Wealth Health
Personal Wealth Management

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Market Review

While there are always many factors that affect financial markets in the short-run, it seems pretty clear that a key driver of the rally in stocks and other riskier assets over the past few months has been global central bank monetary policy, with markets reacting positively to policymakers' signals — and ultimately the announcements — of additional liquidity and market support by the European Central Bank and the Federal Reserve. With the exception of the U.S. housing market, which is finally showing signs of improvement, the bulk of the economic news was not positive during the quarter, highlighted by disappointing U.S. employment numbers. However, the stock market's mindset seemed to be: bad news is actually good news because it means the Fed will step in with even more aggressive intervention, which will be a further boost for risk-taking. And the market was right (at least in the short term). Similarly in Europe, central bank action led European stocks to strong gains in the third quarter even as Europe's economic fundamentals did not improve and the growth outlook remains pretty bleak for the Eurozone over the next few years at least.

Index Returns *Through 9/30/2012*

			Annualized Returns		
Index	**QTD**	**YTD**	**1-Year**	**3-Year**	**5-Year**
S&P 500	6.35%	16.44%	30.20%	13.20%	1.05%
Russell 2000	5.25%	14.23%	31.91%	12.99%	2.21%
MSCI EAFE	6.92%	10.08%	13.76%	2.12%	-5.24%
MSCI All Country World Index	6.84%	12.88%	20.98%	7.23%	-2.07%
MSCI Emerging Markets Index	7.74%	11.98%	16.93%	5.64%	-1.28%
Barclay Capital US Aggregate Bond	1.59%	3.99%	5.16%	6.19%	6.53%
Barclay Capital Municipals	2.32%	6.07%	8.32%	5.99%	6.06%
Dow Jones UBS Commodity	9.69%	5.63%	6.00%	5.26%	-3.03%
HFRI Fund of Funds Composite Index	2.31%	3.38%	2.89%	1.49%	-1.64%

The ECB: OMTs

Throughout July and August, ECB President Mario Draghi, with the support of other Eurozone political leaders, communicated that the ECB was preparing to take strong action in an effort to eliminate the risk of a Eurozone break up and financial crisis. This policy signaling culminated in the ECB's announcement on September 6th of a major new policy, "outright monetary transactions," or OMTs, under which the ECB committed to potentially unlimited purchases of distressed Eurozone government bonds (e.g., from Spain or Italy) with maturities of up to three years. However, the ECB also said such purchases would be conditional on the target country's government formally requesting assistance and also agreeing to give up some sovereignty by committing to additional fiscal controls (austerity) and structural economic reforms, under external oversight. The ECB also said it could stop its bond purchases if the target country breaks its commitments. Finally, the ECB said it will "sterilize" its bond purchases by removing an equivalent amount of liquidity from the financial system. This provision was likely included in order to pre-empt criticism that the OMTs are monetizing the bad debt, i.e., "printing money."

The third quarter was a risk-on period as markets reacted positively to global central bank moves to stimulate the economy.

With the exception of the U.S. housing market, which is finally showing signs of improvement, the bulk of the economic news was not positive during the quarter and our concerns over the longer-term health of the global economy remain.

Given the highly uncertain global economic and political environment, we continue to structure our portfolios to perform at least reasonably well across a wide range of outcomes rather than bet heavily on a single scenario.

Our economic outlook continues to be one of subpar economic and earnings growth due to headwinds resulting from the ongoing deleveraging.

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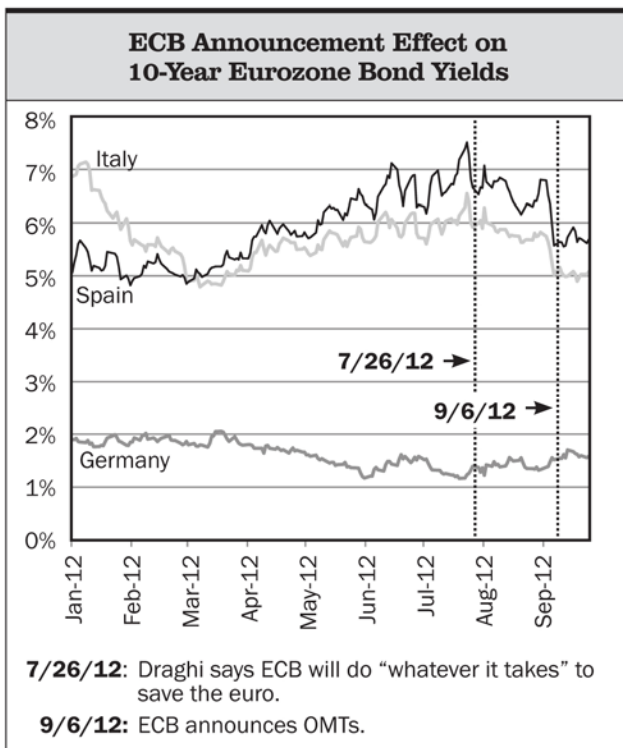
This program is significant because it is the first time the ECB has made an open-ended commitment — in terms of both the amount of government bonds it might buy and the time frame over which the policy will be active. The ECB's words and actions had the desired effect of sharply reducing yields on Spanish and Italian government debt and appear to have reduced the perceived and actual risk of a systemic debt crisis in the Eurozone, at least over the nearer-term. But there remain many unanswered questions and unknowns with regard to the actual implementation of the OMTs (let alone its longer-term effectiveness). So the OMTs buy some more time for Eurozone political leaders to try to work toward a long-lasting solution, but obviously, it still does not "solve" the structural problems threatening the existence of the Eurozone (e.g., competitive imbalances between the Northern Europe and Southern Europe economies).

Our view remains that there is a significant likelihood that the Eurozone does not survive this crisis intact, and a lesser but still material probability that the breakup is disorderly (implying a major shock to the global financial system and markets). The OMTs appear to have at least extended the potential time frame before a breakup, if not substantially reduced the risk of that ultimate outcome. As things stand now, the OMTs don't change our assessment of the range of potential outcomes and risks related to a potential Europe crisis over the next five years.

The Fed: "QE Infinity and Beyond!"

After foreshadowing further action several weeks earlier, Fed Chairman Ben Bernanke made yet another major monetary policy announcement on September 13: 1) The Fed initiated a new program of quantitative easing (QE3) saying it would buy $40 billion per month of government agency mortgage-backed securities. An important distinction compared to QE1 and QE2 is that QE3 is open-ended, with no pre-defined end point in terms of its duration or magnitude. 2) The Fed said it will continue its Operation Twist program through year-end, buying $45 billion per month of longer-term Treasury bonds and selling shorter-term Treasuries. 3) The Fed emphasized that QE3 would be tied to conditions in the labor market—the unemployment rate in particular.



Source: Litman Gregory Analytics. Data through 25 September 2012.

4) The Fed attempted to further influence market expectations regarding its commitment to reflation, and perhaps marked the initiation of a new inflationary monetary regime. 5) The Fed also said it expects to keep the federal funds rate at exceptionally low levels (0% to 0.25%) at least through mid-2015. Previously their expectation was through the end of 2014. These are significant changes to Fed policy.

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There is already plenty of liquidity in the U.S. banking system and U.S. corporations are also flush with more than $1.7 trillion in cash on their balance sheets. In other words, there is plenty of credit potentially available if lenders are willing to lend and borrowers want to borrow, so the recent Fed moves are clearly not needed for liquidity reasons.

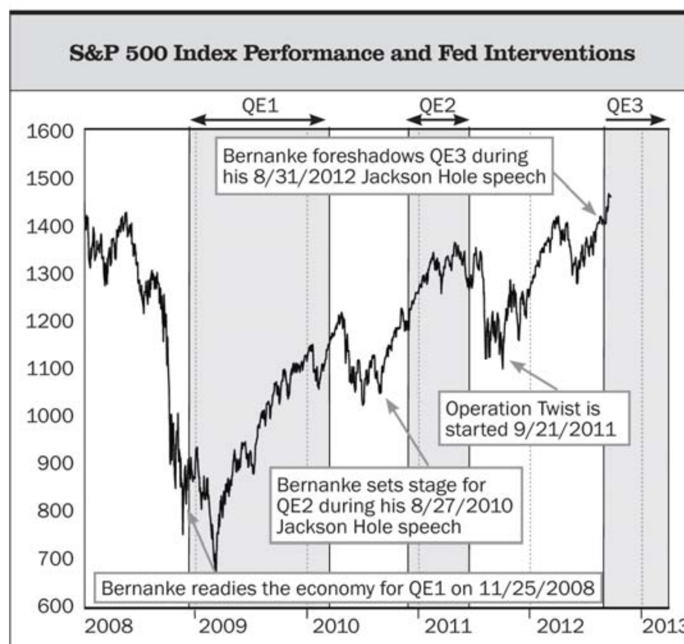
Instead, Bernanke and the Fed are trying to signal even more strongly that they have no intention of pulling back on their aggressively accommodative monetary policy and that they view unemployment as a significantly greater risk than inflation. As Bernanke stated with the prior two QEs, the goal is to depress interest rates even further in order to encourage (or push) investors further out on the risk spectrum, causing further inflation in asset prices, such as the stock market and housing, with the hope that the positive "wealth effect" will stimulate consumer spending and ultimately business investment and job creation. Whether this will lead to any significant real economic impact is questionable and the subject of debate among economists.

Changing gears: What about the U.S. Election?

Moving away from central bank policy, a question we frequently get from clients every two or four years is: What is your take on the U.S. election and how is it impacting your investment outlook? Our answer to this question hasn't changed much over the years. In general, there is too much uncertainty and too many non-election variables that impact longer-term investment outcomes for us to see any value in positioning our portfolio for a particular election result. We aren't saying the result of this election is meaningless to the path of the economy and financial markets over the next four years. We do believe that different fiscal and monetary policies are likely to be implemented depending on who is President and which party controls the Senate. But we are saying that 1) we are not willing to bet on a particular election result; 2) there is a wide range of potential macro outcomes around either election result, stemming from the uncertainty related to policy implementation and ultimate effectiveness in achieving desired results; and 3) there are a multitude of other variables and factors unrelated to the election results that are out of U.S. politicians' control that are likely to have at least as meaningful an impact on the course of the global economy and financial markets over the next five years.

Portfolio Positioning

At the broad asset class level, the recent central bank actions have not yet led to any portfolio changes. (However we would expect these policy actions and the markets' reaction to them to impact our bond fund managers' assessments of relative risks and returns across their investment opportunity sets.) While central bank actions may continue to encourage investor risk-taking, pushing stock prices higher, we are not going to play that speculative game.



Correlation is not causation, but stocks have rallied during periods of Fed intervention since late 2008. Source: Yahoo! Finance. Data as of 21 September 2012.

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It doesn't fit with our investment process and discipline, which is focused on assessing asset class fundamentals and valuations over a longer-term time horizon, while being cognizant of the potential shorter-term downside risks in various scenarios. To the extent global central bank monetary policies continue to stimulate risk-on market behavior our portfolios will benefit from our already meaningful stock and other risk-asset exposures. But we are not likely going to be adding to our risk positions in that circumstance. To the contrary, if stock prices move higher and higher, our assessment may be that the return-for-risk equation is getting worse (all else equal), and we would likely take some more equity-risk out of our portfolios. Given the highly uncertain global economic and political environment, our aim is to position our portfolios to perform at least reasonably well across a wide range of outcomes; any one of which we think is at least reasonably likely to happen. Currently, our portfolios are tilted away from core U.S. bonds and more in favor of flexible fixed income portfolios including corporate and high yield bonds. In addition, we are underweight both U.S. and international stocks in light of the current headwinds discussed above. Instead, our portfolios are tilted more in favor of relatively higher yielding assets like high dividend paying stocks, REITs and high yield bonds. We have also added a small allocation to gold which investors likely will turn to as a safe haven in the event the Eurozone does not survive the crisis and/or the U.S. does not aggressively tackle its ongoing deficits and rising debt.

We will continue to challenge the assumptions that underlie our views, consider new information as it becomes available, and stay intellectually honest in making well-reasoned investment decisions for our clients. We appreciate your continued confidence and trust.

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