

OVERVIEW

Economic Analysis and Market Review

Q3 — 2011

Well, what smelled like a recovery in the first quarter turned out to be burnt toast. If it was a recovery, it was the shortest recovery in modern history. It now appears almost certain that we're headed for a "double dip" recession. According to Jonathan Basile, a senior economist at Credit Suisse in New York, "A lot of the economic indicators are teetering. We've gone very quickly from a slowdown scare to a recession scare." Morgan Stanley now says that the U.S. and Europe are "hovering dangerously close to a recession" and that there is a good chance we could enter one at some point in the next 6 to 12 months. The Federal Open Market Committee said after their August 9 meeting, "Downside risks to the economic outlook have increased." They noted that consumer spending has "flattened out", the labor market has deteriorated and the expansion is "considerably slower" than expected. As a result, the Fed pledged to hold interest rates at a record low through at least mid-2013.

The Philadelphia Federal Reserve District's survey of economic conditions in their region provided further evidence of a pending recession. According to one analyst, "the Philadelphia Fed's latest survey of regional manufacturing activity was "absolutely nightmarish". Their survey fell from a reading of +3.2 in July to -30.7 in August. A reading that low has always signaled that a recession was coming in the near future. Add that disturbing news to the latest Consumer Sentiment reading which also has historically always led to a recession and, the surveys conducted by the Institute of Supply Management (ISM) all point to a contraction.

At the crux of the crisis is the housing market and the Fed early on expressed the need to bolster the banks and mend the housing market to get us back on track. Well it appears that the banks are appropriately capitalized but the housing market is getting even worse. According to the National Association of Realtors, sales of previously owned homes dropped 3.5% during July, the third decline in the last four months. Sales of previously owned homes are even lagging behind last year's moribund pace. Mortgage rates are now the lowest they have been since the '50s, but there are very few interested buyers in the marketplace. At last check, the rate for a 30-year fixed mortgage is 3.75%.

And in the equity markets the signs all point lower as investors seem spooked by the nasty news from Europe, a sluggish U.S. economy and a market that appears to have no bottom. Investor nervousness is reflected in the CBOE volatility index or VIX and the readings on this index show a high degree of investor fear. But with all the apparent fear registered in the last month, you'd think the market would be at much lower levels. Yet, as much as the market is moving around, it's really going nowhere. The Dow Jones Industrial Average has been in a 1000 point trading range between roughly 10700 and 11700. It has come close to the low end of the range three times and the high end of the range three times. That means the Dow has bounced 700 – 1000 points six times in just four weeks—August 12 to September 12. Picture a yo-yo.

Similarly, the NASDAQ index, different from the Dow in that it is heavily weighted to technology companies, has had roughly the same experience. The NASDAQ went up five days in a row (to a high of around 2640), then down four days in a row, then up three days in a row and now down three days in a row—to close this quarter as one of the worst in recent history.

I would expect this pattern to continue as long as there is so little clarity as to the successful and timely resolution of the global bank credit/sovereign debt crisis. The instability in the financial markets in the Eurozone has a powerful influence on our markets and if that is not resolved imminently, many are predicting a global financial catastrophe of unimaginable proportions. These are truly interesting times we live in. One final note. Lloyds of London, a venerable institution of insurance brokers skilled in risk assessment, has recently withdrawn all of its money from European banks.

INDEX	Q3'11	YTD
S&P 500	-13.87%	-8.68%
Russell 2000	-21.87%	-17.02%
Europe, Aust., Far East	-19.01%	-14.98%
Barclays Agg. Bond	3.82%	6.65%
Wilshire Real Estate	-14.54%	-5.20%
Treasury Bills	0.02%	0.10%

- The S&P 500 is an index of 500 large, well-established companies
- The Russell 2000 is an index of 2000 small companies
- The Europe, Australasia, Far East Index (EAFE) is an index of the developed countries around the world
- Barclays Aggregate Bond Index is an index composed of investment grade bonds
- Wilshire Real Estate Index is an index of commercial real estate properties