



Investment Commentary: Third Quarter 2011

Summary

- Stocks fell on concerns about EU
- U.S. economy still growing slowly
- Record corporate profits
- Bonds gain as interest rates fall

Thoughts on the Investment Markets

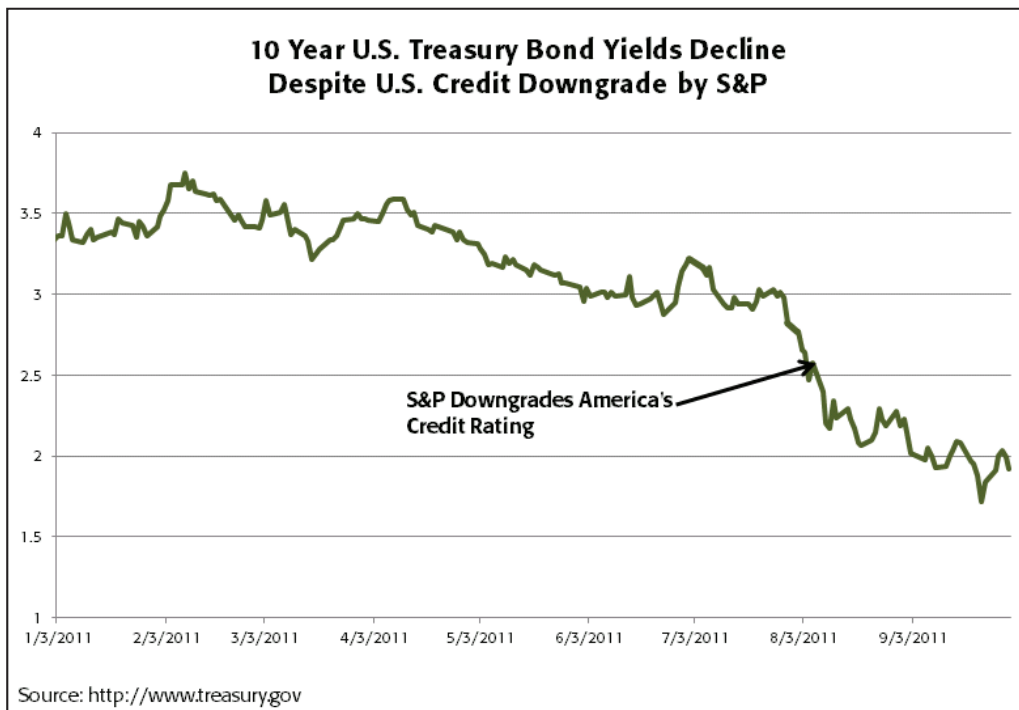
Stocks around the globe sold off during the third quarter over continued uncertainty surrounding the European sovereign debt crisis and concerns of a slowing global economy. The market seemed driven more by emotion and macro events than by fundamentals. While it was a difficult quarter for stocks, bonds rallied as interest rates on treasury bonds declined. Returns for alternative strategies¹ held up much better than stocks in the third quarter. For diversified portfolios, bonds and alternatives helped to cushion the decline from stocks.

Despite global concerns, we do not think it is a foregone conclusion that the United States will fall back into recession. Second quarter GDP was revised up to 1.3 percent from 1 percent due to upward revisions to exports and consumer spending. Companies continued to be a bright spot in the economy, reporting record high earnings and profits in the second quarter. Analysts expect another solid quarter when companies report third quarter earnings. Auto sales rose 8 percent in September and are up 10.8 percent over last year. The manufacturing sector expanded for its 26th consecutive month. The

unemployment rate remained steady at 9.1 percent and jobless claims fell. Record low mortgage rates combined with low home prices have combined to make mortgage payments on the average new home more affordable than they have been in over 35 years. Also, the September new jobs number came in higher than expected.

Even with some good news, the S&P 500 Index declined 13.9 percent for the quarter and is now off 8.7 percent for the year. Small cap stocks² were down 21.9 percent for the quarter and are now down 17 percent for the year. Our decision to decrease small cap stocks and increase large cap stocks in our equity strategy in February has been beneficial. Looking forward, we believe large cap growth stocks remain very attractive given recent falling stock prices and record earnings. These types of companies should do well especially if we have a slow growth environment in the years ahead.

International stocks declined more than U.S. stocks³, down 19 percent for the quarter and 15 percent on the year. International stocks have been shaken primarily by the European debt and banking crises.



The impact will not be the same on all European countries. For some European companies who do a majority of their business in emerging markets and the United States, a lower euro may actually be a benefit. European stocks appear to be selling off indiscriminately, which will likely create opportunities for stock pickers. While these crises are far from over and volatility will remain high, now would seem to be a good buying opportunity for investors with an appropriate time horizon of at least five years.

Despite S&P's downgrade of America's credit rating in August, U.S. Treasuries rallied through the quarter. The United States remains the most liquid sovereign debt market in the world and a safe haven for investors. For the quarter, the yield on 10-year U.S. Treasury bonds fell from 3.18 to 1.92 percent and hit a record low of 1.695 percent on September 22 [see chart]. Fifteen and 30-year mortgages hit record lows of 3.28 and 4.01 percent as well, making it a good time to consider refinancing for those with mortgages.

Falling rates also helped the broad U.S. bond market⁴ gain 3.8 percent for the quarter. It is now up 6.7 percent for the year. Municipal bonds⁵ also performed well and are up 5.4 percent for the year. While declining interest rates have helped boost bond returns this year, bond investors should expect more modest returns from here given the extremely low yield levels today.

We anticipate continued volatility in the global equity market as it digests the possibility of slower global economic growth and as the European sovereign-debt issues work their way towards a resolution. We expect to see European governments recapitalize their banks, which should help bring greater stability in the coming months. Despite the current low consumer confidence, the U.S. economy may escape recession for now. For many businesses, we think much of the downside risk is already priced into the current market prices for their stock. What does this mean for investors? For those with an appropriate multi-year investment horizon, there are attractive buying opportunities in U.S. and global stocks. Ironically, **investing in times like today, when many people are afraid, often yields better results than investing when the economy appears strong and overconfidence sets in.** 🦋

Canada's Redemptive Decade – Lessons for the United States



Don Wilson
CFA, CFP®
Director of Portfolio Management

At times the current U.S. economic situation may seem hopeless. Deficits are projected to continue as far as the eye can see, adding to our sky-high debt. Politicians seem unwilling to make the tough choices needed. In the book, *The Canadian Century*, the authors describe how Canada went through a similar situation 15 years ago. Decades of government deficits led to a mountain of debt, the loss of Canada's AAA credit rating and rising interest rates on government bonds. Canadian politicians took action to address their dire fiscal situation. Today Canada is in better fiscal condition than most other developed countries. How did Canada do it and what can the United States learn from our northern neighbor's experience?

Canada ran a budget deficit from 1975 to 1996. At its peak, Canada's federal and provincial debt to GDP was over 120 percent, the second highest in the developed world. Government spending on a bloated welfare state consumed half of the country's GDP. Interest payments on the debt ate up nearly a third of the budget (compared to about 6 percent for the United States today). Yields on Canadian government bonds rose as investors feared Canada might require a bailout from the International Monetary Fund (similar to what is happening with EU countries like Portugal, Italy, Ireland, Greece and Spain).

Canadian politicians got serious about solving their fiscal crisis. In 1995, the national Liberal party unveiled a budget that cut spending dramatically. Over the next two years it cut program spending, reduced government employment and cut grants to the provinces. It cut spending on the military and unemployment insurance. As part of the cuts, Canada's federal government significantly reduced its involvement in the transportation, agriculture and business sectors of the economy. Tax increases played a role as well, although spending cuts were four and a half times larger than tax increases.

The success of these changes emboldened Canadian politicians to take on even greater reforms in the years that followed. Canada reformed their welfare system and the Canadian Pension Plan (their version of Social Security) putting it back on sound financial footing. They significantly reformed their tax system to encourage businesses and entrepreneurs to work hard, take risks, and create jobs by reducing corporate and personal income taxes. To offset these income tax cuts, a consumption tax was added.


As a result, Canada balanced their Federal budget in just three years as did most of the provinces. Canada went on to run 11 straight annual budget surpluses. This slashed Canada's federal debt from 80 percent to 45 percent of GDP in just 10 years. From 1997 to 2007 Canada led the G7 (France, Germany, Italy, Japan, U.K., U.S. and Canada) in economic growth, job formation, and investment. Their sound fiscal policies and strengthened financial position helped Canada to weather the 2008 recession better than many industrial countries and to rebound more strongly.

What lessons can the United States learn from Canada's experience of wandering into the fiscal wilderness and then returning to fiscal responsibility?

1. Canada didn't use massive spending in an attempt to stimulate growth. They tightened their belts, made hard choices to cut spending and created a smaller, more efficient government.
2. Politicians finally got serious about getting their fiscal house in order.
3. Canada's turnaround was fast. They balanced their federal budget in just three years.
4. Canada reaped benefits from getting their fiscal house in order including strong economic growth, good job growth and increased investment.

Up to this point the U.S. government has borrowed and spent more in an attempt to stimulate the economy and grow our way out of our deficits and debt. Needless to say it hasn't worked very well. Hopefully the downgrade of America's credit rating will serve as a wake-up call for American politicians to get serious about getting our financial house in order. The debt and deficit issue is now a big concern for U.S. voters across the political spectrum so expect American politicians to someday start getting the message.

While some will warn that cutting government spending will throw the United States back into

recession, Canada's experience demonstrated that is not necessarily the case. Following sound fiscal policies at the Federal, State and local levels will increase the confidence of U.S. consumers and foreign investors. These changes will put in place a solid foundation for strong economic growth for America in the years ahead. Our politicians should learn from Canada's experience and emulate it. The situation is not hopeless. With the right policies, we, too, can turn our country around and enjoy a brighter tomorrow. 

Source: *The Canadian Century: Moving out of America's Shadow* by Crowley, Clemens and Veldhuis

Footnotes from Thoughts on the Investment Markets

¹ As measured by the HFRI Fund of Funds Composite Index

² As measured by the Russell 2000 Index

³ As measured by the MSCI EAFE Index

⁴ As measured by the Barclays Capital U.S. Aggregate Bond Index

⁵ As measured by the Barclays Capital 5 Year Municipal Index