

The stock market continued its roller coaster ride in the third quarter, with strong September gains bringing returns solidly into the black for the full quarter. The S&P 500 Index was up 11.3% for the third quarter, yet just 3.9% for the year. Foreign stocks had an even stronger quarter, with the MSCI EAFE Stock Index up 16.48%, bringing the year-to-date gain to 1.07%. On the bond side, the Barclay's Aggregate Bond Index posted a solid 2.48% gain for the quarter and is up nearly 8% for the year to date.

Index Returns

Through 9/30/2010

Annualized Returns

Index	QTD	YTD	1-Year	3-Year	5-Year
S&P 500	11.29%	3.89%	10.16%	-7.16%	0.64%
Russell 1000	11.55%	4.42%	10.75%	-6.79%	0.86%
Russell 2000	11.29%	9.12%	13.35%	-4.29%	1.60%
MSCI EAFE	16.48%	1.07%	3.27%	-9.51%	1.97%
Barclay Capital US Aggregate Bond	2.48%	7.94%	8.16%	7.42%	6.20%
Barclay Capital Municipals	3.40%	6.83%	5.81%	6.04%	5.13%
Dow Jones AIG Commodity	11.61%	0.90%	10.01%	-6.84%	-2.35%
HFRI Fund of Funds Composite Index	3.36%	2.12%	3.62%	-3.00%	2.17%

The National Bureau of Economic Research recently announced that the Great Recession officially ended in June 2009—marking the country's longest and deepest recession since the 1930s—but our big-picture view of the economic environment in the United States remains cautious and is largely unchanged from what we have been describing over the past year. We continue to believe we are in for a sustained (multiyear) period of sub par economic growth as a consequence of the financial crisis of 2008 and its aftermath. Ongoing "structural" headwinds such as consumer deleveraging, high levels of unemployment and underemployment, weak wage and income growth, tight credit availability to households and small businesses, weak housing markets, higher taxes, and cuts in local, state, and federal government spending in response to their financial difficulties all imply that aggregate demand, and ultimately corporate revenues and earnings growth, are likely to be under pressure for a while. In short, this is not your typical post-WWII business cycle.

With regard to deleveraging, households have started to make progress reducing debt toward sustainable levels—although they still have a considerable way to go—but federal government debt has ballooned.

In the second quarter, household debt contracted by \$57 billion (a 2.3% annual rate), marking the ninth consecutive quarterly decline. State and local government debt also declined slightly in the second quarter after five consecutive quarterly increases. However, growth in federal government debt continued to soar, at an annual rate of 24%. Over the medium to longer term, there is a great deal of uncertainty about the ultimate resolution of the growing government debt problem. But even in the near term, there remain serious questions about the sustainability of the current (weak) economic recovery as the short-term boost from business inventory restocking ends and the \$800 billion federal stimulus program winds down.

The Great Recession may be officially over, but we continue to expect that sluggish economic growth may continue for years.

We realize this is a similar story to what we've been writing in the last few quarters, and it's not necessarily encouraging. However, it's not all gloom and doom either. In the scenario we think is most likely, the economy continues to grind ahead slowly as we work through the aftermath of the recent crisis. While we think it will take years to work through all of the housing, debt, and job market issues, at least we are on that track.

However, we think significant risks remain, and at current valuations, we aren't being paid very well for taking on risk.

Though we see few tactical opportunities at the moment, we believe that the longer term environment will be one that favors our tactical asset allocation approach, as periods of fear and volatility create compelling opportunities.

After spiking to a 5% growth rate in the fourth quarter of 2009, real GDP growth dropped to just a 1.6% annualized rate in the second quarter of 2010. The recent economic weakness is not a surprise to us and is consistent with the view we expressed a year ago that slow consumer spending growth coupled with increasing regulation and likely reduced risk taking on the part of businesses and investors (relative to much of the past 20 years) suggests that any near-term burst of economic activity is unlikely to be sustained at a robust level.

Exacerbating the economic uncertainty is the significant political uncertainty and risk of policy errors. Most pronounced is the tension between those who argue for fiscal austerity now in order to start addressing our deficit and debt problem, and those who argue that more government stimulus is needed to get the economy out of its current rut. On the one hand, if the creditors who are lending to the U.S. government at the current very low interest rates (2.5% for a 10-year Treasury note) start to lose faith in the credibility and credit-worthiness of the United States and/or the dollar, that could lead to a sharp rise in interest rates, which would not be good for the economy. Fifty percent of Treasuries are held by foreigners, with China and Japan each accounting for 10% of the total. On the other hand, a premature move towards fiscal restraint—before the economy is in a self-sustaining growth mode—could tip the economy back into recession or worse, as economic historians argue was the cause of the second down-leg of the Great Depression in 1937.

We realize this is a similar story to what we've been writing in the last few quarters, and it's not necessarily encouraging. However, it's not all gloom and doom either. To be balanced, there are some positive economic signs. Industrial production and earnings have rebounded strongly. Profitability is high (due to aggressive cost cutting during the recession) and companies also have very high levels of cash on their balance sheets (however, it should be noted that corporate debt levels are also very high, as companies have opportunistically issued long-term debt and held much of the proceeds in cash). The personal-savings rate rose to 6.1% in the second quarter, which, while not helpful for near-term economic growth is necessary for the longer-term healing of the economy. Interest rates remain low and relatively stable (but low rates also reflect the risk of deflation and even the Federal Reserve recently stated that inflation is currently "somewhat below" its target range). Developing economies continue their high rate of growth (the IMF forecasts they will grow 6.5% next year versus 2.5% for the developed world) and have relatively strong fiscal/debt balances, which should drive growth in emerging-market demand for U.S. exports.

While we acknowledge these positives, we continue to view the economic/macro risk as asymmetrical in that a negative shock to the system could tip the fragile economic recovery back into a recession, but it's hard to imagine a substantial positive shock to economic growth or employment. (A peaceful resolution to the various conflicts in the Middle East would be an example.) Of course, that doesn't mean there won't be positive surprises and developments that are good for societies, economies, and businesses. But given the imbalances currently in place, we view the macro risks as still skewed toward the downside.

Asset Class Returns

U.S. Equities – At current prices, we don't think stocks are cheap enough to provide a level of return to fully "pay" us for taking on the additional risks that exist. While we don't consider stocks overall as cheap, many of our active equity managers, on the other hand, still report finding good opportunities at the stock-picking level.

5 Becker Farm Road
Roseland, NJ 07068

Tel: 973.535.9577
Fax: 866.734.4227

www.wealthhealthllc.com
info@wealthhealthllc.com

We have also heard a number of equity fund managers make the point that stocks have never been more attractive relative to bonds. They will typically compare the stock market's earnings yield (the inverse of the price/earnings ratio) relative to current bond yields and note that the gap is very wide relative to historical norms. While this is suggestive, it is only part of the picture in our view. When constructing portfolios we assess not only the potential returns but also the potential risks. And while our return analysis is based on a five-year time horizon, we look at risk on a shorter-term, 12-month horizon. To say that stocks are likely to beat bonds over five years ignores the significantly higher downside risk (at least over a 12-month period) of stocks versus bonds. While we'd agree that the stock market is likely to beat the bond market over the next five years, when we look across our scenarios we don't think we are being adequately compensated to take on additional equity risk at current valuations. Moreover, we believe our active bond funds are all likely to outperform the bond index over this period, which reduces equities' relative attractiveness (or put differently, it reduces the opportunity cost of being underweighted to equities).

Investment-Grade Bonds – Returns across the broad intermediate term, high-quality bond universe are similarly unexciting. We think this overall asset class is unlikely to generate more than low single-digit returns in the next five years. That said, we believe the bond market is generating good investment opportunities within certain bond sectors.

Concluding Thoughts

First, this is not a typical business cycle; it is the aftermath of a financial crisis the likes of which the United States has not experienced since the 1930s. Therefore, one should not rely on the cycles of the past few decades as a road map for what the next five years are likely to entail.

This is an environment that requires an intensive and disciplined analytical approach that is also flexible and open-minded in assessing the risks and investment opportunities. One must be aware that the four most expensive words in investing are *It's Different This Time*, while also understanding that this period is different from the rest of the post-WWII U.S. economic and financial experience, and understanding the investment ramifications of these differences.

The multi-decade tailwind of declining interest rates for bonds is likely over, so returns from traditional bond indexes will be low. Equity index prospective returns also look sub par relative to their long-term historical averages. Lower returns compounded over the next five to 10 years might push back retirement dates or require adjustments to spending levels. Investors should also reevaluate and be honest about their true risk tolerance and make sure their overall portfolio allocation is consistent with it. The experience of 2008 through 2009 provided everyone a real-world test of their ability to handle extreme risk and volatility.

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