

P E R S P E C T I V E S

October 26, 2010

Executive Summary

The belated declaration in September by the National Bureau of Economic Research that the Great Recession officially ended in June of 2009 was unremarkable, and we remain focused on the more important questions of whether we will avoid a second recession and, if so, how the global economy and financial markets will fare in the wake of the Great Recession. We do not discount the possibility of a “double-dip” recession, but we believe that, given the current conditions, such an outcome is unlikely. We expect the recovery to be restrained and irregular, but it should continue unless there are any policy mistakes or major shocks to the economy. Longer-term, however, we remain concerned about high unemployment, housing weakness, high budget deficits, and consumer debt reduction. In light of this economic outlook, our general investment thesis is that today’s environment of low inflation, accommodative monetary policy, and moderate economic growth continues to favor select risk assets over risk-free assets such as Treasuries. Over the next several months, however, many concerns must be addressed, and we remain poised to assume a more defensive tactical posture if necessary.

Review

U.S. Equities. In our last issue of *Perspectives*, we reported on the abrupt decline of the equity markets during the second quarter of 2010. We noted that, after having produced substantial gains over the four preceding quarters, each of the Dow Jones Industrial Average, the S&P 500 Index, and the NASDAQ Composite Index experienced significant declines and heightened volatility.

In the third quarter of 2010, the equity markets resumed their winning ways, generally reversing their second-quarter losses and moving back into positive territory for the year. Bolstered by a convergence of strengthening corporate balance sheets and growing confidence that the Federal Reserve will take further action to strengthen the economy, the Dow returned 11.1%, while the S&P 500 and NASDAQ returned 11.3% and 12.3%, respectively, for the quarter. For the year, the Dow is now ahead 5.6%, the S&P 500 is positive 3.9%, and the NASDAQ is up 4.4%.

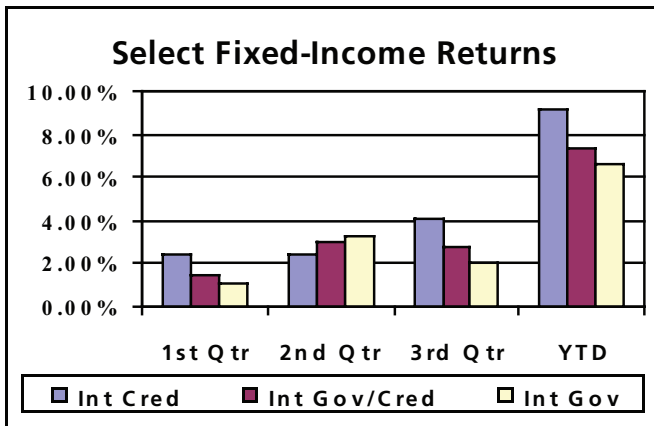
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U.S. Fixed Income. As investors again embraced riskier assets, the fixed-income markets largely underperformed the equity markets during the third quarter. Nevertheless, fixed-income investors benefitted from respectable returns on the strengthening of corporate balance sheets, an increasing conviction that there will not be a “double-dip” recession, the growing expectation of moderate growth and low inflation, and the uncompetitive yields offered by cash.

For the quarter, corporate debt generally outperformed government debt — a reversal from the prior quarter. The Barclays Capital Intermediate Credit Index of corporate bonds was up 4.1%, and the Barclays Capital Intermediate Government/Credit Index of government and corporate bonds was up 2.8%. The Barclays Capital Intermediate Government Bond Index lagged behind but was up 2.1%, and the Barclays Capital 1-10 Year Municipal Blend Index, which includes municipal bonds from around the country, finished the quarter ahead 2.4%.

In turn, bond yields generally fell during the quarter, prompting large issuances of debt by corporations seeking to borrow at low rates. “Spreads” of investment-grade bond yields over Treasury yields fell from approximately 2.0% to just over 1.8% during the quarter.

Real Assets. During the third quarter, a declining dollar, strong demand from the emerging markets, extreme



weather, and growing confidence in the recovery pushed many commodity prices higher. The Dow Jones UBS Commodity Index returned 11.6%, but, as was the case last quarter, its components were mixed.

While various agricultural commodities posted substantial gains during the quarter, energy commodities were mixed. Increased supply forced a 16.1% drop in natural gas prices. In contrast, oil traded in a narrow range throughout the quarter but ultimately rose 5.7% to \$79.97 per barrel on continued emerging-market demand. Such demand also led to higher prices for certain industrial metals, including copper, which rose 24.2% in the quarter. Gold was up 5.3% for the quarter, to \$1,307.80 per ounce, as investors became increasingly concerned about the efforts of central banks to devalue their currencies.

U.S. Dollar. During the third quarter, “stress tests” performed on European banks were relatively positive, economic data out of Europe was better than expected, and the European Central Bank declined to engage in further quantitative easing. As a result, the euro rose 11.5% against the dollar. The dollar also fell against other major currencies, including a 5.6% drop relative to the Japanese yen. The U.S. Dollar Index finished the quarter down 8.5%, erasing last quarter’s gain of 6.1%.

International Markets. Last quarter, the international markets were weighed down by the European debt crisis, concerns about a possible slowdown in China, and uncertainty about economic growth. During the third quarter, the international markets appeared to overcome these concerns, as the Dow Jones Global Index, excluding the U.S., was up 15.9%.

The MSCI Emerging Market Index gained 18.0% for the quarter, with indices in Thailand, Indonesia, and India gaining approximately 22%, 20%, and 13%, respectively.

The Shanghai Composite Index has been among the worst performers of 2010, but even it gained about 11% for the third quarter, reducing its year-to-date losses to about 19%.

The MSCI EAFE Index of developed economies gained 16.5% for the quarter, with indices in France, the U.K., and Germany all posting gains. Japanese markets continued to struggle, however, with the Nikkei Index still down about 11% for the year.

Analysis

With little fanfare, the National Bureau of Economic Research declared on September 20th that the Great Recession that began in December of 2007 ended — after 18 months — in June of 2009. We now know that the Great Recession lasted longer than any recession since World War II, surpassing the 16-month recessions of 1973-75 and 1981-82.

In our view, however, the end of the recession was not new information — a view shared by the financial markets, which began discounting the end of the recession as early as March of 2009. For several months, we have been focused on the more important questions of whether we will avoid a second, “double-dip,” recession and, if so, how the economy and financial markets will fare in the wake of the Great Recession.

As we have written before, we do not dismiss the possibility of a double-dip recession, but we believe that such an outcome is less likely given the current conditions. We expect the recovery to remain moderate, fragile, and uneven, but it should be sustainable in the absence of any policy mistakes or major shocks to the economy. Longer-term, however, we remain concerned about lingering impediments such as high unemployment, housing weakness, high budget deficits, and consumer debt reduction.

In light of this outlook, our general investment thesis is that low inflation, accommodative monetary policy, and moderate economic growth presently continue to favor select risk assets over risk-free assets such as Treasuries. In this issue of *Perspectives*, we will focus our analysis on the critical issues of monetary and fiscal policy, currency trends, and the relative strength of the financial markets.

U.S. monetary policy remains supportive of the recovery process. A year ago, many predicted that the process of tightening monetary policy in the U.S. would begin in 2010. In turn, interest rates would rise, the dollar would be strengthened, inflation would be rekindled, and equity and bond values would decline. These predictions now

appear premature, as the financial markets seem to be pricing in further *easing*, not tightening.

Specifically, in addition to keeping interest rates low, the Fed appears poised to announce at its meeting on November 3rd (the day after Election Day) that it will start a second round of quantitative easing, known as “QE2,” in which it may begin another program of purchasing long-term Treasury securities. In theory, this action would cause longer-term interest rates to fall, the dollar to drop, and riskier assets to rise in value, much as occurred when the Fed launched its first round of easing.

Our view is that as Fed officials outwardly have implied the possibility of QE2, the financial markets have been pricing it in and that much of the latest rally in risk assets has been attributable to expectations of QE2. Therefore, should QE2 come to fruition, we do not expect a dramatic further response from the financial markets. If, however, QE2 falls short of market expectations, a retrenchment in risk assets could occur. Nevertheless, our underlying premise remains that, whether or not QE2 occurs, U.S. monetary policy should remain accommodative and interest rates should remain low for the foreseeable future. Indeed, the futures markets are not pricing in an increase in the federal funds rate until November of 2011.

Monetary policy abroad is less coordinated and predictable. Expectations surrounding QE2 in the U.S. have helped to drive down the value of the dollar relative to the euro. In turn, European exports have been pressured, and an already fragile European economic recovery has been strained. Yet, the European Central Bank has not responded to the Fed’s apparent plan with its own plan for further easing. We believe that, eventually, the ECB will be forced to engage in some form of further easing, but, until it does, further weakness in Europe, particularly in Greece, Spain, Portugal, Ireland, and Italy, seems likely.

In contrast, within the more robust emerging markets, low interest rates have been stimulative, leading some countries to take steps toward tightening their monetary policies. While tightening could lead to slower growth, it is important to note that such activity is beginning in the context of an already stimulated environment. Furthermore, the global backdrop of low interest rates is likely to remain in place for some time, continuing to bolster the emerging markets.

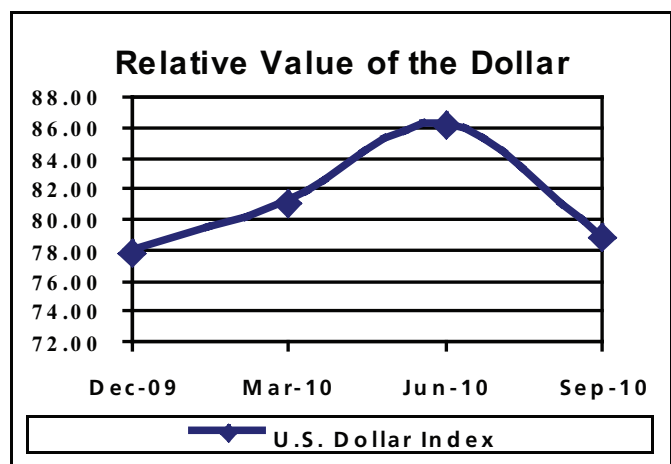
Accommodative fiscal policy has become scarcer. While we expect monetary policy to remain favorable within many of the world’s developed economies, the governments responsible for those economies may no longer be

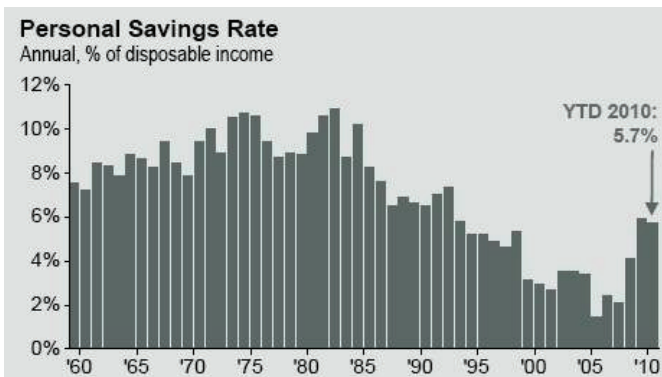
able to rely on fiscal policy, e.g., tax relief and spending programs, as they seek to support growth. Large public debt, budget deficits, and political forces have impaired the ability of governments to adopt fiscal stimulus programs similar in scope and magnitude to those that they adopted during the Great Recession. In fact, a significant countertrend appears underway, as state and federal tax increases in the U.S., coupled with austerity measures in Europe, could function as an encumbrance to growth. While we do not believe that fiscal retrenchment is likely to derail the recovery, we remain alert for policy mistakes that could necessitate a tactical shift in our investment strategies.

Currencies are now being used as another policy tool. On September 28th, Brazil’s Finance Minister, Guido Mantega, warned of an “international currency war.” Mr. Mantega’s comments followed a period of declines by the dollar, as well as recent moves by Japan, Taiwan, and South Korea to devalue their currencies.

We are monitoring developments in the currency markets for several reasons. In our view, provided that the decline of the dollar remains gradual and orderly, it should bolster the recovery. A lower dollar means that U.S. exports generally are more affordable to foreign buyers and are increasingly competitive globally.

Yet, the dollar’s decline is a relative phenomenon. As the dollar has fallen, for example, the euro has risen. In turn, a stronger euro could put additional pressure on European exports, thereby hampering an already fragile recovery there. We note, however, that the euro remains well off its historic levels and may still be sufficiently devalued to support European trade. We are carefully watching developments with the euro as a potential indicator of future strength or weakness in Europe.





Sources: Bureau of Economic Analysis; J.P. Morgan Asset Management

The financial markets continue to offer select opportunities for investors. In our opinion, the U.S. equity markets should continue to benefit from rising earnings, low inflation, accommodative monetary policy, and moderate economic growth. They should also be supported by strengthening corporate balance sheets, which, by historical standards, are flush with cash — cash that can be used for stock redemptions, dividends, acquisitions, or capital spending. In fact, capital spending has begun accelerating, fueled by lower borrowing costs, depleted stocks, and improving profits.

We also are encouraged by improvements in the household savings rate, durable goods orders, and other reports that suggest potential increases in future consumer spending. Certain employment trends continue to improve, albeit slowly, and spending on larger items such as homes and automobiles is positioned for an increase. Annualized automobile sales were approximately 11.7 million in September, compared to about 16 million prior to the Great Recession. As automobiles continue to age and population increases, automobile purchases become more likely. Similarly, housing starts are now down approximately 70% from their pre-recession peak. Yet, this level is below the level needed to accommodate new household formation, suggesting future increases in activity. Nevertheless, the timing of an increase in housing activity is dependent on a reduction in the inventory of unsold homes and the number of homes in the foreclosure process.

Fundamentally, at the close of the quarter, the S&P 500 was trading at about 12.3 times forward earnings. By historical standards, this is a reasonable valuation, as the 15-year mean forward P/E ratio of the S&P 500 is 17.2.

Internationally, we continue to favor select developed and emerging markets, with an emphasis on the emerging markets and a range of commodities that can benefit from increasing emerging-market demand. Many emerg-

ing markets have been experiencing strong business activity, rising asset prices, and, in turn, a healthy recovery process. Yet, the emerging markets still are broadly trading at about 11.7 times forward earnings, lower than their historic norms and lower than the forward P/E ratio of the S&P 500.

With respect to bonds, our view is that Treasury yields eventually will begin to rise (and Treasury prices will fall) as the economy continues to recover and risk assets continue to rise in value. Having performed well for much of the year, investment-grade corporate bond gains may be more subdued.

Conclusion

By region and asset class, the global economy has become more complex and more divergent. Within the U.S. and many other developed nations, we expect the recovery to continue in moderate and uneven fashion absent any policy mistakes or major shocks to the economy. Longer-term, however, we remain concerned about unemployment, housing, high budget deficits, and continued consumer debt reduction. We currently are less optimistic about Europe and more optimistic about the emerging markets.

We continue to favor select risk assets, such as U.S. and emerging-market equities, certain commodities, and certain bonds, but we remain prepared to assume a more defensive tactical position if necessary. As always, the best defensive strategy in light of uncertainty is a well diversified, yet tactical, asset allocation strategy.

Sources: BCA Research, FactSet, Bloomberg, the *Wall Street Journal*, Bureau of Economic Analysis, Federal Reserve Board, J.P. Morgan Asset Management, and National Bureau of Economic Research.

This newsletter represents the opinions of The Colony Group, contains forward-looking statements, is subject to alteration based upon changing market conditions, and is general and educational in nature. It should not be construed as providing investment advice.



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