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October 2010

ECONOMIC OUTLOOK

## Summary

The economy continues to expand, but at a relatively slow rate. As each month comes and goes, there are some positive signs and some not so positive signs. The National Bureau of Economic Research finally declared that the worst recession since the 1930s ended in June 2009. This was not unexpected due to the recent growth in the economy. Unfortunately, the fear that the economy will turn downward and enter another recession hasn't been totally eliminated.

There are positives, such as the continued growth in manufacturing, that give us confidence the economy will continue to expand. This growth may not be strong enough to really move the economy forward, but it is growth nonetheless. Some of the negatives, however, such as the weakness in the job market, remain a worry. The unemployment rate is not expected to decline materially for perhaps a couple of years. So long as the unemployment rate stays high, and the job picture remains weak, there are ripple effects for the consumer. One of these ripple effects occurs within the housing sector. Even though there were some encouraging signs in August, such as the rise in housing starts, there has not been a significant reduction in the number of foreclosures, which can be tied to the weakness in the overall job market. In addition, the weak job market continues to impact overall consumer confidence, with a concomitant impact on consumer spending. Due to structural changes in corporate America's appetite for additional workers, and the lack of conviction in the economy's growth, corporations will most likely be slow to hire.

The net of these positives and negatives should be an economy that continues to move forward, but at a slow and disappointing pace. Continued encouragement by the Fed should also help, but it may be further out in 2011 before any strong improvement is seen.

### POSITIVES

- Increase in Institute for Supply Management manufacturing index
- Retail sales rose in August for second-consecutive month
- Desire by Federal Reserve to provide additional easing to aid economic growth

### NEGATIVES

- Consumer confidence fell in September to lowest level in seven months
- Continued weakness in the job market and its impact elsewhere on economy
- Drop in durable goods orders in August was largest since August 2009

### UNKNOWNS

- Ultimate impact of mid-term elections on legislation coming out of Washington

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EQUITY OUTLOOK

## Summary

Although the equity market has been stuck in a trading range throughout 2010, encouraging news during September drove the S&P 500 8.92 percent higher for the month, the strongest September in over 70 years. So far this year positive economic news and good earnings have moved the averages to the top of their trading ranges. In contrast, news of additional financial problems in Europe and concern about a double dip recession have tended to move the averages to the bottom of their ranges.

The changes made by corporate America to reduce expenses and improve margins have enabled companies to report good earnings growth. As a result, stock valuations do not appear too expensive. The low level of interest rates has also been a positive for valuations. Not only have the equity markets advanced in response to positive news on the economy, the markets also appear to be anticipating a change in leadership in Congress. The anticipation is enough that stock prices may weaken if the change does not occur. This adds to short-term uncertainty.

In general, earnings are still coming in strong and estimates for the overall market indicate stocks are not overpriced. Any positive news on the economic front will provide additional downside protection. When all of this is considered, we remain cautiously optimistic. We recognize the political and economic headwinds, but historically markets have been able to "climb the wall of worry" and provide solid returns. The headwinds in October may be such that the markets are choppy during that month, especially as the gains of September are digested. However, so long as the political and economic scenarios don't turn negative, there is the possibility for a rally into year end.

### POSITIVES

- Interest rates are still relatively low
- The economy is still generally improving
- The majority of corporate earnings are still exceeding expectations

### NEGATIVES

- Impact of sovereign debt issues in Western Europe
- Expectations of higher tax rates
- Global slowdown

### UNKNOWNS

- Outcome of mid-term elections
- Impact of reducing massive government monetary and fiscal stimulus

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FIXED INCOME OUTLOOK

## Summary

The Barclays Capital Aggregate index returned 0.11 percent in September, bringing the rolling 12-month return to 8.16 percent. A wide range of senior Federal Reserve officials continue to fret over the slow pace of payroll and economic growth in the U.S. and have intimated that another round of quantitative easing may be around the corner. Over the last few weeks the 10-year Treasury yields have dropped approximately 35 basis points to 2.375 percent in anticipation of $500 billion in additional Treasury security purchases by the Fed.

The currency market appears to believe that Ben Bernanke means business: the dollar has plunged almost 12 percent against major foreign currencies since early June. This could help U.S. exports but increases the domestic cost of commodities and energy. The Fed is on a mission to boost the economy and raise inflationary expectations and they will likely succeed. Put November 3 on your calendar. That date marks the end of a two-day meeting by the Fed and may herald the next phase of unconventional monetary policy.

### POSITIVES

- Low to nonexistent inflation
- FOMC still maintains language about keeping rates low for an extended period of time

### NEGATIVES

- Commodity prices beginning to creep up
- Dissent within FOMC. Some members prefer changing official language and raise rates

### UNKNOWNS

- Likely expiration of the 2003 Bush tax cuts at the end of the year
- Federal Reserve may resume purchases of securities, known as quantitative easing