Drexel Morgan Capital Advisers

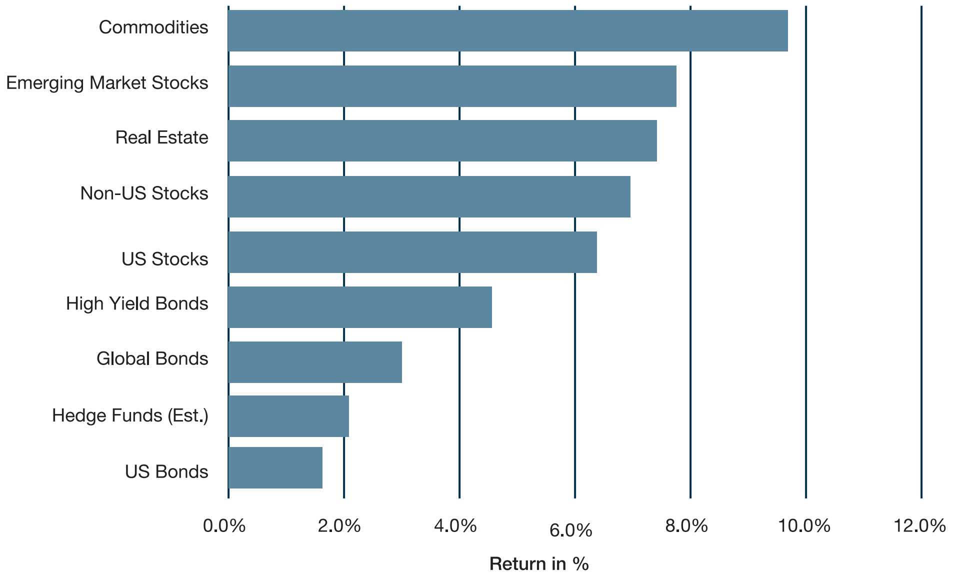
The McCabe Perspective

Third Quarter 2012

Global equities posted a positive 6.7% return in the third quarter according to the MSCI World Index, led by European stocks which gained 9.6% as measured by the MSCI Europe Index. Both the anticipation and actual announcements of further monetary easing measures by major central banks were the primary contributing factors. Despite weakening expansion of economic activity in emerging economies and sluggish growth in the developed economies, the gains in the cyclically sensitive commodity market were even greater than those in the major equity indices. By contrast, fixed income returns were relatively modest in the quarter with the Barclays Capital U.S. Aggregate Index returning 1.6%. High-yield and global bonds performed significantly better than the U.S. bond market during the period. The high-yield market returned 4.5% as measured by the Barclays Capital U.S. Corporate High Yield Index while the Citigroup World Government Bond Index returned 3.0%.

Market Performance

For the Quarter Ended September 30, 2012



Source: S&P 500 Index, MSCI EAFE Index, Barclays Capital U.S. Aggregate Index, Barclays Capital U.S. High Yield Index, Citigroup World Government Bond Index, Wilshire REIT, Dow Jones UBS Commodity Index, Dow Jones Credit Suisse Core Hedge Fund Index

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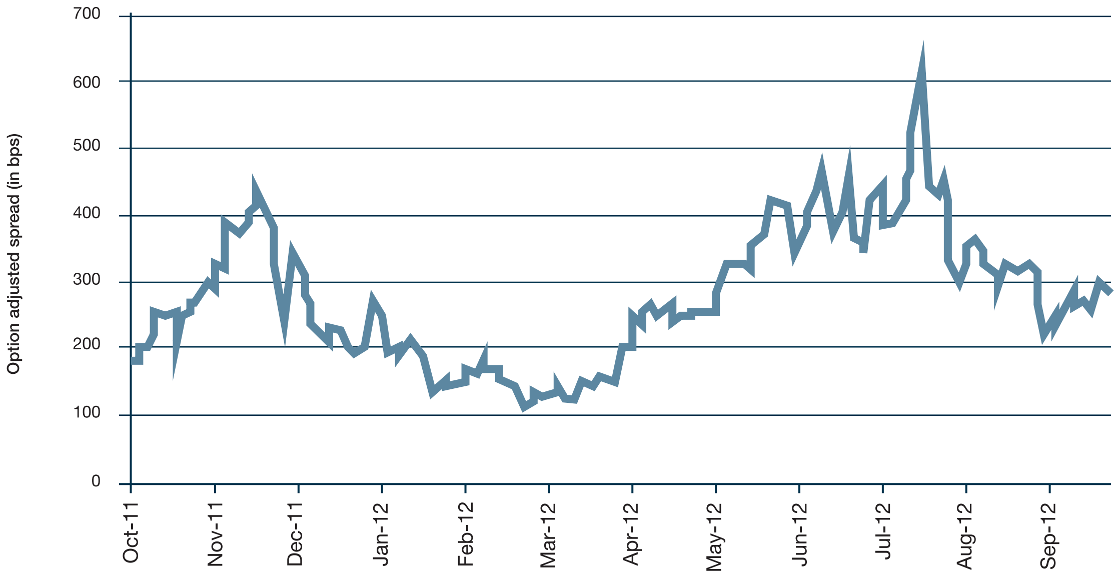
European Economy

Increased optimism about the survival of the eurozone seems to have been a major factor behind the rally in risky assets in the third quarter. The last business day of the prior quarter saw a major rise in asset prices in response to a proposal for eurozone banking sector reform and oversight, as well as one involving direct financing of troubled banks by the European Stability Mechanism (ESM). The new risk-on trade, initiated by this statement, was reinforced by a European Central Bank (ECB) cut in its major refinancing rate from 1.0% to 75 basis points in early July. In addition, it was announced that the eurozone group would provide €100 billion of refinancing to the Spanish banking sector, an upward revision from the €40 billion, announced earlier. This was followed by ECB President, Mario Draghi's July 26th statement that he would do, "Whatever it takes" to save the euro and by the subsequent announcement of the ECB's intention to buy sovereign bonds of up to three years maturity in the secondary market via its outright monetary transactions (OMT) program in return for strict but as yet undefined conditions. Unlimited bond buying will be available to eurozone members to support their short-term sovereigns, but only if they make a formal request to the EFSF or ESM.

Spanish 2-Year Government Bond Spread
October 30, 2011 - October 7, 2012



Source: Barclays Capital Live, October 7th 2012

These policy announcements, combined with the Dutch election results, in which the pro-European parties obtained a parliamentary majority, and the approval of the ESM by the German High Court, reduced the outsized European risk substantially and prompted a major advance in European equities from late July to mid-September, which erased their second quarter losses completely. Short-term yields on the sovereign bonds of the weaker countries fell steadily, as much as 3.8% for two-year Spanish bonds. This was evidence that in the view of markets the ECB's new framework has reduced the risk of liquidity-driven default in the eurozone.

However, certain critical problems still remained unsolved. For example, by the end of the third quarter, Spain had not yet decided whether and when to request EFSF/ESM assistance, which it seeks to avoid. Nor had a detailed plan on bank recapitalization been announced. In addition to the uncertainty over these issues, September brought a well anticipated dispute between France and Germany over the timing of eurozone banking union and common oversight. There was also resistance by Finland and the Netherlands over the use of direct loans by the ESM to finance the past deficits of the Spanish banking system. As a result, European equities started to fall back in the second half of September and Spanish and Italian sovereign bond borrowing rates rebounded substantially, particularly at the long end. This waning of the initial euphoria shows that there is much hard work still ahead.[1]

At the same time, continued deterioration in the eurozone economy is anticipated for the remainder of the year where the consensus expectation is for a 0.5% decline in 2012. In contrast, the S&P expects European growth to be -0.8% for the same period. This is being driven largely by the harsh austerity measures and tight credit conditions in the peripheral European markets. These measures are necessary over the longer term to control excessively large external government deficits and, in the presence of a common currency, to restore competitiveness vis-à-vis major trading partners. Already falling income and price levels have substantially reduced the gap between the peripheral and core country unit labor costs. To some degree, particularly in Spain and Italy, this process is being reinforced by structural reform. However, fiscal contraction is definitely exacerbating the weakness in economic activity and should have probably been postponed until the recovery from the Great Recession was well underway. In Keynes's words, "The boom, not the slump is the right time for austerity at the Treasury."[2] Recently the IMF has shown that austerity during economic weakness is particularly destructive when interest rates are at their lower bound and when the fiscal multiplier is likely to be above one as is currently the case in the Eurozone.[3]

[1] "The Euro Crisis: Game Changer?" The Economist, September 15, page 12

[2] As cited by Robert Skidelsky, Keynes, The Return of the Master, Public Affairs™, 2009.

[3] O. Blarchard and D. Leigh, IMF, World Economic Outlook, 2012

Chinese Economy

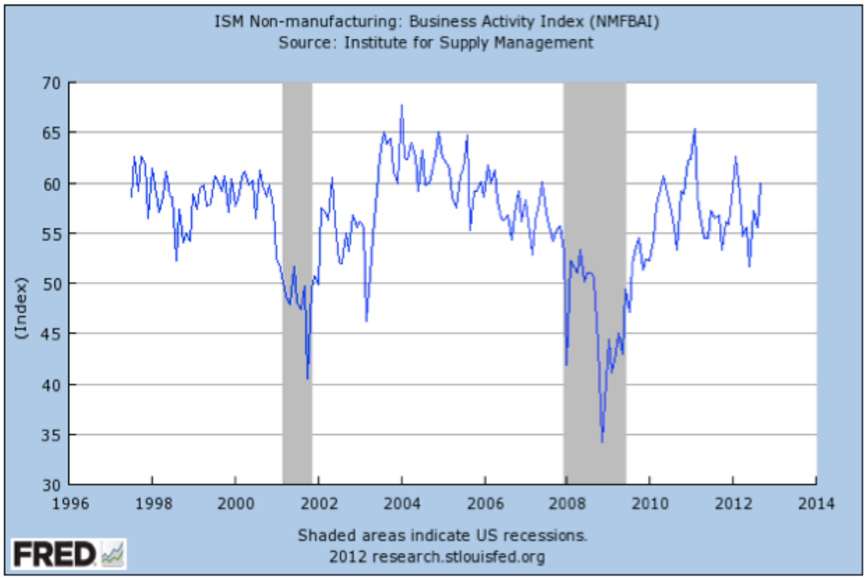
With the Shanghai Index down 5.5% year to date, the Chinese equity market has substantially underperformed other global equity indices since January 1, 2012. Our forecast of 6.0% to 7.0% real GDP growth in 2012, first discussed at the beginning of the year, is no longer well below consensus. The latest figures show that Chinese industrial production has declined for 11 consecutive months, mainly due to slowing exports to Europe. The once popular thesis that the Chinese economy is decoupled from the rest of the world is proving to be highly flawed. It is obvious that the Chinese economy has to become more dependent on domestic demand growth, especially that of domestic consumption, and less dependent on external demand growth if it is to sustain a target growth rate in the 7.0% to 8.0% range over the longer term. This should not be infeasible, since private consumption is now less than 40% of GDP. However, such a major reallocation of resources away from the external sector and toward the internal market is unlikely to occur without substantial disruption.

We believe that this problem is likely to become critical later rather than sooner and the Chinese government will partly offset the recent weakness in external demand through short-term fiscal stimulus. Unfortunately, much of this stimulus will result in higher investment (which is already excessive at 50% of GDP).

The Chinese growth slowdown is structural as well as cyclical. The Chinese economy is transitioning to normal development, characterized by slowing growth, inflationary pressure and forced industrial upgrading. For this reason, the Chinese government has not been as aggressive as markets expected in stimulating growth. Looking forward, however, we expect moderate monetary expansion, as well as extensive infrastructure financing in the next year. We think concern about the current leadership is overdone. Most of the leaders in China agree on the direction they wish to go. In our view, the soft landing scenario is still the base case.

US Economy

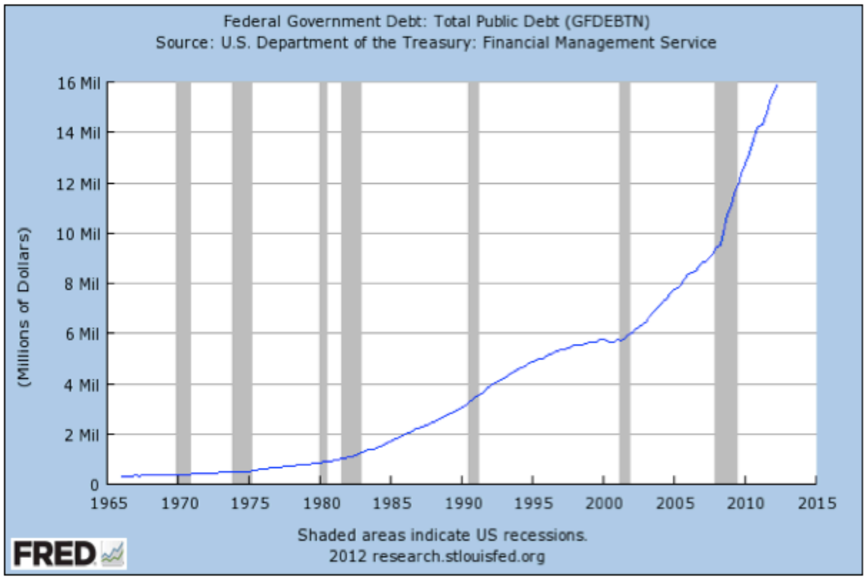
The latest information on monthly consumer demand shows that it is only rising about 10 basis points above inflation, although there have been recent improvements in consumer confidence readings. We expect some deleveraging to continue and US private sector spending to be constrained by relatively slow income growth, which turned negative in real terms in August. However, there is evidence that both distressed and undistressed home prices have bottomed and are starting to rise, which leaves open the possibility of positive wealth effects on consumption.



Source: Federal Reserve Economic Data – St. Louis Fed, September 30th 2012

The sharp rise in the ISM non-manufacturing sector index for September (a leading indicator) would indicate that consumer demand is expected to strengthen eventually. We appear to still be in a period of exaggerated lulls in between retail events with the next "event" being Christmas and the holidays. Sales have fallen off so far in September, and are likely to be depressed until Black Friday which is after the elections. The retail calendar is set up positively for the fourth quarter this year, with two extra days between Thanksgiving and Christmas, and many retailers have an extra week in the fourth quarter. We believe that inventories are in good shape, and cotton prices are lower so we will look for a strong end of year in retail.

The “fiscal cliff,” tax increases and expenditure reduction scheduled for the end of the year, are in principle a significant fiscal drag accounting for up to 5% of GDP. This could easily tip the US back into recession in 2013, if not before. Our view is that a 1.6% fiscal tightening is much more likely. We believe that, because of this enormous potential impact, the overall magnitude of the tightening will be constrained independent of the election outcome. However, different election results could affect the makeup of the policy measures and the speed at which any impasses are resolved.



Source: Federal Reserve Economic Data – St. Louis Fed, September 30th 2012

The FOMC’s recent round of monetary stimulus, QE3, announced on September 13th, includes not only a move toward open ended asset purchases, but also a strong commitment to keep the federal funds rate lower for longer than traditional interest rate cuts suggest. It represents a clear shift in the Fed’s policy function which has become less sensitive to inflation and more sensitive to the unemployment rate. This announcement, combined with the European Central Bank’s promise to buy as much sovereign debt as necessary and the Bank of Japan’s unexpected extension of its asset purchasing program by ¥10 trillion ($128 billion), has justifiably encouraged investors. The latest round of quantitative easing differs from its predecessors since, like the ECB’s announcement, it works not simply through the impact of bond purchase, but also by altering expectations, especially concerns about deflation.

Developed Equities

Over the course of the year, developed equities have performed well despite the continued uncertainty facing the global economy. Our diversified approach within US equities has recently been emphasizing higher quality, lower volatility strategies since we do not believe that near-term fiscal policy risk is adequately discounted. Our year-end target for the S&P 500 is 1350, down approximately 6.0% from end of quarter levels, assuming a budgetary compromise is not reached shortly after the election. Our estimate for year-end 2013 is based upon projected earnings of about $105 for the S&P 500, as compared with the $100 this year. Thus we are anticipating that the annualized return on the S&P 500 will be about 7.0% through the end of 2013 assuming a constant earnings multiplier.

Our prior expectation that the S&P 500 would increase only modestly in 2012 in the face of stagnating economic and earnings growth was too pessimistic. New investor enthusiasm about Fed and ECB policy actions since June 2012 has been much greater than we expected. The forward multiple on the S&P 500 has increased by 15% to 13.44 and the S&P 500 has advanced by 15% year to date through September 30, 2012.[4] This is in contrast to the 2011 pattern when earnings-per-share rose by 15% but the market remained flat at 1258.

Our baseline assumption is that fiscal issues will be resolved during the first half of 2013, but they will remain a major medium-term risk to US equity performance and economic growth. We expect about $255 billion in fiscal consolidation out of a potential $667 billion. This represents a drag of about 1.6% of 2013 GDP which is significantly less than the estimated 4.3% of GDP that would have occurred if the US had fallen off the entire fiscal cliff.[5] We expect 1.7% GDP growth and about $105 in S&P 500 operating earnings in 2013 and about $110 in operating earnings in 2014. This is consistent with the 3.1% annualized growth rate that occurred in the private economy since 2004, according to the Bank Credit Analyst.[6] The private economy grew faster than the total economy because of negative growth in government expenditure due to the winding down of the 2009 stimulus package. Under these growth assumptions the S&P 500 target at the end of 2013 would be about 1500. This is a based on an assumed forward P/E ratio of about 13.6 at the end of 2013.

According to Goldman Sachs, the forward P/E ratio for European equities in relation to that for US equities is substantially below its ten-year average. In addition, estimates of cyclically adjusted PE ratios indicate that the European cyclically adjusted multiple (11.5) is nearly half that of the U.S. (21.4 according to the Schiller estimate), a discount much larger than normal.[7] European equities look attractive because the gap between dividend yields and

[4] Bloomberg

[5] “Eye on the Market”, JP Morgan October 9, 2012

[6] Bank Credit Analyst, “The Longs and Shorts of Keynesian Stimulus”, October 5, 2012

[7] Absolute Value Research

real bond yields is close to a 40-year high and the equity risk premium is close to its historic high. Part of this is driven by very low bond yields, but the equity risk/reward still looks attractive even if bond yields are normalized. Predicted as of September 30, 2012 the probability of a 10% or greater negative return on equities during the next 12 months is estimated by Goldman Sachs at 14%, as compared with 19% historically.

Emerging Equities

A quality approach to emerging market equity has been rewarded thus far in 2012. However, the MSCI Emerging Market Index has underperformed the MSCI World Index by 1.03% year to date. The performance of this equity group is very dependent upon the growth of the global economy. While global leading indices are beginning to improve significantly and global real GDP growth should rise in 2013, we do not expect it to approach anything resembling pre-2008 trends. Most of the pick-up in global growth next year will come from monetary and fiscal stimulus within the emerging markets. The overall growth rate of the developed countries is not expected to reach trend levels. On a valuation basis, the Chinese equity market looks attractive. For example, the Shanghai composite index is trading at only 11.4 times earnings, the lowest level since at least 1997. This is a reflection of the fact that the Chinese economy is likely to grow at its lowest rate in 13 years in 2012. A market turnaround should occur in 2013 with signs of a genuine turnaround in economic growth and improvement in corporate earnings.

The overall multiple for emerging markets is only 12.8 times trailing 12-month earnings.[8] According to Morgan Stanley, world trade growth is expected to be 0.0%. Emerging market exports to developed countries are unlikely to expand much and commodity prices are likely to remain range bound. With some exceptions, only a modest recovery in emerging market equity prices seems likely. This is not to say that a large commitment to the asset class would not be interesting for long-term investors.

Fixed Income

In general, our fixed income portfolios are positioned for a slow growth global economic environment. Recognizing that there may be a bond bubble and that treasury yields are below normal levels as a result of highly expansionary central bank policies, we have generally kept the duration of US Treasury positions below that of the benchmark. We expect ten-year US Treasury bond yields to remain in a 1.0% to 2.0% trading range over the next year, with risks to the upside if no progress is made with respect to solving the structural deficit problem.

In addition, we have, over the last few years, augmented some of our traditional bond holdings by buying high-quality, high-yield corporate and international bond funds in an effort to enhance returns and reduce US interest rate and currency risk. We continue to like investment grade corporate high-yield debt and believe that there are further gains to be made. Total return in high-yield since October 2008 has been significant, outperforming that of the S&P 500 Index, but with less volatility. With yields in this market remaining in the 6.0% to 7.0% range and the corporate sector generally maintaining healthy balance sheets, we believe better quality high-yield fixed income continues to represent a good investment.

The inclusion of international bond funds is intended to raise yield and to hedge against expected dollar weakness resulting from accommodative monetary policy and continued quantitative easing. We expect that these positions will benefit from the expansionary policies being pursued by the Fed, the ECB, the Bank of England and the Bank of Japan which tend to lower yield and weaken currency.

Alternatives

Within the alternative asset class there was a wide dispersion of results in the third quarter. Commodities and real estate benefited from sector specific dynamics. The drought in the U.S. farmlands meant that prices for commodities such as corn reached record highs. Real estate securities have been performing well on the back of better fundamentals in both the commercial and residential property markets. Hedge funds, including equity long short strategies, credit strategies and global macro strategies also delivered varied results. In general the equity long short segment of the market has failed to keep pace with the equity market this year mainly due to the fact that their hedging strategies have been a drag on a generally rising market. Credit strategies have produced strong returns this year as market conditions improved to a degree that enabled many companies to restructure debt on their balance sheet and sell off assets.

Finally, global macro strategies that seek to capture opportunities from trends in currency, interest rate and equity markets found the reversals in the market difficult to navigate. One of the focus areas of such funds is on the direction of the Euro/Dollar exchange rate which has moved with ECB statements and changing sentiment despite any actual policy implementation. We believe that going forward foreign exchange traders will focus less on decoding statements by central bankers and more on the fundamentals such as inflation differentials driving exchange rates. In addition, trend following strategies and equity long short strategies should prove successful in a less headline driven market with fewer reversals and less co-movement among issues.

Summary

Global economic growth is below trend this year and is likely to remain so next year. Even so, the probability of disaster, a 10% or greater decline in per capita GDP in a major developed economy, has been substantially reduced in the third quarter. This has been largely accomplished through a significant reduction in the immediate risk of European sovereign default and eurozone break up. Dovish announcements by the US and Japanese central banks and to a lesser extent the ECB have also reduced the risk of accelerated decline in economic activity. The Fed is placing a greater priority on unemployment reduction and less priority on inflation control in its most recently announced quantitative easing policy. For these reasons, the risk premium, the difference in expected return on risky and safe assets, has fallen and equity and commodity prices have risen.

There are three situations that could cause the price of risky assets to decline: 1) continued eurozone crisis and extreme economic weakness; 2) deterioration in US earnings growth and market sentiment resulting from profit margin contractions from historically high levels or a protracted fiscal debate and greater than expected fiscal tightening; 3) a hard landing in China with global spillover effects.

In sum, our base case outlook, even though it has these clear downside risks, calls for a pickup in global growth in 2013 because of the ongoing European actions and commitment to reduce tail risk, because of substantial monetary easing and more reasonable budget compromises in advanced countries and because of the monetary and fiscal stimulus taking place or about to take place in emerging market economies. Although the short-term outlook for US equities is negative, we expect that a higher growth rate in the world economy will enable global equities to achieve a positive return in 2013.

Sincerely,

James L. McCabe, Ph.D.	**Mark E. McCarron, CFA**
President	Chief Investment Strategist

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