

Perspective

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UP AND DOWN MARKET

“Greed, fear, impatience and hope will all fight for mental dominance over the speculator.” – Jesse Livermore

Small fractures in stock market sentiment that were observed earlier in the year gave way in the third quarter to what effectively was a shattering of investor confidence.



Just a couple days after an agreement had been reached to raise the U.S. debt ceiling, Standard and Poor’s downgraded the sovereign debt obligations of the United States. This marked the first time in history debt of the U.S. was not rated AAA by every major domestic ratings agency.

While not the source of the stock market’s ongoing anxiety, the downgrade was certainly a catalyst for one of the most volatile quarters in post-war history. On August 8, the first trading day after the announcement, the VIX volatility index shot up more than 50% and closed at a level not seen since March of 2009. The remainder of the quarter saw the S&P500 move at least 3% up or down intraday 15 times.

Ironically, subsequent to the rating downgrade and in the face of all the indiscriminant selling in the stock market, prices for U.S. Treasuries jumped and yields fell to all time lows. In addition, the dollar strengthened substantially and insurance against default on U.S. sovereign debt remained the lowest of any major economic power. To be sure, investors around the globe feel the U.S. is still the ultimate safe haven regardless of its credit rating.

The true underlying fear on investors’ minds remains the inability of the European leaders to get out in front of their sovereign debt crisis. When the crisis first broke, EMU policy officials perceived the problem as a political issue. Consequently, the crisis did not receive the required assistance to stem an economic and financial contagion until recently. In fact, most of the centralized actions taken by European leaders over the last year have only exacerbated the region’s problems by tightening fiscal and monetary policy. Now, even though the region still has the necessary tools, and perhaps the political will to stabilize the region, it appears a Greek default or restructuring is all but inevitable.

Europe aside, an uncertain business climate has led to a continued downward trend in U.S. economic data. The Federal Reserve’s outlook has turned more guarded over the past few months and the risk of another recession has risen. As a result the Fed stated it would keep the Fed Funds rate at essentially zero through mid 2013, and it unveiled Operation Twist, where it plans to lower long-term interest rates by purchasing \$400 billion of long-term debt.

The market has been bombarded with bad news, and has undergone broad swings within a wide range throughout the quarter. However, the trading has been largely dictated by short-term traders based on macroeconomic headlines. Stock performance will ultimately be determined by the operating performance of the underlying companies.

There is a struggle between attractive relative stock market valuations and an array of escalating fears. While European and recession headlines will keep stock market volatility elevated, the truth is the underlying companies in corporate America have rarely looked better.

Market Measures*	% Change 3Q Ending 9/30/2011	% Change 6 Mo Ending 9/30/2011	% Change 1 Yr Ending 9/30/2011
Dow Jones Industrial Avg	-11.52%	-10.33%	3.65%
S&P 500 (Cap Wtd)	-13.87%	-13.80%	1.07%
NYSE Composite	-18.36%	-19.19%	-6.72%
NASDAQ Composite	-12.68%	-12.71%	3.00%
Russell 1000 Large Cap	-14.68%	-14.68%	0.91%
Russell 2000 Small Cap	-21.87%	-22.83%	-3.53%
Russell 1000 Growth	-13.14%	-12.50%	3.78%
Russell 1000 Value	-16.20%	-16.81%	-1.89%
S&P CitiGroup Growth	-11.56%	-10.12%	4.85%
S&P CitiGroup Value	-16.30%	-17.53%	-2.66%
Lipper Large Cap Value Fd	-14.81%	-15.40%	-1.07%
Barclays Capital Int Bond	2.39%	4.57%	3.40%
U.S. T-Bills (90 days)	0.03%	0.09%	0.16%
Consumer Price Index	0.50%	1.51%	3.85%

*Total Return

Market

After a jittery, but relatively flat, first month of the quarter, the stock market proceeded to experience strong volatility over the final two months that saw 2/3 of the trading days result in a change of at least 1% on the day. Amid concern

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Europe's debt crisis is spreading and the U.S. economy may slip into a recession, all indices were down significantly during the quarter and even briefly touched bear market territory – defined as down 20% from the recent peak. The S&P500 ultimately closed the quarter at a level first achieved in 1998.

S&P 500 Closing Prices

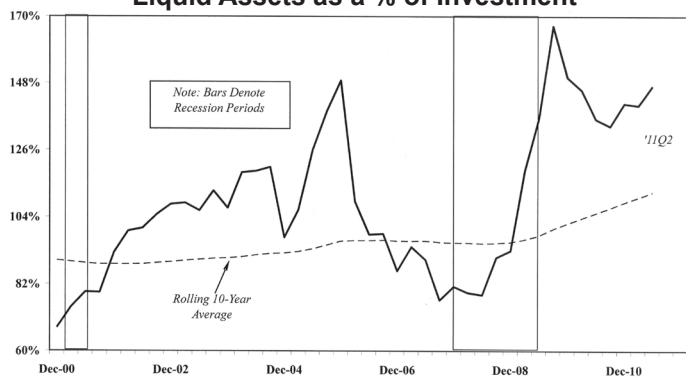


Source: Calculated RISK

The stock market typically leads the economy and performance for the quarter would indicate a high probability of recession. However, there can still be bear markets without recessions. In fact, looking at all post-war bear markets, the average drop in the market was -26% without a recession and -30% preceding a recession. Therefore, even if the U.S. economy does officially fall into a recession, it doesn't necessarily mean the market would deteriorate much further from last May's high.

Global financial pressures will no doubt continue to weigh heavily on the direction of equities. Nonetheless, even if Greece were to default, we believe the setback to the stock market, though violent, would be temporary. After Russia's default in 1998, which caused the collapse of hedge fund Long-Term Capital Management and sent the index down 15 percent in August, the S&P500 jumped 21 percent in the fourth quarter.

Liquid Assets as a % of Investment



Source: Wells Capital Management

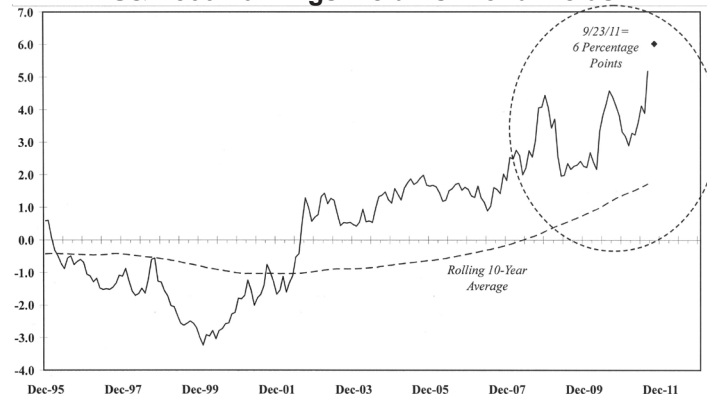
Companies are well positioned against the current pickup in volatility and uncertainty. Unlike 2008, companies currently have liquid assets that dwarf their short-term liabilities. In addition, borrowing on the part of companies has been primarily to refinance existing debt at lower costs or it has been precautionary borrowing to merely pad an already sizeable cushion against another credit crunch scenario. Furthermore,

resources from internally generated funds and excess liquidity of non-financial companies are more than 30% above long-term averages.

Relative Value

For the first time since 1962, the dividend yield on the S&P500 is greater than the yield on the 10-year Treasury. To add, the combination of strong earnings growth, attractive equity valuations and historically low interest rates have resulted in an unusually wide gap between the S&P 500 earnings yield and the yield on investment grade bonds (equity risk premium).

S&P 500 Earnings Yield Vs. Bond Yields



Source: Wells Capital Management

The forward P/E of the S&P500 is about 11 times, or 25% below its long-term average of 14.8 times. Put another way, the earnings of the S&P500 would have to drop from current estimates of just under \$100 per share to \$76 per share in order for the P/E to reach its long-term average. The market is pricing in a deep recession which may not occur.

Interestingly, as the economy has sputtered during the last couple of years, corporate earnings have climbed well above the pre crisis peak. Moreover, in the face of several downward revisions to GDP over the past few quarters, the earnings projected to be generated by the S&P500 in 2012 are more than six times as large as the index's earnings in 2008.

This may seem paradoxical, but it can be explained. The first reason is that companies have become far more efficient. Doing more with less is good for profits, but weighs on aggregate expansion.

The second reason is due to modest inflation. Both Headline and Core CPI have been edging persistently higher over the course of the year and each measure currently stands at three-year highs. Real GDP is adjusted for inflation and therefore real GDP percentage changes have been negative. However, nominal GDP, or growth in output before inflation remains positive. In fact, it has been proven over time that corporate earnings tend to do best in an environment of modest inflation such as the one we're currently experiencing.

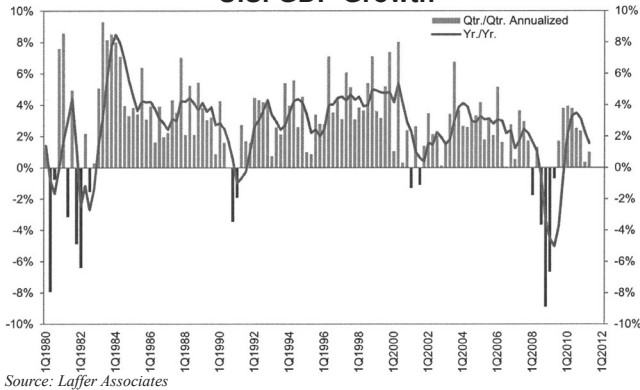
While we continue to believe inflation is something to monitor and will ultimately become a problem, near-term inflation risks remain in check due to corporate efficiency, large

economic output gap, low velocity of money, and a declining trend in commodities (stronger dollar).

Economy

Annualized GDP growth is expected to be around 1.8% in the third quarter, following 1.3% and 0.4% increases for the second and first quarters respectively. Not only do these numbers continue to remain well below past post-recovery trends, but a majority of the time less than 2% growth in GDP has occurred prior to or entering a recession.

U.S. GDP Growth



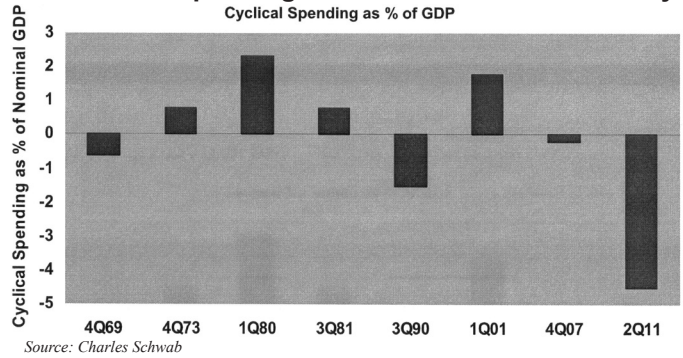
Moreover, the downturn in economic indicators has become widespread in terms of geography and the types of indicators. The slowdown has been worldwide, including the Emerging Market growth engines, and has been seen in manufacturing, consumer spending, consumer confidence and unemployment.

Rather than signaling recession, we believe the sputtering economic data more corroborates a view of a subpar recovery with persistent headwinds. In an environment of massive deleveraging and weak growth, monetary policy is extremely loose. In response, asset prices, including commodities, increase dramatically. In turn, this rising inflation causes emerging economies to tighten monetary policy and leads to slowing economic growth. Combined with uncertainty stemming from anti-business legislation, this negative cycle creates a slow-growth, choppy environment.

Recessions often result from excesses in need of a correction. Since the end of the recession two years ago, the recovery has not really generated any excesses. Housing and small businesses never really recovered from the recession, and manufacturing gains have been associated with restocking bare inventories. Growth has remained below potential and it's difficult to recess something that's already flat.

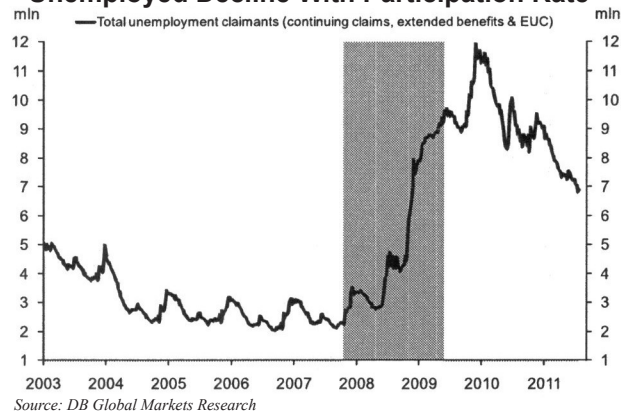
In fact, investment is never this low heading into a recession, and the lack of aggregate demand over the past couple of years suggests pent up demand for the future. Small businesses have neither been confident nor willing to spend on investment because of government regulation and red tape. Cyclical spending (investment) as a % of GDP is at extraordinarily low levels as too much uncertainty has kept businesses from building new plant and equipment.

Investment Spending Prior To Recession Vs. Today



The national unemployment rate was 9.1% at the end of September, the 6th consecutive month that the rate has been at least 9%. Since 1950, the longest streak of 9% or greater unemployment is 21 consecutive months from May 2009 through January 2011.

Unemployed Decline With Participation Rate



The employment problem has been prolonged compared to other post recession recoveries, especially to those of 1980 and prior. Over six million people have been unemployed more than 27 weeks – more than double the peak in 1983. However, heading into the 2008 recession the participation rate and the employment to population ratio were far higher than those of 1980. As the long-term unemployed leave the workforce, and the participation rate has declined back to 1980's levels, the unemployment rate should continue to contract from its 2010 peak.

Sovereign Debt Crisis

Greece is expected to receive the release of the 6th tranche of its 2010 bailout at the beginning of the fourth quarter to survive another 3 months. The total loaned to Greece so far is 73 billion out of the 110 billion euros that was committed in May 2010. A second bailout of 109 billion euros was committed in July 2011.

Greece can either persist with its unprecedented fiscal squeeze for a decade or more, with the risk of further social collapse, or it can devalue and take the pain overnight. We believe the debt burden taken on by Greece cannot be paid in full. The only question is how much of the debt will be marked down and when. European leaders have already shifted from promising to prevent a Greek default to promising instead to

ensure that European banks are well capitalized.

The International Monetary Fund has estimated European banks may face potential losses of up to 300 billion euros. Most of those banks are French and German. The vast majority of U.S. financial institutions do not hold large amounts of troubled sovereign debt, and even those exposed in the U.S. are highly capitalized, and can absorb any significant write downs.

It remains in the best interest of Greece to default, and to leave the euro so it can depreciate its currency. Previous defaults in Iceland, Argentina and other emerging markets suggests, post-devaluation, the economy could be growing again within a year or so. However, the only way to get new international capital after a default is for Greece to cancel enough of its legacy obligations that new investors reasonably expect the country to make good on any new funding that is provided.

A full-blown financial contagion coming out of Europe would be extremely serious, but it is not likely at this point in time. The lack of success in curtailing the problem thus far has been due to the relatively small effort to get out in front of the problem. There are many tools at the EMU's disposal that have yet to be used – and it now appears they have the will to use them.

The more likely fallout from the crisis in Europe is sluggish economic performance which will impact U.S. export markets. Almost 1/3 of U.S. goods and services exports went to European buyers, which is substantial. However in 1990, the world's second largest economic power, Japan fell into a deep recession – and the rest of the world proceeded to have an economic boom. In addition, today there are several other burgeoning economies to help pick up any slack in European demand.

Outlook and Conclusion

The following is a summary of some of the indicators that guide our equity investment policy:

Commodity Prices	Turning
Earnings Growth	Positive
Fiscal Policy	Negative
Earnings Momentum	Turning
Inflation	Positive
Interest Rates	Positive
Monetary Policy	Positive
Yield Curve	Positive
Price to Book	Neutral
Price to Dividends	Neutral
P/E Ratio	Neutral
Volatility	Negative
Technical Outlook	Negative

To summarize our current thoughts:

- Inflation outlook still positive in intermediate term
- No economic contraction, but sputtering
- Unemployment persistently high but coming down
- Corporate profits still growing
- Volatility persists as Europe remain unresolved
- Treasuries are overvalued
- Dollar testing upper boundaries
- Price of oil continues to ease
- Budget deficit expanding

The effects of the 2008 financial meltdown continue to linger. The problem has been shifted from the private sector to the public sector and deleveraging has been painful and slow. Now that the public sector has been burdened, and has fewer monetary and fiscal stimulus options, a renewed crisis of confidence has emerged.

At the same time, stock markets have traded down on the Euro region scare, believing a probability exists that the crisis will trigger a global financial dislocation similar to 2008. Markets are not out of the woods until there is some sort of resolution in Europe. Slowing growth around the globe, combined with a European induced credit squeeze, all but ensure economic contraction ahead.

The U.S. is in much better shape than Europe. As opposed to 2008, now U.S. banks are very well capitalized, and consumers have much less debt. Meanwhile stocks are supported by fairly cheap valuations, as earnings remain relatively strong, and corporate cash hoards are the dry powder for stock buybacks, takeovers, dividend increases, or riding out any impending storm.

Extreme pessimism is a contrarian indicator, and the basis for strong returns in the stock market has historically come during periods lacking confidence. We believe markets often turn when sentiment is at its worst.

While we still believe the U.S. will avoid a recession, the economic recovery is stagnating. The unstable macro environment is likely to persist for the foreseeable future, and there will continue to be significant swings in the market.

Valuations can remain low for a long time. Pessimism can hang around for a while. However, the dividend yield on the S&P 500 is above the 10-year treasury yield and the market's P/E ratio is well below its long-term median. Historically, these valuations have rewarded patient investors.

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