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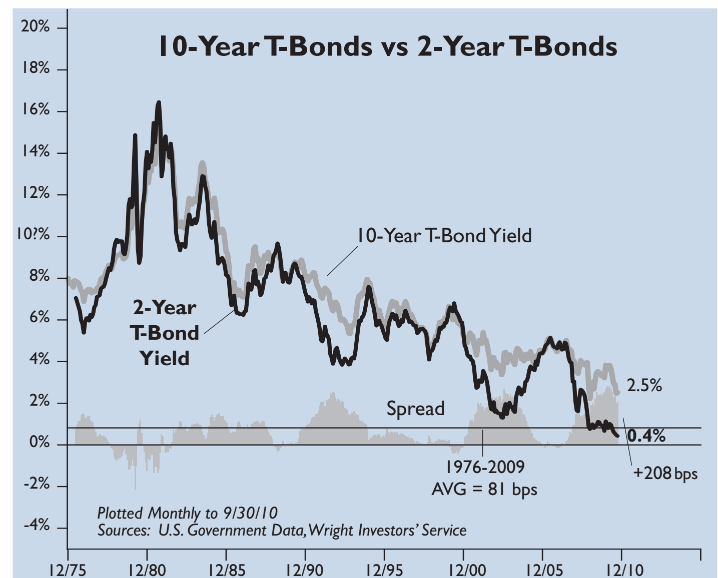
Quarterly Investment Report

October 2010

***SUMMARY:* The third quarter of 2010, though volatile, was the best for the S&P 500 in a year, while the Barclay's U.S. Aggregate bond index continued its string of positive returns. We expect the economic recovery to persist through 2011, but growth is likely to be below average. Even though economic and political uncertainties may keep investors on edge for a while, strong profit growth should support positive returns for equities over the next 12 months. Bonds will depend on coupon income and spread tightening for near-term returns.**

With stock market gains in July and September bracketing a pullback in August, stocks just about recouped the second quarter's losses in the third quarter. Stocks have been basically range bound for the last six months as concerns that the economy is on the verge of a "double-dip" have waxed and waned. Although data continues to paint a picture of lackluster growth, in the last month of the third quarter the economic data took a more positive bias, providing fuel for September's reversal of August's stock market retreat. The stock market also got help from the continuation of good news on corporate profits, with second-quarter profits for S&P 500 companies coming in about 10% above expectations. The European debt crisis, which has to take a lot of the blame for the second quarter's stock market retreat, is a long way from fully resolved, but investors seem to have more faith that the worst outcome will be avoided, if the appreciation of the euro compared to the dollar last quarter is any indication. Bonds also did some equivocating on the economy in the third quarter. Treasury yields moved sharply lower as investors seem to be expecting the Fed to have to make good on its commitment to more "quantitative easing" to keep the recovery going. At the same time, corporate spreads tightened and the yield curve remained steep, suggesting a more upbeat view of the economy. Investors' uncertainty contributed to the seemingly unstoppable rise in gold prices, which began the fourth quarter at a record price up 16% from its April low.



Last month was the best September for U.S. stocks in 71 years. U. S. stock market gains in July and September more than made up for August's slip, with the S&P 500 generating an 11.3% return for the third quarter; this was enough to put the S&P back in positive territory for the year to date with a 3.9% return. (The S&P was still about 6% below April's high price at the end of the third quarter.) The S&P's forward P/E multiple moved up less than a point in the quarter, perhaps an indicator of investor cautiousness but with a positive aspect also since it leaves room for further expansion. Although the VIX volatility measure declined in Q3 compared to Q2, it remained at an elevated level, suggesting that despite the stock market's solid showing for the quarter, investor uncertainty remains at a high level. The Nasdaq and Dow Jones Industrials also had returns in the 11%-12% range for the third quarter and are back in the black for the year to date. The S&P Midcap 400 topped the S&P 500 in Q3 with a 13.1% return, but the S&P SmallCap 600 lagged with a respectable return of 9.6%. All S&P 500 sectors had positive returns in Q3, with telecom and materials leading while financial and health care brought up the rear.

Global Investment Returns
In U.S. Dollars

	Q3 2010		9 MONTHS 2010	
	Stocks	Agg. Bonds	Stocks	Agg. Bonds
U.S.	11.4%	2.5%	3.5%	7.9%
Canada	13.2%	6.8%	7.4%	9.7%
Mexico	11.5%	8.3%	9.4%	17.6%
Japan	5.8%	7.0%	3.0%	14.8%
Pacific ex Japan	22.1%	N/A	8.0%	N/A
Australia	23.6%	12.5%	4.3%	11.3%
Hong Kong	21.9%	5.9%	17.6%	9.8%
Europe	19.4%	N/A	-0.6%	N/A
France	20.8%	13.8%	-5.8%	3.2%
Germany	16.6%	12.5%	-1.0%	2.8%
Italy	19.8%	14.0%	-12.9%	-0.9%
Netherlands	16.3%	12.1%	-0.1%	3.6%
Switzerland	13.3%	11.5%	4.0%	8.1%
U.K.	19.8%	10.0%	2.6%	7.2%
World	**13.8%**	**7.3%**	**2.6%**	**7.0%**
World ex U.S.	16.1%	10.8%	1.7%	6.4%

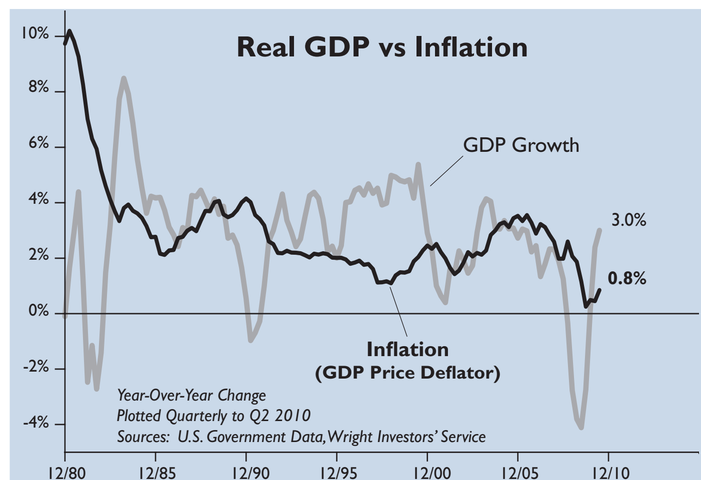
Sources: MSCI Stock & Barclays Capital Bond Indexes.

After trailing in the first half of the year, international stocks outperformed U.S. stocks in the third quarter of 2010. The MSCI World ex U.S. index of developed markets returned 16% in dollar terms in Q3, with more than half of the gain coming from depreciation of the dollar, which lost about 8% against the currencies in the index during the quarter. The risk that one of the euro region countries could default or that one or more major European banks could fail, which significantly affected stocks and currencies in Q2, continued to weigh on investors in Q3. But in the third quarter the euro gained more than 10% against the dollar, which suggests that investors saw less chance that one of these dire outcomes will come to pass. Euro region stock markets returned nearly 20% in dollar terms for the quarter. The only euro region stock market that declined in Q3 was Ireland, where the need for bank bailouts was again making headlines near the end of the quarter. The dollar also lost ground against the yen over the July-September period, though to a lesser extent than against the euro. In Q3, Pacific region markets returned more than 11% in dollar terms. The MSCI World ex U.S index is still lagging the S&P 500 for the year to date with a return of 1.7% (vs 3.9%).

Investors continued to pile into Treasury bonds in the third quarter. The yield on the 10-year Treasury bond declined by more than 40 basis points in Q3 to 2.5%, the lowest since January 2009, after declining 90 basis points in the second quarter. The entire Q3 decline came in August, when worries about a "double dip" were rising; in September, when stocks were advancing smartly, bonds did not give up any of their earlier gains. Continuing uneasiness about the economy and the European debt crisis as well as the low near-term inflation threat contributed to the appeal of Treasury bonds. Investors also see in the prospect of "quantitative easing" by the Fed the potential for yields to go somewhat lower. In its post-FOMC meeting statement in September, in addition to suggesting that further accommodation could come in the form of Treasury purchases, the Fed also indicated that the pace of recovery in output and employment had slowed in recent months, and that inflation is lower than it believes is consistent with maximum employment and price stability. The personal income and spending report for August showed the PCE deflator up just 1.5% over the past year. The Fed might be pleased that market inflation expectations (implied by the difference between the nominal and TIPS 10-year yields) rose in September, though they edged lower for all of the third quarter.

The Barclays U.S. aggregate bond index returned 2.5% in the third quarter of 2010, pushing its year-to-date return to 7.9%. In the third quarter, corporate bonds (+4.7%) and commercial mortgages (+6.4%) led the investment-grade market as spreads tightened. For the year to date, returns on investment-grade corporate bonds have topped 10% and commercial mortgage returns are approaching 20%. Treasury bonds also beat the Aggregate in Q3, returning 2.7% (8.7% year to date). Agency bonds, asset-backed issues, and mortgage-backed securities have all lagged the Aggregate and Treasury bonds for the year to date; widening spreads on mortgage and agency issues from unusually tight levels were not unexpected. U.S. non-investment-grade bonds (not included in the Aggregate) returned close to 7% in the quarter. The Barclays Global ex U.S. bond aggregate index returned nearly 11% in Q3, benefitting from the depreciation of the U.S. dollar.

In September, the NBER declared that the recession that began in December 2007 ended in June 2009, in line with the thinking of most economists. But investors were more concerned about when the next recession might begin than about when the last one ended. Final figures show that U.S. real GDP increased at a 1.7% annual rate in the June 2010 quarter, down from 3.7% in the first quarter. Growth in GDP and final sales of domestic product has been lackluster compared with previous economic cycles. Most of the Q3 data available doesn't suggest much improvement (although data released in September overall was more upbeat that that of July and August). On the top of the list of disappointments has been pace of the jobs recovery. Private sector jobs growth averaged under 80,000 per month over the last three months (total employment declined due to the loss of temporary census jobs), below what is needed to keep up with population growth, let alone make up for jobs lost in the recession. The 2.2% annual rate of growth in consumer spending in Q2 was the best since before the recession began, which shows just how tepid the recovery has been so far. Based on July and August spending data, the third quarter doesn't look much better. Housing also continues to disappoint, with sales and price recovery stalled.



Comparative Bond Returns Total Investment Return for a Ten-Year Treasury Bond*						
If Bond Yields at End of Period Are:						
1.6%	1.9%	2.2%	2.5%	2.8%	3.1%	3.4%
Next 12 Months — Annual Rate of Total Return:						
10.0%	7.5%	5.0%	2.5%	0.1%	-2.2%	-4.4%
Next 2 Years — Annual Rate of Total Return:						
5.8%	4.7%	3.6%	2.5%	1.5%	0.4%	-0.6%
Next 3 Years — Annual Rate of Total Return:						
4.4%	3.7%	3.1%	2.5%	1.9%	1.3%	0.7%

*: Estimated returns for a hypothetical 10-year 2.5% Treasury bond due September 2020 under various interest rate scenarios at 9/30/10.
Source: Wright Investors' Service

On the bright side, business spending continues to look pretty solid, supported by rising profits and improving corporate balance sheets. Businesses as well as consumers have deleveraged since the financial crisis of 2007 hit in 2008. Real spending on business equipment and software increased at a better-than-20% annual rate in the first half of 2010; the second quarter's increase was the best in more than 25 years. Based on recent trends in non-defense capital goods orders, the trend should continue. In the second quarter of 2010, S&P 500 profits came in better than 30% above Q2 2009's level (about 10% better than expected) and double-digit increases are expected to continue over the next 12 months. Government measures of profits also look strong: earnings are not back to peak rates, but profit margins have returned to prerecession levels, a testimony to the benefits of productivity improvement. Another sign of improving balance sheets: government data showed year-over-year dividend growth in the second quarter for the first time in more than two years.

Investment Outlook

While the third quarter's stock market gains brought relief after the second quarter's sell-off, there will be fuel for continuing stock market volatility over the next few months. On the plus side, we expect that the economy will avoid the "double-dip." (In fact, there has been only one cycle in recent memory that could be described as a double dip; in the typical postwar business cycle, the expansion phase has lasted almost five years.) However, in the third quarter the economy probably grew at a tepid rate only a little better than the second quarter's 1.7%. We expect that it could be some time before growth breaks out of this pattern, which is much slower than the growth rate that is typical after a deep recession. Despite the deleveraging achieved so far, consumer balance sheets need more work given damage done by lower home values and stock prices. Add to this the practically non-existent recovery in jobs and our conclusion is that consumers will continue to be cautious. Our forecast calls for modest increases in consumer spending, but not yet enough to propel the recovery into a more robust state, even though business spending is likely to continue to show satisfactory gains.

Developments outside of the United States may add to the volatility of U.S. markets over the next several months. Although the worst possible outcomes of the European debt crisis may be avoided, risks are still high. At best, growth in the euro region is likely to be dampened by government spending cutbacks and a reduction in confidence. Also a detriment to confidence, the risk of terrorist activity has recently ticked up a notch But there are also potential international developments that could make our economic forecast turn out to be too cautious. The recent weakness of the dollar, if it continues, will give a boost to exports, which have grown since the recovery began. Growth in emerging markets, particularly in China and India, is a positive for the global economy. A pick up in exports would be one reason for the jobs market to recover faster than we currently expect, a necessary condition for a stronger recovery.

Uncertainty about the outcome of the November election will weigh on U.S. markets over the next month. Investors would also be more comfortable knowing with certainty the future of the Bush tax cuts; at this writing it appears the matter will not be resolved until sometime after the election. But while stocks may be volatile for the rest of this year, the 12-month outlook is more positive. Whichever way the political and tax uncertainties are resolved, the uncertainty will be removed. (Our view is that the Bush tax cuts will be extended for most if not all taxpayers.) Stock prices will also benefit from a solid increase in corporate profits over the next 12 months. Despite some waffling on the economy, Wall Street still expects profits of S&P 500 companies to increase more than 35% this year and 14% in 2011. At just over 12 times year-ahead earnings, stocks have priced in much of the risk in the economic environment, so long as the current slow recovery does not turn into something

Historical and Prospective Returns from Equities and Bonds

Annual Rates of Return S&P 500 (9/30/10)	1950-2009	1950s	1960s	1970s	1980s	1990s	2000-02 Bear Mkt	2003-07 Bull Mkt	2008	2009	Projection Next 5 Yrs
Dividend Income	3.8%	5.1%	3.3%	4.3%	4.5%	2.5%	1.4%	1.9%	1.5%	3.0%	2.5%
+ Earnings Growth	5.6%	3.9%	5.5%	9.9%	4.4%	7.7%	-2.1%	12.0%	-23.2%	-8.6%	11.0%
+ Change in P/E Ratio	2.2%	10.4%	-1.0%	-8.3%	8.6%	8.0%	-13.9%	-1.1%	-15.3%	32.1%	-3.5%
= Total Return	11.0%	19.4%	7.8%	5.9%	17.5%	18.2%	-14.6%	12.8%	-37.0%	26.5%	10.0%
— Agg. Bond Return	6.2%	1.0%	3.0%	6.6%	12.3%	7.7%	10.1%	4.4%	5.2%	5.9%	3.0%
= Equity Risk Premium	4.8%	18.4%	4.8%	-0.7%	5.2%	10.5%	-24.7%	8.4%	-42.2%	20.6%	7.0%

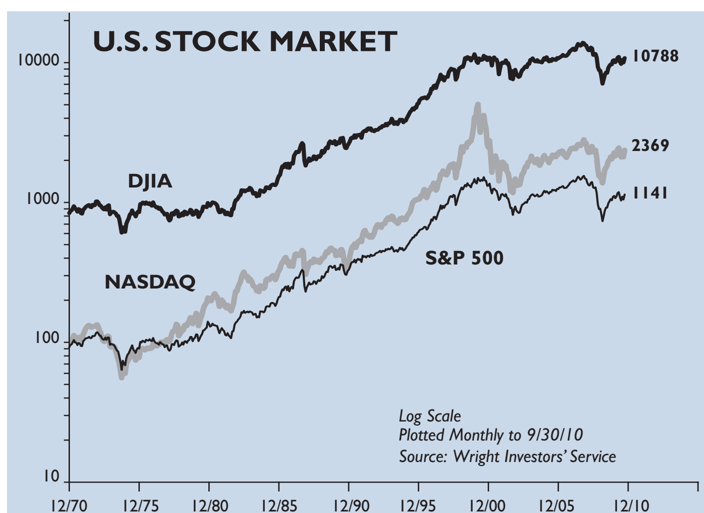
Source: Wright Investors' Service

worse. Even if P/E's stay at these low levels, earnings growth alone could make for attractive returns from equities over the coming 12 months, volatility in the near term notwithstanding.

It is unlikely that the Fed will change its near-zero interest rate policy until well into 2011 – if indeed it moves at all next year. The Fed's confirmation that "quantitative easing" is on the table suggests that it is worried about too little inflation rather than too much. Quantitative easing and low inflation suggest that we are not going to see much upward pressure on bond yields over the next 12 months. Looking forward, however, it is difficult to see much upside in low-yield Treasury securities except under dire economic conditions; if, as we expect, we avoid that outcome, next year's rates should be heading modestly higher as Fed tightening draws closer. Assuming global recovery stays on track, aggregate bond returns may be only slightly positive over the next two years, with coupon income and spread tightening offsetting higher Treasury yields. In the interim, continued volatility in stocks, along with Fed purchases of Treasury bonds, could work to the bond market's favor.

Long-Term Outlook

The unwinding of the financial excesses of the past decade will eventually result in a healthier global economy. The reduction of private sector leverage and the development of more rational financial markets would be positive for sustainable long-term growth. We continue to believe, however, that it will take several years for the global economy to shake off the effects of credit crisis and the steep recession of 2008-09. And in order for the beneficial effects of private sector deleveraging to be fully realized, governments around the globe will need to pare huge budget deficits incurred during the financial crisis, which will require a withdrawal of stimulus. As globalization continues, growth in the emerging markets of Asia, Latin America and Eastern Europe stand to benefit the developed economies as well.



The U.S. Economy 2008–2011

		% Change In			End of Period Rates	
		Real GDP*	PCE Core Deflator*	Profits from Operations#	90-Day T-Bills	10-Year T-Bonds
2008	Q1	-0.7%	2.6%	-17%	1.3%	3.4%
	Q2	0.6%	2.6%	-19%	1.7%	4.0%
	Q3	-4.0%	2.2%	-18%	0.9%	3.8%
	Q4	-6.8%	0.6%	-65%	0.1%	2.2%
2009	Q1	-4.9%	0.9%	-32%	0.2%	2.7%
	Q2	-0.7%	2.3%	-19%	0.2%	3.5%
	Q3	1.6%	1.5%	-6%	0.1%	3.3%
	Q4	5.0%	2.1%	199%	0.0%	3.8%
2010	Q1	3.7%	1.2%	54%	0.2%	3.8%
	Q2	1.7%	1.0%	34%	0.2%	2.9%
	Q3 e	2.3%	1.5%	24%	0.2%	2.5%
	Q4 e	1.5%	1.6%	22%	0.3%	2.6%
2011	Q1 e	2.3%	1.5%	9%	0.4%	2.8%
	Q2 e	2.8%	1.5%	5%	0.5%	3.0%
	Q3 e	2.9%	1.6%	15%	0.7%	3.2%
	Q4 e	3.0%	1.7%	16%	0.9%	3.5%

e: *WIS* estimate @ 9/30/10; *: Annual rates; #: Year-over-year chg. in S&P 500 e.p.s.
Sources: U.S. Government data, Wright Investors' Service.

While the current environment of subdued growth and high uncertainty may persist for quite a while, equity investors may still expect satisfactory returns over the next several years. The S&P 500 has moved up almost 70% from its 2009 low, but stocks are valued at levels that will allow prices to respond to improving profits, and we are optimistic about the outlook for corporate profits. Companies have invested heavily in productivity growth; the fact that businesses can do more with less has some negative implications in the short run – especially for employment. But over the long run, strong productivity growth supports an improved standard of living and tame inflation as well as healthy profit growth that should support higher stock prices. With corporations building strong cash positions, dividends may play a bigger roll in equity returns going forward than they have recently. We expect that stocks will outperform bonds over the next several years, but in the long run bonds should manage to provide modest positive real investment returns. *Wright Investors' Service* is steadfast in its view that diversified investment portfolios of high-quality assets are the best strategy for long-term investment success.

October 4, 2010

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