the other hand, more liquidation is necessary by hedge funds getting hit with redemption notices, then gold may remain under some pressure in the short term.

SUMMARY

In the next few weeks, we will get the Corporate America report card along with countless domestic economic reports. Investors will be attempting to determine if a recession is looming or if the economy will be able to "muddle" along. Stocks will take their cue from what CEOs of major companies have to say about their prospects for the coming quarters, and what signals the economy in general are giving. But underlying all of that is the continuing global macro picture that seems to get murkier every day. We were pleased to have tended to the protect portion of our portfolios earlier this year and look forward to adding items to the growth side of the ledger. As we stated previously, price and trend will determine when we add to growth. Economic conditions will determine what we add to growth. In the meantime, we feel comfortable with our allocations and feel we are positioned well to protect now and grow when the opportunity arises.

FINALLY

Be sure to look for our new website that will be rolled out in the 4th quarter. We hope to have the type of content that you will find helpful, with the addition of audio commentaries to go along with

our market updates. Please don't hesitate to let us know how we can better serve you and, as always, ask us any questions you might have. We like to have your feedback. Thank you so much for being part of the CHJ family.