Light at the End of the Tunnel

Price Swings of S&P 500 during September 2011	
Sept 1-6	-4.4%
Sept 7	+2.9%
Sept 8-9	-3.7%
Sept 10-16	+5.4%
Sept 17-22	-7.1%
Sept 23-27	+4.1%
Sept 28-30	-3.7%

Source: Yahoo! Finance

Historically, September has been viewed as a difficult month for equity investors. In recent times, however, the reputation for tough performance has been compounded by a more insidious accomplice - extreme volatility. Both the bulls and the bears had reason to cheer in September as the S&P 500 index posted alternating surges and drops. The volatility was no surprise given the murky political and policy backdrop across the developed markets, as well as the struggling domestic economy in the U.S. We expect the market swings to continue for much of the rest of the year as the economic slowdown at home persists and the Euro-zone struggles to solve its debt problems.

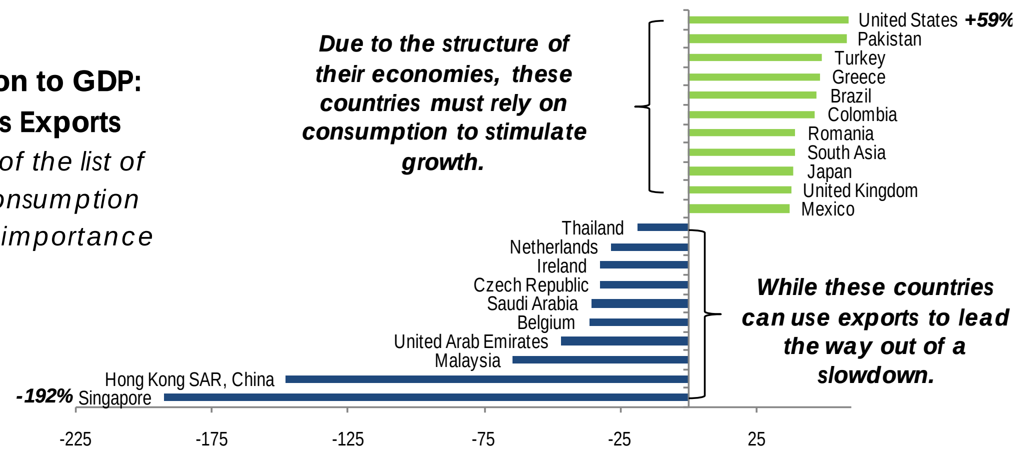
In our research piece last month, "*Third Time's Not the Charm*," we discussed the challenges facing the markets in the near term. This month, we now look forward. There are some indications that relief could be in store early next year, at least from a cyclical perspective. Here we discuss how an easing of inflationary pressures and a stronger dollar could help support the American consumer, and thus the economy and the equity market, in 2012.

The Consumer Lynchpin

Weighing in at 70 percent of GDP, it's no surprise that consumption is key to the success of the domestic economy. As Americans spent their way through the 1990's - and borrowed and spent through the 2000's - the country had the economic growth to show for it. On the other side of that coin, however, post-recession efforts to sustainably revive growth have been hampered by the consumer's lackluster recovery. The Fed's "experiment" with quantitative easing (QE) led to a decline in the dollar, which gave the manufacturing/export sector a boost for a few quarters. However, the unintended byproduct of QE was commodity price inflation and thus higher costs for consumers. As we illustrate below, consumption remains a far more crucial element than exports for a sustained economic upturn. In the end, it seems that QE2 might have hurt the economy more than it helped.

Relative Contribution to GDP: Consumption Minus Exports

The U.S. is at the top of the list of countries in which consumption outweighs exports in importance to GDP growth

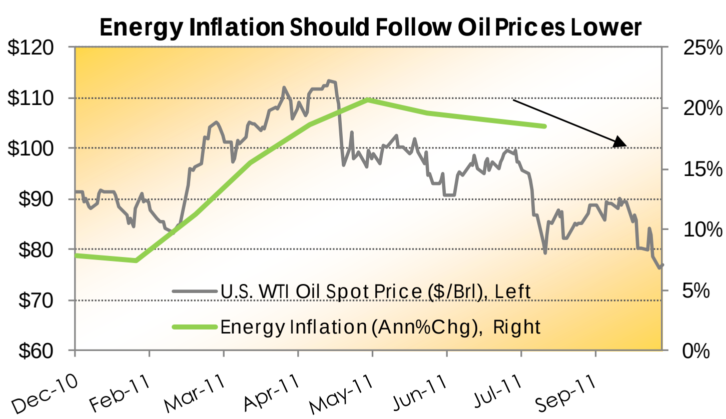


Disinflation - The New Stimulus

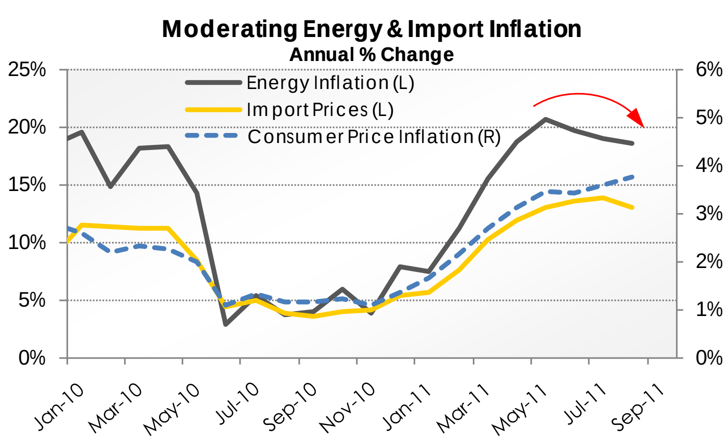
Adjusting to the "weak-consumer scenario" is difficult for most investors who are accustomed to the upward mobility Americans have enjoyed throughout much of modern history. For the last two decades, expanding job opportunities have enabled American workers to hop from company to company and improve their salaries each step of the way. In addition, improved access to credit and rising financial markets boosted the consumer's propensity to spend and to take on additional risk. Today, however, these financial support pillars have significantly eroded. In the current environment, we must ask, "*Without significant job, income or credit growth, is there a light at the end of the tunnel for the consumer*?" The answer is, *yes*, there is a glimmer of light on the inflation front. Data in recent months show that inflationary pressures are beginning to ease, and this could translate into better economic news in the quarters ahead.

When consumers have a set amount of income to spend every month, the dollars taken up by necessities like food and gas play a major role in what is left over for discretionary purchases. When prices of necessities become inflated, the result is like an added tax on consumers. There is simply less money left over for discretionary purchases, and economic growth suffers. If the portion of income required for necessities decreases, then more income is available for people to buy things like clothes, toys, and electronics.

Inflation data in the last few months have been encouraging. Oil is now trading below $80 per barrel - one positive impact from a slowing global economy. As a result, since peaking in May, energy price inflation has declined steadily and should continue to do so if oil prices remain under pressure.



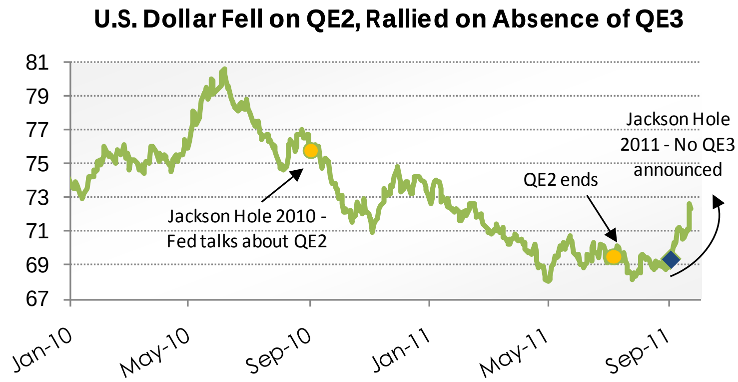
Source: eia.gov, dailyfx.com



Source: BLS.gov

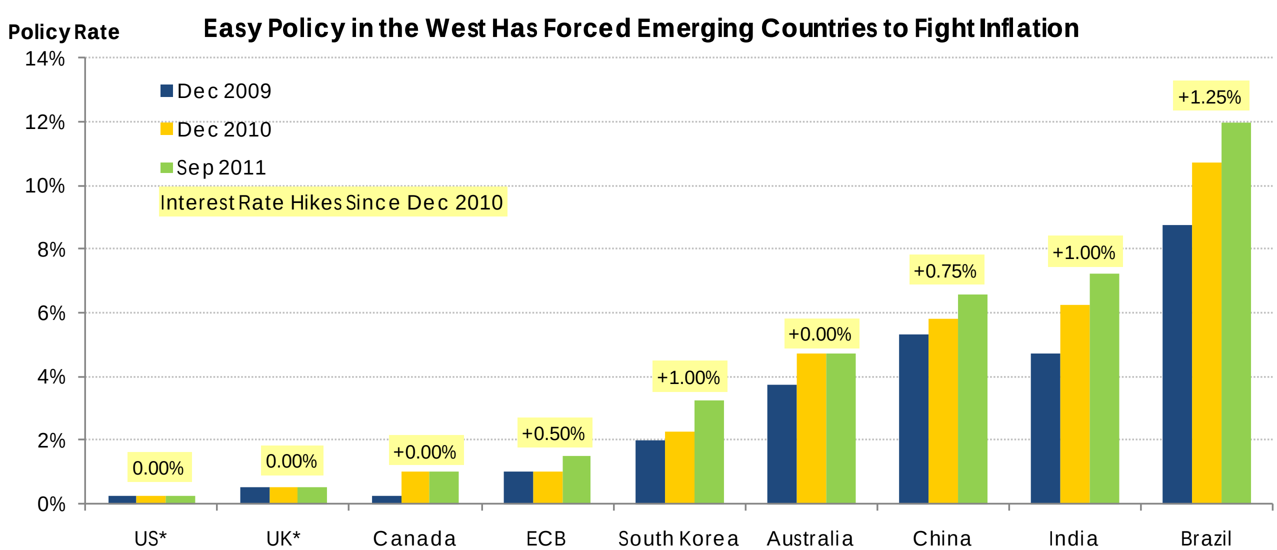
The moderation in energy prices already appears to be flowing through to lower import price inflation, which is an area highly impacted by commodity prices. As shown in the graph at left, import inflation ticked downward in August for the first time since September 2010 - which was just prior to the start of QE2.

The Federal Reserve declined to announce a continuation of QE at its annual conference in Jackson Hole this August, and since that time the dollar has been marching upward. A stronger dollar should help inflation moderate even further by contributing to lower commodity prices, and giving Americans better purchasing power in the global market place.



Global Policy Reversing Course?

Despite the Fed's goal for its QE2 easing program at home, we believe that this program actually stimulated tighter monetary policy around the world. In the U.S., QE constrained consumption by elevating commodity prices. Americans were forced to pay more for items like gas and food, as well as imported goods that were now made with more expensive raw materials. In high-growth countries like emerging markets, however, commodity price inflation fed more directly into headline inflation. Since most central banks (other than the Fed) have a single mandate to control inflation, a series of rate hikes ensued to try to reign in price levels. Tighter policy in emerging countries essentially helped put the brakes on the world economy, and counteracted the goals the Fed hoped to accomplish.



** US and UK Central Banks also pursued a quantitative easing program to further ease policy*
Source: fxstreet.com, tradingeconomies.com

The good news is that QE2 is now history, and most global central banks have stopped raising interest rates. Neither the Fed's announcement at this year's Jackson Hole meeting in August nor its statement from the September policy-setting meeting contained signs of additional dollar-depressing monetary stimulus[1]. Ironically, by merely removing the threat of more QE, the Fed has in a sense loosened its policy stance by allowing other central banks to do the same. Most central banks have not gone so far as to reduce rates just yet - Brazil and Israel are the exceptions that have already cut rates - but if inflation trends continue to moderate more rate cuts could emerge in the coming months. The U.S. dollar should also benefit as global interest rates fall and the currency becomes more attractive to foreign investors.

Stocks Could Price in a Recovery in 2012

Investors are frequently confused by the seemingly-contradictory signals sent by the markets and economic data. While they may often appear to be at odds, it is usually just a matter of timing. Stocks act as a leading indicator of the economy, which means that the equity market prices in expectations for economic growth well in advance of when it occurs - normally by about six months. Continued easing of inflation trends would create tailwinds for consumer spending, and equities could begin to price in this recovery by early 2012. Better economic data would likely follow a few quarters later.

Unfortunately, we believe that a weak outlook for the rest of 2011 is already baked in the cake. Leading indicators of the economy have moved from a slower pace of expansion into actual contraction territory - both in the U.S. and abroad - but this is a sign that the final phase of the downturn is approaching. The worst part of a cycle is the last part of a cycle, but the upside is that it does pave the way for a recovery. The instability in Europe contributes to the volatility we have been experiencing in the equity markets, and a negative event there could in fact prove to be the catalyst for the final leg down. We would consider that to be an excellent opportunity to return to a more aggressive asset allocation. In the mean time, we will watch for a continued easing in commodity, import, and headline inflation gauges to signal that relief is on the way for the consumer.

October 4, 2011

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[1] The Fed has embarked upon so-called "Operation Twist" which entails selling short-dated Treasury debt in exchange for longer-dated Treasury debt, but this operation does not further expand the Fed's balance sheet.

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