

THIRD QUARTER REVIEW

The stock market hit its high for the quarter in early July and then corrected sharply into early August. It was the worst quarter for stocks since 2008. The rest of the quarter was spent in a volatile trading range. The S&P 500 spent 40 consecutive trading days gyrating between 1,119 and 1,220 to close out the quarter. International markets didn't fare any better than our domestic markets, and the safety of U.S. Treasury securities provided one of the few safe havens during the quarter.

It was an eventful quarter during what are supposed to be sleepy summer months. Our government narrowly avoided a complete shutdown by finally coming to their senses and ending the bickering over the debt ceiling. The world took notice of our political process (or lack thereof), and not even a \$2 trillion rounding error by Standard and Poors prevented them from lowering the credit rating on the U.S. Government.

The ongoing saga in European debt markets also continued in the third quarter. There are real problems in some of the Eurozone countries, and there is an extremely high probability of some sort of default. Germany has been trying to strong-arm their Eurozone partners into austerity plans, but the progress has been slow. At this point, it seems Germany will continue its tough stance and continue to demand deeper spending cuts from countries on the brink of default.

All of this has contributed to U.S. consumer confidence being remarkably low. Frankly, with all that is going on, it is not surprising. High unemployment, sluggish consumer spending, high levels of consumer and government debt, a weak housing market, European debt problems, and a dysfunctional domestic political process have all played a role in the pessimistic tone of the U.S. consumer.

Although none of these problems are new, it seems that a sort of fatigue has set in. I sense that many investors expected that some of these

problems would be resolved by now and that a recovery would be well underway. So far the economic bounce-back has been underwhelming and the disappointment has been significant.

Is there any good news at all? A balanced view of the economy would have to point out that jobless claims are declining and employment is actually improving—just very slowly. The Federal Reserve, somewhat controversially, has declared that near-zero interest rates will be maintained at least through next year. Consumer spending is declining, but so is the level of consumer debt. The Case-Schiller housing index has been rising for four months in a row. The Leading Indicator Index is, very quietly, still rising. The amount of cash piled up on corporate balance sheets continues to expand, as earnings have generally been very good. As rough as the broad market has been, on a more granular level there are still many individual companies performing well. A fair observer would say that many of the positives are being overlooked.

We're left with the political process, both here and in Europe. Surveys show Americans to be deeply pessimistic, much as they were in the late 1970s and early 1980s when Americans were fatigued with oil shortages, rising commodity prices, inflation, and industrial decline. A lack of economic opportunity made Americans frustrated and that frustration fueled not just a recovery but a new economic boom. We don't know exactly when Americans' frustration quotient will erupt, but it is already apparent in the electoral process.

Of course, our relative strength investing approach is designed to adapt regardless of the current investing environment. The environment is incredibly uncertain at this point and opposing viewpoints are causing much of the recent volatility. These periods of uncertainty don't last forever. Trends emerge whether people want them to or not. This time won't be any different. We can't predict how long it will take, but as trends emerge our process will adapt to them.