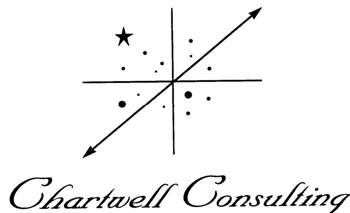

CHARTWELL REVIEW

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got growth?

The 3rd quarter was marked by pronounced and broadly apparent risk aversion across global financial markets. Macroeconomic concerns came to dominate micro fundamentals, with the result that correlations across and within asset classes rose to near-record levels. Everything seemed to decline except Treasury bonds, as marginal investors indiscriminately sold to cash.

Over the last few months, investors have been trying to come to terms with reference scenarios built from four key issues –

- Direction of U.S. monetary and fiscal policy;
- The European Union sovereign debt crisis;
- Chinese GDP growth (a proxy for EM-Asian growth);
- The price of oil (a proxy for broad commodities);

This is a heady brew of macro uncertainties, for which no one can rationally expect clarity over a short time frame. Instead, we think the 3rd quarter's evident difficulties (see tables at right) were derived from the formation of a very simple conclusion - *Developed market nations got no growth*. They're headed for a recession, eroding the fundamental value of all risk assets.

We think one day last quarter connected the dots for investors. That was July 29th, when we learned 2nd quarter GDP was up just an estimated 1%, first quarter growth had really only been +0.4% (marked down from almost 2%), and that our 2009-2010 recovery from the Great Recession had been considerably slower, quarter-by-quarter, than originally reported. Thus, the recovery has been much more anemic than published, and, despite that, this year's pace of GDP growth was running at less than 1%. That same morning, the widely regarded Institute for Supply Management also reported that its Purchasing Managers' Index for July was 50.9%, unexpectedly and sharply lower than June's 55.3 figure, and indicative of a barely expanding domestic economy.

So, *no near term growth in the US*, and certainly *no growth in Europe*, which appears caught up in an unsustainable but politically unsolvable financing problem. With that, the S&P 500 dropped from an open at 1332 on 7/27, to a close at 1199 on August 5th, which was **before** the S&P announced it had cut our debt rating. The market would drop another 6% in reaction to the ratings cut announcement, but most of the damage was already done. Take away that eight-day period, and local equity markets the rest of the quarter were extremely volatile, but flat.

Table 1: Index Benchmarks

Market Index	Trailing Returns *				
	3Q 11	1 Yr	3 Yr	5 Yr	10 Yr
S&P 500	-13.9	1.1	1.2	-1.2	2.8
U.S. Top-cap Stocks	-12.8	1.7	0.7	-1.5	1.8
U.S. Mid-cap Stocks	-18.9	-0.9	4.0	0.6	7.4
U.S. Small-cap Stocks	-21.9	-3.5	-0.4	-1.0	6.1
Non-US Stocks (**devel**)	-19.0	-8.9	-0.7	-3.0	5.5
Non-US Stocks (**emerg**)	-22.5	-15.9	6.6	5.2	**16.4**
3 mo. LIBOR	0.0	0.3	1.0	2.4	2.4
U.S. Aggregate Bonds	**3.8**	**5.3**	8.0	6.5	5.7
High Yield Bonds	-6.3	1.3	**13.7**	6.9	8.6
Global Bonds, unhedged	1.3	3.9	7.5	**7.0**	7.0
CPI, annualized	***2.1***	***4.0***	***1.2***	***2.2***	***2.4***
DJ-UBS Commodity	-11.3	0.0	-5.7	-1.1	5.9
S&P Global REIT's	-15.6	-0.6	-0.6	-3.4	9.2
Chartwell Global 65/35	***-12.1***	***-2.1***	*4.8*	*2.9*	*6.6*

Table 2: Average Mutual Fund Returns

Fund Category	Trailing Returns *				
	3Q 11	1 Yr	3 Yr	5 Yr	10 Yr
U.S. Large-cap	-15.7	-1.0	1.3	-1.0	3.2
U.S. Mid-cap	-19.7	-2.1	3.2	0.9	6.4
U.S. Small-cap	-21.5	**-2.3**	2.1	0.1	6.6
International Lg. Cap	-20.5	-10.8	-1.1	-2.8	5.8
International Sm. Cap	-19.9	-7.3	5.6	0.1	10.2
Emerg. Mkt. Equity	-21.3	-17.2	3.9	3.9	**15.4**
Balanced/Hybrid	-9.2	0.0	4.3	2.0	4.7
General Bonds	2.3	4.5	9.0	6.2	5.5
Government Bonds	**7.5**	**7.3**	8.0	**6.8**	5.5
High Yield Bonds	-6.1	1.0	**10.0**	5.3	7.1

* Annualized trailing returns for periods ending 9/30/11.

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Macro Stuff

In late September, the final report of 2nd quarter GDP growth was issued, along with final downward revisions for the past three years. Real GDP grew at a 1.3% annualized rate in the second quarter, versus an anemic 0.4% in Q1 (see Table below). It was a broadly weak quarter for our economy. Personal spending grew at just a 0.7% annual pace, and disposable personal income at an even more modest 0.6%. Real final sales of domestic product (GDP growth less the change in private inventories) increased at just a 1.6% rate.

Table 3: Breaking Down Real GDP

% Change from Preceding Period *(seasonally adjusted)*

Factor	3Q '11	2Q '11	1Q '11	4Q '10
Real GDP Growth	**2.5**	**1.3**	**0.4**	**2.3**
Nominal GDP Growth	**5.0**	**4.0**	**3.1**	**4.2**
Final Sales	**3.6**	**1.6**	**0.0**	**4.2**
Personal Spending	2.4	0.7	2.1	3.6
Private Investment	4.1	6.4	3.8	(7.1)
- Businesses	*16.3*	*10.3*	*2.1*	*8.7*
- Residential	*2.4*	*4.2*	*(2.4)*	*2.5*
*Chg. In Inventories **(bn)***	*$11*	*$54*	*$62*	*$39*
Export growth	4.0	3.6	7.9	7.8
Import growth	1.9	1.4	8.3	(2.3)
Government Spending	0.0	(0.9)	(5.9)	(2.8)

The BEA just reported out their "advance" estimate of 3rd quarter GDP (see above). While this is subject to re-statement as better data comes in, the estimate numbers were really quite good relative to expectations. Real final sales growth was easily apparent from earlier in the year, despite consumer confidence surveys that weakened throughout the quarter. People may be very concerned, but they're spending money. So, too, are businesses, where investment in non-inventory items is *accelerating* this year. The export/import mix added little to 3rd quarter GDP, but it had been detracting as recently as March. Finally, inventory building was not evident, and actually brought the numbers down. That's great, because companies aren't over-producing.

Price indices continued to rise in the 3rd quarter, which is a concern. After seasonal adjustment, CPI rose at an annual rate of 4.8%, up from 1.5% for the June quarter. Over the past twelve months, headline CPI is up 3.9%, driven by a 4.5% increase in food and an 11.8% increase in transportation costs. On the brighter side, CPI less food and energy costs rose at an annual rate of just 2.7% in the quarter, and the trailing one-year change in core prices through September was 2.0%.

The PPI-finished goods index, which increased 7% for the year though June, was up 6.9% for the year through September.

The US employment situation continued to make slow progress, with a similar number of persons added to the work force as during the second. Data from the much larger survey of employers indicated a +287k gain in total non-farm payrolls, compared to a +290k gain in the 2nd quarter. The "headline" unemployment rate changed little, standing at 9.1% in September versus 9.2% in June. According to household-survey data, 691,000 *more* persons identified themselves as employed at the end of the quarter, making up for the unexpected 530,000 drop reported in the 2nd quarter.

The industrial production picture brightened as we moved through the quarter, increasing 0.2% in September after having been unchanged in August and up 1.2% in July. For the third quarter, industrial production rose at an annual rate of 5.1%. Total industrial production for September was 3.2% above its year-earlier level. **Capacity utilization** for total industry edged up to 77.4%, a rate 1.7% above its level from a year earlier.

The advance estimate of total retail sales for July-September was also more favorable than expected, up 8.0% over the same period one year ago, and +1.1% compared to the second quarter, with September advancing 1.1% from August levels. While these are figures before price adjustment, they indicate continued moderate levels of real consumer spending growth.

Although domestic economy outputs displayed a more stable orientation as we moved through the quarter, it is the global economy that occupies the greatest share of mind with investors. The 27 member states of the European Union collectively comprise the largest economy in the world, with the 17 common currency euro-zone countries accounting for roughly 26% of the global total. For China, which is increasingly relied upon as a primary engine of global growth, the E.U. represents its largest export market. The US and the E.U. are symbiotically entwined on too many levels to count. The point is that bad news and uncertainty for the E.U. is bad news for the global economy. The Federal Reserve thinks the downside risks to the US economy are "significant" because of the E.U. sovereign debt problems. Who wants to argue that?

Accordingly, most economists have continued to reduce their projections for 2011 global growth during the last three months. Domestic 2011 growth is now forecast at 1.6%, down from 2.5%, with the second half advancing at something over a 2% rate. China, which reported 3rd quarter GDP was up 9.1% in annualized terms, is still attacking its rising inflation with higher interest rates and constraints on lending. Full year growth is forecast at 9%. This compares to Germany (reduced to +2.8%), Britain (down to +1.0%), Japan (a decline of -0.4%), India (still at +7.8%), Brazil (down to +3.6%), and the entire Euro area (only +1.6%).

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The Conundrum Deepens

The great investor Sir John Templeton always evaluated the significance of events in terms of whether the markets would "remember" them eighteen months hence. That is, whether they would have a lasting impact on future prices and/or fundamental values, regardless of how important or newsworthy they seemed at the moment. Viewed from that perspective, it's not easy to assess the importance of the United States' loss this past quarter of its AAA sovereign debt rating, primarily because it has had no discernible impact (yet) on the one thing that investors feared most – rising Treasury yields. In fact, as Table 4 demonstrates, the apparent effect of the downgrade was a dramatic shift in the *opposite* direction, as Treasury rates plunged during the second half of the third quarter to their lowest levels in more than 50 years.

Table 4: Primary Bond Sector Yields

	Sep-11	Jun-11	Dec-10	*Y-T-D Change*
Treasuries				
3-month	0.03%	0.03%	0.13%	*-0.10%*
2-year	0.25%	0.45%	0.60%	*-0.35%*
5-year	0.97%	1.76%	2.01%	*-1.04%*
10-year	1.93%	3.18%	3.30%	*-1.37%*
30-year	2.92%	4.38%	4.35%	*-1.43%*
BarCap Aggregate	2.35%	2.83%	2.97%	*-0.62%*
BBB Credit bonds	4.48%	4.42%	4.66%	*-0.18%*
AA Credit Bonds	2.54%	3.19%	3.39%	*-0.85%*
MBS	2.82%	3.53%	3.67%	*-0.85%*
Emerging Mkts	6.59%	5.65%	5.76%	*0.83%*
US High Yield	9.51%	7.67%	7.51%	*2.00%*
TIPS	1.86%	2.70%	2.78%	*-0.92%*
UST30y-US3mo	2.89%	4.35%	4.22%	*-1.33%*

As Table 6 reflects, the prime U.S. 10-year Treasury bond led the quarter's drop in sovereign yields among the most creditworthy countries, and has generally done so throughout 2011. Our thought is that the U.S. downgrade and narrow avoidance of a technical default (remember the debt ceiling drama?) was of little consequence to investors, who had anticipated it in the 1st quarter (when base rates rose a bit), and that near term demand for US Treasuries accelerated in the 3rd quarter when global economic growth hit an air pocket, because they are still regarded as one of the few safe havens. On that basis, one could have expected Swiss and German bond yields to drop further than the US, but the latter has a few problems to sort out with its other 16 Eurozone siblings, while the former was indeed forced to peg its currency to the Euro during the quarter in an effort to stem overwhelming capital inflows.

Non-Treasuries, or spread bonds, were decidedly not swept up in the quarter's risk-off frenzy. Those closest in credit quality, agency-backed mortgage bonds, dropped about 85 bps in yield during the quarter, as did the relatively rare AA credit bonds that are in such high demand among corporate pension plans and insurance companies. However, BBB credit yields were little changed in the quarter, US$ emerging markets bond yields rose 1%. Local currency EM bond rates rose 2%, as did those of US$ high yield bonds.

Reflecting the accelerating flight-to-quality turnabout from Q1, spread bonds decidedly underperformed government bonds (**Table 5**). Total return for the BarCap US Aggregate was a healthy 3.82%, but the Treasury sector (32% of the market) returned 8.84%. Only long Invest. Grade Credit bonds matched this.

Table 5: Primary Bond Sector Returns

Index	3Q '11	1 year	3 years
Treasuries, 1-3 Yrs.	0.5	1.2	2.7
US Treasuries, long	24.7	17.1	13.0
U.S. Inflation-Linked	5.0	10.2	8.3
Mortgages	2.4	5.7	7.0
CMBS	(0.8)	4.4	10.8
ABS	2.4	3.3	8.9
Inv. Grade Credit, 1-10yr	0.8	2.8	10.1
Inv. Grade Credit, 10+yr	8.8	8.7	17.0
High Yield Credit	(6.3)	1.3	13.7
Non-US Global	1.5	4.7	9.0
Non-US Global, $ Hedged	3.0	1.5	5.0
Emerging Mkts Bonds	(1.2)	1.4	11.6

Concerns about the long-term prospect of too little European growth, too much sovereign debt, and certainly too much politics deepened in the quarter. Bond vigilantes appear to be in control for now. Greek long-term bonds have gapped out to trade at 2000bps over German bunds. Spain trades 320bps over, with Italy at +360bps. Normally, you'd find a lot of buyers at those spreads, but we can't find any managers who admit to new money buys of "peripheral" Europe.

Table 6: Sovereign Bond Trends, selected countries

10-year gov't bonds	9/30/11	6/30/11	12/31/10	Y-T-D Change
United States	**1.93**	**3.10**	**3.30**	***-1.37***
Germany	1.84	2.98	2.98	*-1.14*
Switzerland	0.93	1.63	1.62	*-0.69*
Britain	2.35	3.24	3.60	*-1.25*
Poland	5.82	5.83	5.99	*-0.17*
Italy	5.51	4.95	4.68	0.83
Spain	5.07	5.56	5.44	*-0.37*
Greece	22.19	16.10	12.20	10.00
China	3.88	4.08	4.01	*-0.13*
Australia	4.10	5.19	5.68	*-1.58*
South Korea	3.76	4.21	4.40	*-0.64*

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Domestic Equity Markets

In the third quarter, US investors grappled with globally weak economic data, European and US political gridlock, downgrades of sovereign debt, and fears of escalating contagion in the euro zone debt crisis. In this environment, investor sentiment plummeted, leading to heightened market volatility, which increased 150% over the quarter as measured by the VIX, to levels not reached since Spring 2009. Concomitantly, a broad-based selloff of risk assets made it virtually impossible to weather the storm in any particular region or sector. US equities performed better than those on non-US markets, with much of the difference attributable to currency effects.

This was an awful quarter for equity investors; after holding up well earlier this year as the economic backdrop deteriorated, stock prices fell sharply in market action consistent with a serious financial crisis. We noted earlier the market shift in late July and early August, when the S&P 500 dropped 16% in the space of 8 days. After rising during the rest of August, September's 7.2% sell-off was the worst month since May 2010, leading to a 14.3% quarterly decline.

Before writing off the rest of 2011, recall that after May 2010 the third quarter of 2010 saw the S&P rise 10.7% plus dividends, and the 4th quarter rise 10.2%.

Table 7: U.S. Equity Market - Size/Style Returns

	3Q 2011	YTD 2011	Last 2 Years	Last 4 Years
Growth				
Top Cap	(10.3)	(5.2)	7.9	(2.1)
Mid Cap	(19.3)	(11.6)	9.2	(2.7)
Small Cap	**(22.2)**	(15.6)	6.5	(3.1)
Value				
Top Cap	(15.2)	(10.5)	**1.9**	**(8.9)**
Mid Cap	(18.5)	(13.0)	6.8	(4.2)
Small Cap	(21.5)	**(18.5)**	2.5	(5.2)

The size effect (*smaller > larger*) was not observable for the quarter, as the severe "risk off" environment led smaller-cap stocks to underperform larger-caps (**Table 7**). During the initial stages of our current recovery, higher beta small-cap stocks outperformed large-caps, but this has clearly reversed in 2011. Over the four years since the last market peak, which has generally been a risk-shedding environment, large-cap stocks have modestly out-performed smaller. The notable exception has been with very large-cap value stocks, which have been by far the worse performing size/style sector since September 2007.

From a style perspective, the value effect (*value > growth*) was once again not observable in the quarter for large-cap stocks, but was modestly so for smaller market caps.

Value stocks have now underperformed growth stocks for most of the time since the market peak in late 2007, and during four out of the past five calendar years. This is easily one of the longer such periods since the Great Depression, and the longest since 1989-1991.

Table 8: U.S. Equity Market - Sector Returns

GICS Sector (*as of 30Sept11*)	3Q 2011	YTD 2011	Since Market Low	Since Market Peak
Utilities	**1.5**	**10.8**	68.3	(3.9)
Cons. Staples	(4.2)	3.4	66.6	**18.8**
Info Technology	(7.7)	(5.8)	94.3	(7.3)
Telecom Svcs	(8.0)	(1.5)	59.6	(16.4)
Health Care	(10.0)	2.5	53.4	(4.9)
Cons. Disc.	(13.0)	(5.7)	**128.1**	(1.4)
Energy	(20.4)	(11.4)	**50.2**	(18.0)
Industrials	(21.0)	(14.7)	101.7	(26.6)
Financials	(22.8)	**(25.2)**	96.7	**(64.0)**
Materials	**(24.5)**	(21.8)	78.5	(25.1)
S&P 500	*(13.9)*	*(8.7)*	*76.3*	*(21.1)*

In **Table 8**, we see how dramatically negative the anti-cyclical sentiment was, with energy, materials and industrials shares all dropping over 20%. They were joined by financial services firms, especially the largest "to big to fail" banks (down 35%). Sector performance dynamics in Q3 were a continuation and acceleration of the 2nd quarter, during which health care, consumer staples and utilities stocks posted 5+% returns, while energy, materials, industrials, and technology stocks all declined. Looking back over the past four years since the market peak, the very weak financial sector, which is heavily weighted in value indices, has been the negative performance driver. In contrast, consumer-related stocks (including health care) have been the most favorable performers during the period.

Per Table 9, shares are compellingly cheap relative to earnings, especially large value and international.

Table 9: Global Markets - Price/Earnings Ratios

(1yr fwd)	Value	Blend	Growth
US Large	10.4x	11.4x	13.4x
US Mid	11.7x	13.2x	15.0x
US Small	12.3x	13.8x	15.4x
EAFE		9.4x	
Emerg. Markets		8.8x	

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International Equity Markets

World stocks ended a volatile quarter sharply lower. Investor confidence crumbled in the face of weaker than expected economic growth in the US, Europe and China, and the slow progress in resolving Europe's sovereign debt issues. All sectors in major markets posted negative returns, with procyclical sectors the hardest hit. The most defensive sectors, consumer staples, telecom and healthcare, fell the least. Currency conversion (stating local market returns in US$ terms) was a losing proposition for US$ investors in every country market except one – Japan. The Yen gained 4.5% against the US$ during the quarter. Every other primary currency lost value versus the US$. The greatest currency losses were those of Brazil, South Africa, and Mexico (mid-teens). Australia, New Zealand, Canada, and Korea dropped 8-10%. Major European countries, including the Euro-zone, were down 7-8%. The Pound declined only 3%.

Table 10: International Equity Markets - Returns

thru Sept. 30, 2011	U.S. Dollar Returns (%) 3Q '11	U.S. Dollar Returns (%) YTD	Local Currency Returns (%) 3Q '11	Local Currency Returns (%) YTD
World ex-USA	**(18.9)**	**(14.8)**	**(14.8)**	**(11.9)**
- *MSCI Growth*	*(19.1)*	*(15.8)*	*(15.6)*	*(15.9)*
- *MSCI Value*	*(18.8)*	*(13.8)*	*(15.1)*	*(14.0)*
- Europe ex-UK	(26.0)	(17.4)	(19.8)	(17.5)
- Pacific, ex-Japan	(19.7)	(17.7)	(13.9)	(14.7)
- Japan	(6.4)	(10.8)	(10.6)	(15.2)
- United Kingdom	(15.4)	(10.7)	(12.8)	(10.2)
Int'l Small Cap	**(18.9)**	**(16.1)**		
Emerging Mkts	**(22.5)**	**(21.7)**	**(14.9)**	**(16.5)**
- *EM Ásia*	*(21.1)*	*(19.8)*	*(16.9)*	*(17.2)*
- *EM Europe & ME*	*(29.5)*	*(23.7)*	*(19.4)*	*(17.8)*
- *EM Latin América*	*(24.5)*	*(25.7)*	*(11.6)*	*(17.5)*
- *EM BRIC*	*(25.8)*	*(25.9)*	*(19.0)*	*(21.6)*

In US$ terms, the developed market MSCI World ex-USA index dropped -19% in the quarter. The Emerging Markets index declined 22.5%. Currency conversion losses accounted for -4% in developed markets and for -7.5% in emerging markets.

European markets suffered broad-based declines as the ongoing sovereign debt crisis increased concerns that slow growing Europe will shortly endure a recession. Continental European markets were off 26% in the quarter, versus just 15.5% for the UK. While Greece remained the focus (dropping 46.6%), the major core countries of Germany and France each slid 30%. The Swiss market declined 17%. Year-to-date, European equity returns have not correlated especially well with sovereign bond worries. The best two country stock markets this year have been Ireland (-6.6%) and Spain (-9.5%).

Pacific markets performed better than European markets in the quarter, but this was primarily a Japanese story. Japan was the rich world's best performing stock market in US$ terms. In local currency terms, New Zealand (+1%) was the best, followed by Japan (-10.6%). Ex-Japan, Asian markets declined nearly 20%. Better than Europe, but surprisingly high given the financial strength evident in these countries. Markets moved sharply in response to developments related to Europe's deepening sovereign debt crisis and its expected effects on global trade and economic growth.

Table 11: World ex-USA Sector Returns *(in US$ terms)*

thru Sept. 30, 2011 (*GICS Sector*)	EUROPE Returns (%) 3Q '11	EUROPE Returns (%) YTD	EMERG. MKTS. Returns (%) 3Q '11	EMERG. MKTS. Returns (%) YTD
Materials	(32.7)	**(29.2)**	(27.1)	(27.5)
Financials	(30.7)	(24.8)	(25.9)	(26.5)
Industrials	(29.5)	(22.9)	**(28.9)**	**(30.6)**
Cons. Discretionary	(27.0)	(17.7)	(19.4)	(10.6)
Info Technology	(20.3)	(12.4)	(16.6)	(20.8)
Utilities	(19.1)	(11.3)	(24.2)	(20.5)
Energy	(17.9)	(11.0)	(25.7)	(22.9)
Telecom Services	(12.9)	(4.7)	**(9.8)**	**(6.1)**
Health Care	(11.1)	**3.1**	(17.6)	(19.9)
Cons. Staples	(10.6)	(2.5)	(12.9)	(9.6)
Europe | Emer Mkts	*(22.6)*	*(15.1)*	*(22.5)*	*(21.7)*

Procyclical sectors – energy, materials, industrials, and consumer discretionary – all suffered the steepest declines across the globe (see Table 11, above). In Europe, sovereign debt woes also translated into a sharp markdown of banking shares. Most investors naturally expect a recapitalization of Europe's banks will be dilutive to existing shareholders. The three most defensive sectors globally were consumer staples, telecom services, and health care. We see this in both Europe and Emerging Markets' results. Energy and utilities moderately outperformed in Europe markets, but this was not the case in Emerging Markets.

China has been aggressively trying to control inflation this year by slowing its economic growth to 9% through the imposition of stricter monetary policies. This has led to considerable weakness in its stock market (down 25% in Q3, and 24% YTD), and to those of Emerging Asia. But, weakness in Emerging Markets during the third quarter was much more broadly evident, as some investors took an indiscriminate "dump and run" approach to every primary EM region (see Table 10). The MSCI Emerging Markets index slid -22.5%, with currencies accounting for a third of the loss. Latin American markets (-24.5%) held up only slightly better than European ones (-29.5%), because the large Brazil market dropped 27%.

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Back Page Perspectives

What seemed lost on many investors as they were diving out the windows in September is that US economic growth, while weak, is improving. From 0.4% in Q1, to 1.3% in Q2, to an estimated 2.5% in Q3 and perhaps 2.4% in Q4. High enough to bring down unemployment rates? Not even close. Trending toward recession? Doesn't seem nearly as likely as it did two months ago. It's actually hard to create a recession.

China? Well, it printed a 9.1% GDP number for Q3, after spending the whole year raising short term interest rates (to above 6%), raising bank reserves to constrain credit growth, imposing limits on home purchases, and grappling with weaker demand growth from its two biggest export customers – moribund Europe and the US. We know it's a different world over there, and the 9.1% was the lower than Q2's 9.5%, but we think the risk of a "hard landing" for the Chinese economy and (by reasonable extrapolation) Asia ex-Japan, is a distant scenario.

Oil and other commodities? Oil prices broke down by 20% late in the third quarter, to catch up with other primary hard commodities. Overall, the DJ-UBS Commodities index, which has a 30% weighting to soft commodities, was down 11% in the period. Lately, the uptrend has been re-established. Overall, less of an impact on 2011 global inflation, which is a good thing. For investors in commodities/natural resources companies, the shares of which were hammered down by 30+% in the third quarter, you might consider where commodities prices, and natural resource company profits, might be in 18 months. We think Sir John would be a buyer of this asset class.

Any improvement in Europe? Will the fearfulness of 2011 turn into another panic like 2008? In a sensible world it should not. The asset class at the heart of this phase of the financial crisis – sovereign debt – is far easier to value than securitized mortgages and their derivative spawn. There is also more clarity about where the exposures to dodgy government bonds lie. Ultimately, Greece, which is self-evidently insolvent, has to be allowed to default in some orderly fashion. And, as of today, it looks like there finally **may** be a real plan in place to do that. Recapitalizing the banks, who were induced to buy all the "zero risk-weighted" paper in the first place, is also necessary. The European banking system has done less since 2008 to fortify its defenses than America's. Ultimately, no amount of recapitalization would be enough to protect banks from a cascade of euro-zone defaults. The ECB has to create a firewall around its other members, like Spain and Italy. Again, specific developments today indicate there is a good **chance** of that happening. The situation remains a very complex and difficult one, with so many countries to be accounted for. This is the single issue that investors have the most difficult time incorporating into their reference scenarios.

US fiscal and monetary policy? Well, the Super Committee is running silent. We all hope it's running deep. As cynics, when it comes to forecasting real spending cuts or higher taxes just 11 months from a major election cycle, we'll take the under. Should make for a spirited holiday season, though.

In terms of monetary policy, the Fed announced its QE3 "Operation Twist" program in late September. While the media were underwhelmed, the market immediately bought long-term Treasury yields down to levels seen only briefly during the panic days of 2008. Try 2.80% for the 30-year and 1.72% for the 10-year.

The size of this intervention is huge, even though no net QE is expected. By selling $400bn of short-term securities and buying the same amount of long-term, the Fed's potential investment is expected to account for 92% of all the long-duration T-bonds issued from now through June 2012. Yields along the Treasury curve seem likely to stay low, possibly falling even further, with 0% Fed Funds anchoring the front-end and the "Twist" anchoring the long-end.

What to do? Here's one idea. For the ten years ended 9/30/11, the best performing bond sector was US$ high yield bonds. Check out Table 1. These bonds provided investors with the best cumulative annualized return, despite the brief recession following 9/11, the very deep recession of 2007-9, and last quarter's sharp price decline. How did HY bonds overcome all their many credit risks? Because, in the fall of 2001, HY bonds were wicked cheap. That was the time of Enron, Worldcom, and Tyco. The HY index of bonds was trading at double-digit yield spreads over Treasuries. Their prices were discounting truly dire, never before seen, default rate and recovery scenarios. At the end of this September, after the third quarter's break, the HY index was yielding about 8.5% over the 5-year Treasury and 7.5% over the 10-year. Said differently, you could have five straight years of 10% default rates with only 50% recovery experience (this has never come close to happening), and still make considerably more money from HY bonds than US Treasuries. In fact, the current trailing default rate on HY bonds is 2%, and next year's Moodys' forecast is only 4%. Seems like we may have a good trade – buy US$ HY, sell US Aggregate portfolios. Alternatively, conservative investors could sell some of their frustratingly volatile equity positions and rotate the proceeds into HY bonds. Sort of like investing in a 9.5% dividend yielding portfolio, with little or no appreciation potential but also decidedly better downside protection.

Sell high, buy low. Stay cool. See you next quarter!

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