

# Investment Strategy Outlook

November 15, 2011

Please refer to Appendix – Important Disclosures.

## Volatility Shows Little Sign of Fading

### Highlights:

- European Headlines Continue to Drive Stock Prices
- Global Central Banks Getting More Accommodative
- Economy Struggling for Momentum
- Investors Growing More Hopeful
- Breadth Yet to Issue an All-Clear

Macroeconomic concerns out of Europe continue to buffet the financial markets. Investors around the world are learning more about the internal workings of the Greek and Italian governments than they ever wanted to know. For most observers in the U.S., this means updating a knowledge base that probably stopped with the Greeks inventing democracy and the Romans moving from Republic to Empire under Julius Caesar more than two millennia ago. While the governments in both countries have now been replaced, this alone does not provide anything more than perhaps temporary relief. **The underlying issues do not disappear just because politicians have been replaced with technocrats.** If

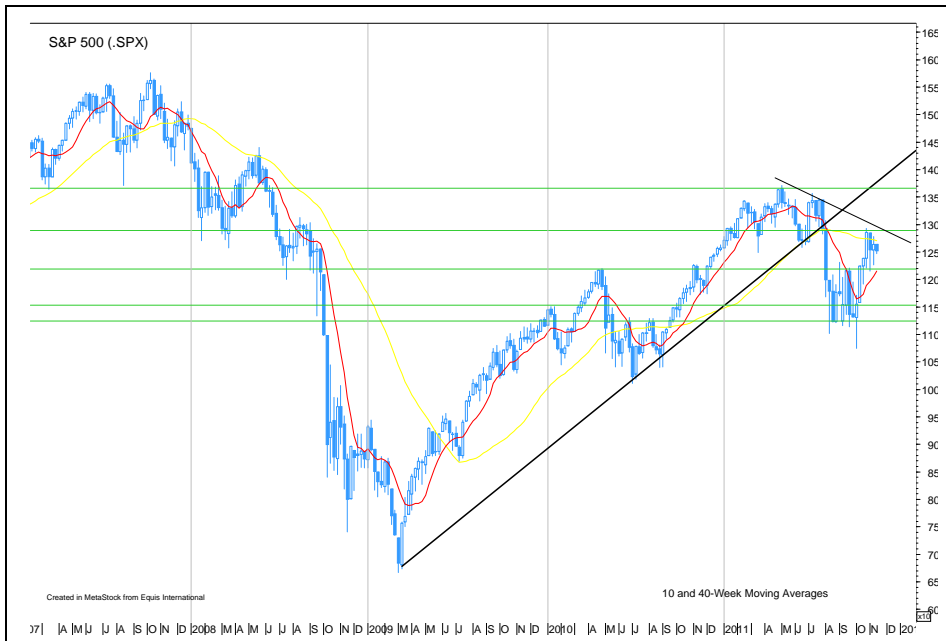
### Outlook Summary

Underweight Exposure to Stocks, Underweight Bonds

Longer-Term Risk/Reward Dynamics Argue for Caution

Trading Could Be Choppy, But Trending Higher Into Year-End

Key S&P 500 Resistance Near 1290; Support Near 1220

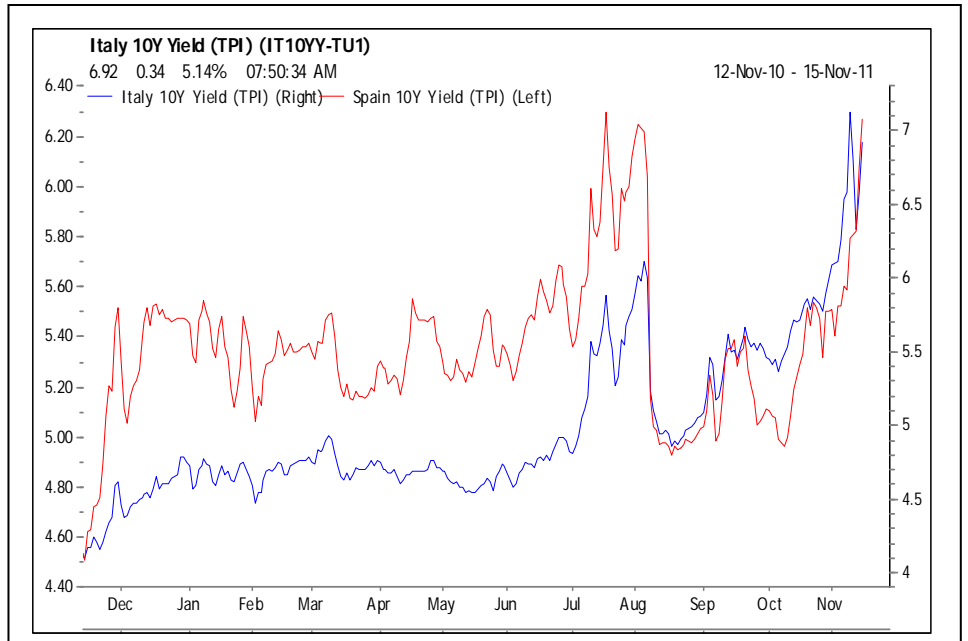


anything, rising bond yields across the European continent suggest risks there are still on the rise.

Developments within these Mediterranean archipelagos are likely to continue to have an outsized effect on global stock markets. *The elevated volatility we have seen since August is unlikely to significantly abate.* This means stocks could continue to move freely within a relatively broad trading range (from 1220 to 1290, using the S&P 500). While the overall weight of the evidence is neutral, there may be more resistance to a breakdown than a breakout. The October index

lows appear to have coincided with excessive levels of economic and stock market pessimism. **This left sellers sold out, and now with seasonal trends positive into 2012 and many investment managers needing to play catch-up to their benchmarks, stocks appear poised to probe higher.** The pattern in recent weeks has been towards abortive sell-offs and more persistent rallies. *This is not, however, a low-risk environment, and we would caution against chasing performance at this point, particularly with the latest investor survey data showing building (but not yet excessive) optimism.*

**Federal Reserve Policy is bullish.** Federal Reserve officials have begun to openly float trial balloons for a third round of quantitative easing, and while no action was taken at the latest FOMC meeting momentum appears to be building for another round of bond buying. Gone were the three dissenting votes who wanted a less accommodative policy, replaced by one dissenter who favors more accommodative policy. This comes at a time when growth projections are being trimmed. In January, the FOMC expected



growth of more than 3.5% in 2011 and growth of 4% in 2012 and 2013. Current projections, published following the November FOMC meeting, are for 1.7% growth in 2011, 2.7% growth in 2012, and 3.3% growth in 2013. In January, the FOMC's projections for the unemployment rate called for it to drop from 8.9% in 2011 to 7.9% in 2012 and 7% by the end of 2013. Now, expectations are for it to remain above 8% through the next two years. *Talk of temporary disruptions to growth has faded, replaced with an increased awareness that growth in the wake of financial crises tends to be sub-par and somewhat erratic.*

**Indicator Review**

**Fundamental Factors**

Federal Reserve Policy	Bullish	+1
Underlying Economic Fundamentals	Bearish	-1
Valuations	Neutral	0

**Technical Factors**

Investor Sentiment	Neutral	0
Trends/Seasonal Tendencies	Bullish	+1
Tape/Breadth	Bearish	-1
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**Weight of the Evidence** Neutral 0

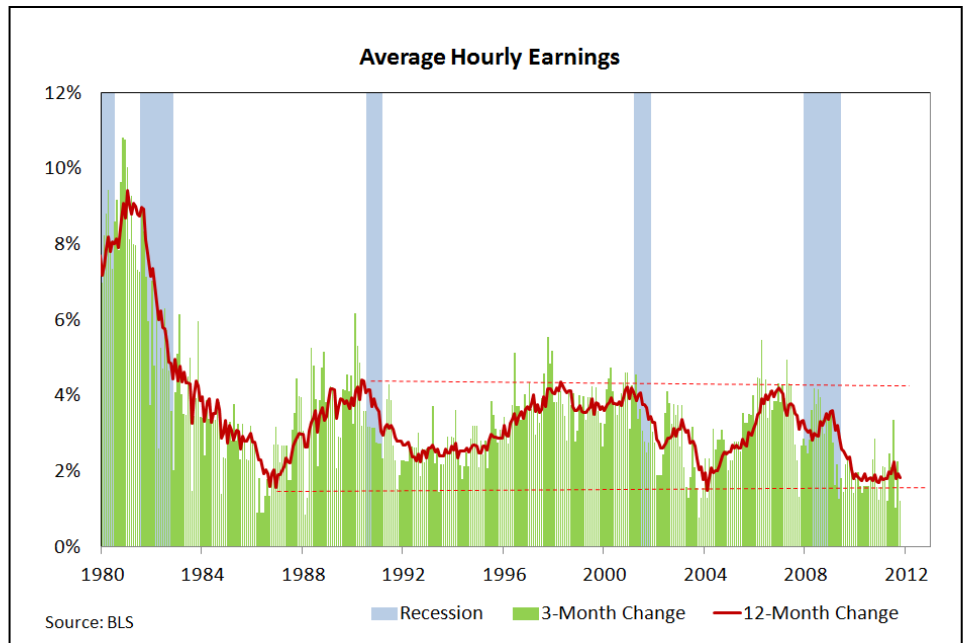
The ultimate efficacy of another round of quantitative easing in promoting lasting economic growth is uncertain, particularly if it is not accompanied by fiscal budgetary and tax reform. Nonetheless, and political pressure notwithstanding, **we believe that QE3 will be unveiled sooner rather than later.** As opposed to QE2, QE3 seems likely to be accompanied by action from other central banks. The Bank of England is buying bonds, and the European Central Bank (ECB) cut interest rates by 25 basis points two days into the term of new ECB President Mario

Draghi. Deteriorating financial conditions in Europe increase the likelihood that the ECB will be placed (willingly or not) in a role as lender of last resort.

**Economic Fundamentals are bearish.** The U.S. economy will likely be able to skirt recession in 2011, but the prospect for continued growth in 2012 may hinge on the ability of politicians in Washington to take action to extend the payroll tax cut that was enacted a year ago. *With elections less than one year from now, policy decisions are increasingly made in a political context.* While we have not considered this payroll tax cut to

be crucial to the long-term health of the economy (a comprehensive reform of the tax code is more important in that regard, as well as entitlement and budgetary reform), its expiration could tilt an already weak economy into recession. For now though, the U.S. economy continues to expand.

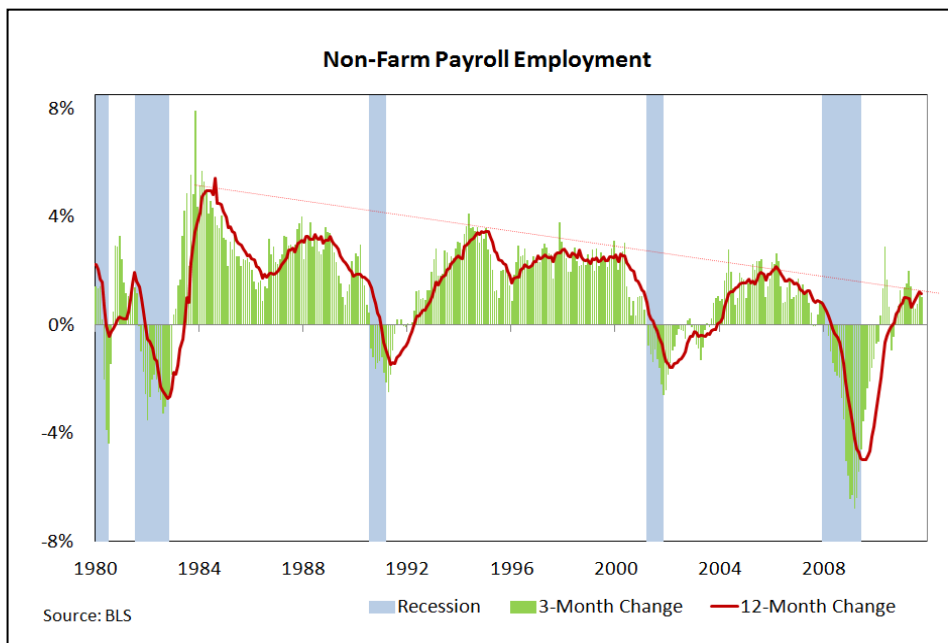
The latest jobs report (for October) showed the economy adding 80,000 new jobs, plus revisions to data for the last two months added another 100,000 jobs. The unemployment rate (which is based on a different survey sample than the payroll data) fell in October from 9.1% to 9.0%. **The current pace of job**



**growth, however, is not sufficient to lead to a sustained decline in the unemployment rate.** The trends in job growth appear to be rolling over. The yearly change in payroll growth, as well as the change in the aggregate hours worked index, are moving lower, and the yearly change in wage growth (currently at 1.8%) is still near the bottom of its recent range.

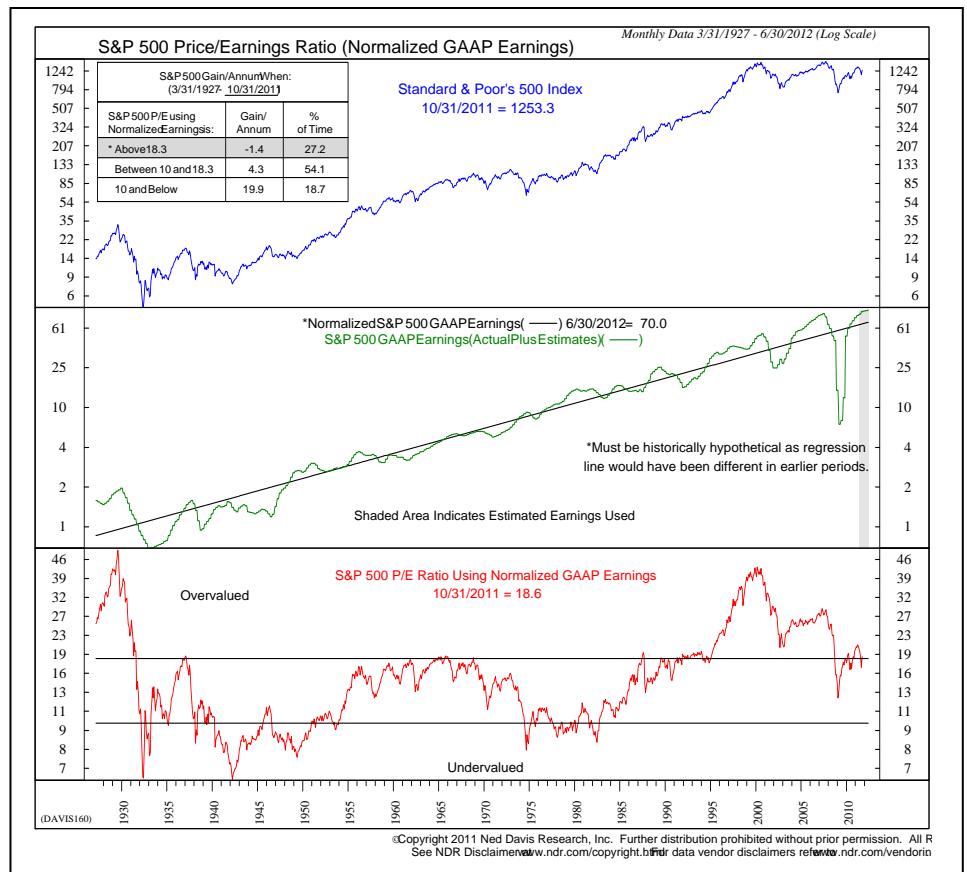
The first look at overall activity in the third quarter showed that Real GDP rose at a 2.5% annual rate last quarter, up from the 1.3% growth rate seen in the second quarter. Additional data released since the GDP report suggests that growth in the quarter could

be revised down towards 2.0%. Underpinning the Q3 rebound in GDP was a bounce back in personal spending, which accelerated from 0.7% growth in Q2 to 2.4% growth in Q3. Real disposable income, however, moved in the opposite direction. After rising 0.6% in Q2, income fell 1.7% in Q3. **This suggests that the Q3 rebound in growth was fueled by spending down savings and/or tapping credit – neither of which is a hopeful development or sustainable trend.** We would expect either consumption growth to cool or income



growth to rebound in coming quarters. Given the state of the labor market, the former seems more likely than the latter.

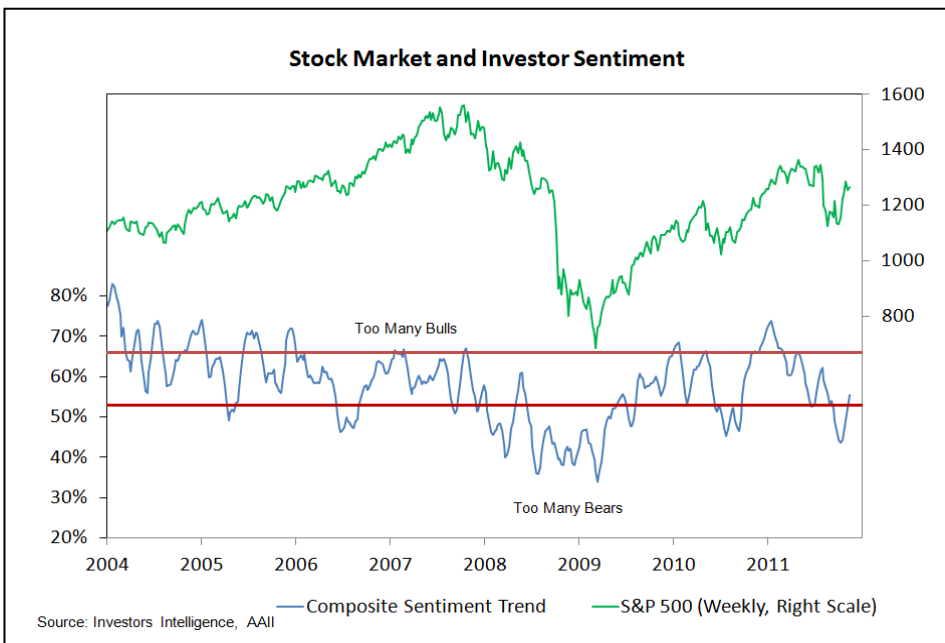
**Valuations are neutral.** Our most preferred measure of valuation, which looks at the median P/E for the S&P 500 (using as earnings the trailing 12-month reported number), is just below its long-term mean. With the ongoing volatility in prices, it may pay to focus more on the earnings side of valuations. Earnings growth is slowing, although the third quarter produced generally better-than-expected results. **The slowing in growth reflects the reality that nominal GDP growth remains generally lackluster, and with profit margins already at record levels, productivity-driven gains have become harder to come by.** Expectations for further earnings growth are moderating, easing away from a level that has typically signaled too much optimism (not that earnings growth could not meet expectations, but that elevated expectations left little margin for error). *On the more cautionary side, using normalized earnings, stocks are bordering on overvalued (see*



*the bottom clip on the chart above*). Overall, while valuations are not a headwind for stock market gains in the near term, this is little evidence that the secular tide has shifted towards the bullish case.

**Sentiment is neutral, but is now approaching bearish.** The excessive pessimism present at the October low (and a primary fuel for the October rally)

has dissipated. Optimism is building, but has yet to reach excessive levels, particularly when viewed from a seasonal perspective. Optimism tends to build over the course of the fourth quarter as investors invariably look towards a better new year. The latest data from the weekly sentiment surveys shows that among both advisory services (II) and individual investors (AII) bulls outnumber bears. *Unless bears in these surveys drop consistently into the teens (the latest data shows the AII bears at 25% and the II bears at 35%), optimism is not likely to become a near-term*

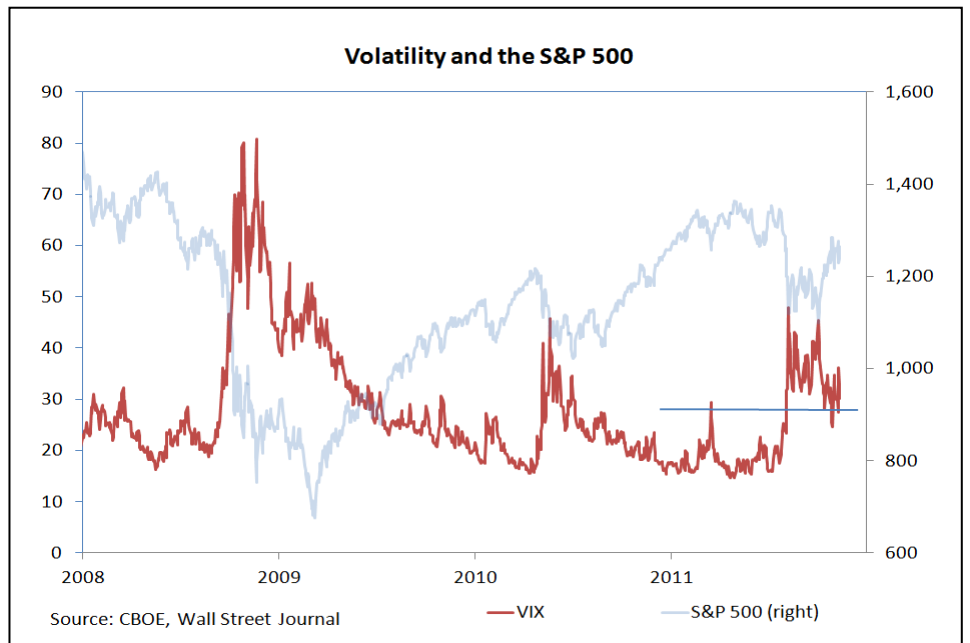


*impediment to stocks.* The NAAIM survey shows that active investment managers have moved from their net short position in early October to a 45% net long position in early November. This is well shy of the more than 80% net long position that was seen at the stock market peak in April. The options data shows a lack of complacency among traders. Put/call ratios have largely remained elevated, and the VIX has not been consistently below 30 since July.

**Seasonals/Trends are bullish.**

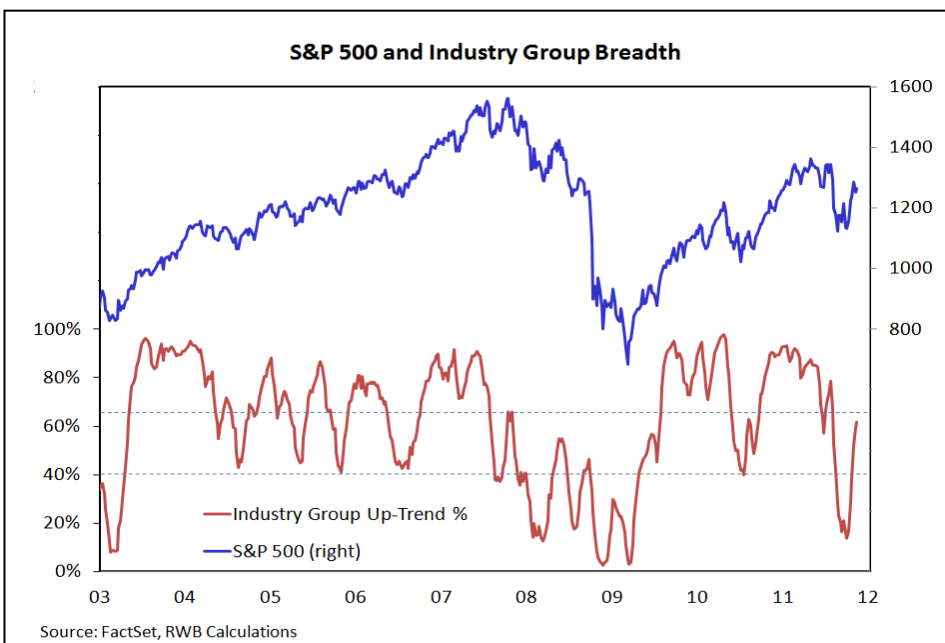
Seasonal patterns, on both the annual cycle and the overall composite cycle, are bullish into year-end. **Given the size of the rally that was seen in October, the market may frustrate those looking for a year-end rally from current levels.** *Rather, while the bias into year-end may be higher, the path is likely to remain choppy, particularly since the trends indicators are largely neutral.*

Momentum from the October rally has been tested, and appears to have dissipated. The major indexes are largely trading between their moving averages, which is neutral from a trend perspective. All 30 of



the primary indexes we track are currently above their 50-day averages, which in every case are rising. However, 22 of these indexes have 200-day averages that are falling, and in all but one case, the 50-day average is currently below the 200-day average. In the case of the S&P 500, an initial trend improvement would be for the index (near 1250 as of this writing) to cross above its 200-day average (near 1275). Further improvement would be for the 50-day average (near 1200) to cross above the 200-day average.

**Breadth is bearish, but approaching neutral.** Our industry group breadth indicator shows that the percentage of groups in up-trends has expanded considerably in recent weeks (from a low below 20% to just over 60% in mid-November), although further improvement is necessary to suggest that the broad market has gotten back in gear. A clear break above 65% would reduce the likelihood that the current rally is a reflexive snap-back move and that it represents a sustainable trend in the broad market.



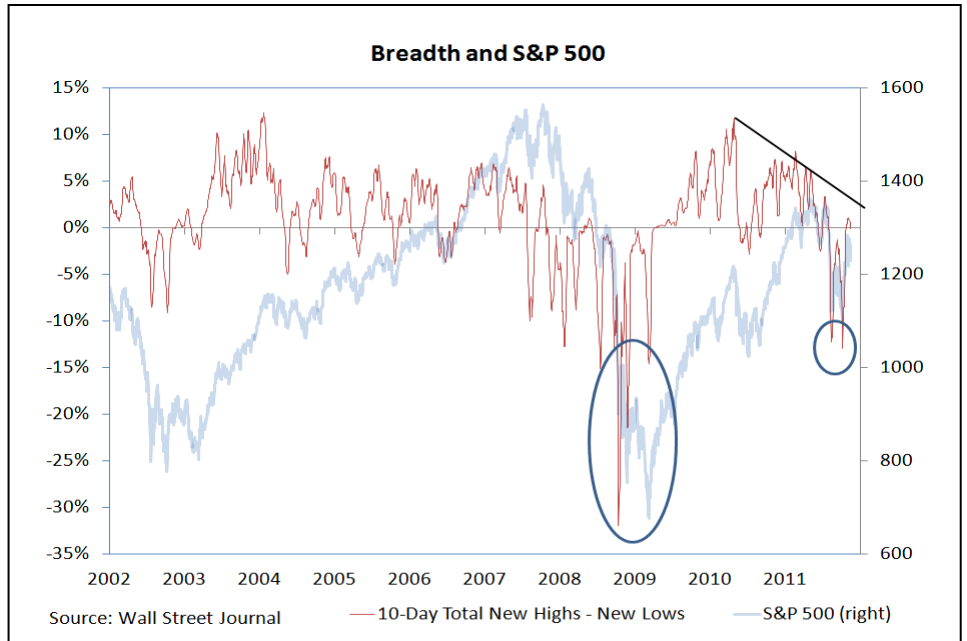
Given the high volatility and elevated correlations across the financial markets, there is some

concern that breadth indicators have lost some of their leading tendencies, moving coincidentally with the indexes as opposed to ahead of them. **Thus we want to see a decisive improvement in breadth indicators to suggest an improved investing environment.**

Short-term breadth has certainly improved, as measured by the McClellan Oscillator and Summation index. However, when we look at the number of issues making new highs versus new lows, the gains do not yet look sustainable. We did not have a significant divergence (between prices and the number of net new highs) at the October low, and that indicator has yet to break out above the downtrend that emerged in the first half of the year.

**Portfolio Thoughts:**

- The investing environment remains high-risk, with elevated levels of volatility and correlation among risky assets. Investors should resist chasing performance – until we see conclusive evidence to the contrary, we assume this is a range-bound, as opposed to trending, market.
- Equity investors with new money to put to work should use pullbacks towards support (near 1220 on the S&P 500) to add to high-quality positions. Pullbacks can also be used to trim hedges, while rallies towards resistance should be used to rotate out of higher-beta, lower-quality areas of the market.
- From a sector perspective, leadership is coming from Technology, Utilities, Energy, and Consumer Discretionary. Financials and



Materials (ex Gold) remain laggards. Large-caps and mid-caps are faring better than small-caps.

- Gold is getting back in gear, supported by favorable seasonal trends, excessive pessimism, and increased chatter (and expectation) that the ECB and the Federal Reserve will increase their bond-buying activities and further de-value the absolute (if not relative) value of their currencies.
- Global investors should continue to steer clear of Europe. Trends in the Emerging Markets, particularly outside of the BRIC (Brazil, Russia, India, China), are improving, and may be an option for investors seeking to diversify away from the United States.
- Fixed income investors should continue focus on high-grade corporates over treasuries. Municipal bonds remain attractive and within the context of a diversified portfolio, some exposure to speculative-grade corporates may be appropriate for investors looking for yield.

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Model Portfolio	Mix: Stocks / (Bonds + Cash)	Risk Tolerance	Strategic Asset Allocation Model Summary
All Growth	100 / 0	Well above average	Emphasis on providing aggressive growth of capital with high fluctuations in the annual returns and overall market value of the portfolio.
Capital Growth	80 / 20	Above average	Emphasis on providing growth of capital with moderately high fluctuations in the annual returns and overall market value of the portfolio.
Growth with Income	60 / 40	Average	Emphasis on providing moderate growth of capital and some current income with moderate fluctuations in annual returns and overall market value of the portfolio.
Income with Growth	40 / 60	Below average	Emphasis on providing high current income and some growth of capital with moderate fluctuations in the annual returns and overall market value of the portfolio.
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Asset Class / Model Portfolio	All Growth	Capital Growth	Growth with Income	Income with Growth	Conservative Income	Capital Preservation
Equities:						
Suggested allocation	95%	75%	55%	35%	15%	0%
Normal range	90 - 100%	70 - 90%	50 - 70%	30 - 50%	10 - 30%	0%
Fixed Income:						
Suggested allocation	0%	15%	35%	45%	50%	60%
Normal range	0 - 0%	10 - 30%	30 - 50%	40 - 60%	45 - 65%	55 - 85%
Cash:						
Suggested allocation	5%	10%	10%	20%	35%	40%
Normal range	0 - 10%	0 - 20%	0 - 20%	10 - 30%	25 - 45%	15 - 45%

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