Bellwether CONSULTING

Your Quarterly Update on the Financial Markets
September 30, 2010

3rd Quarter

MARKET Recap

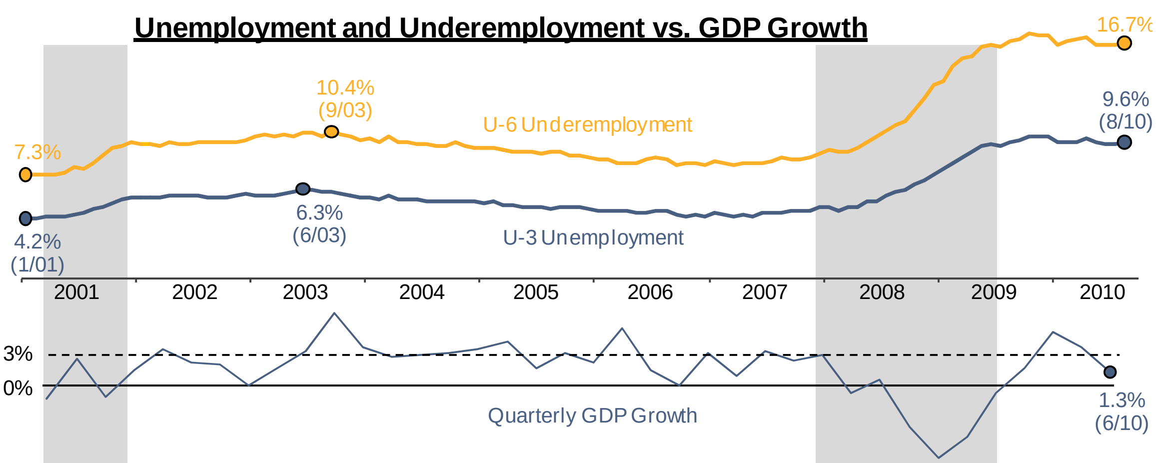
The Economy: *"Structurally Slow?"*

U.S. economic growth continued to slow in the second quarter, to a 1.3% annual pace from a peak of 5%. Personal consumption expenditures increased, as did government spending primarily at the federal level, but these increases were more than offset by a sharp acceleration in imports and deceleration in inventory spending. While a reduction in the pace of growth was widely anticipated, the relatively low pace coupled with low employment prompted widespread fears of a double-dip recession and very high expectations for another round of quantitative easing by the Fed.

> "The bigger issue is mismatch. Firms have jobs, but can't find appropriate workers … The mismatch problems in the labor market do not strike me as readily amenable to the kinds of monetary policy tools currently available to the Fed. But they may well be amenable to other types of policy tools, like job retraining programs or foreclosure mitigation strategies…"
>
> Narayana Kocherlakota, Minneapolis Fed
>
> "… How should monetary policy respond to a slow recovery? My answer to that question is: vigorously, creatively, thoughtfully, and persistently, as long as we have options at our disposal. And we *do* have options…"
>
> Eric Rosengren, Boston Fed

However, in September we got a real treat – debate at senior levels within the Fed aired in public, in a polite and technical way that is as close as that group ever gets to a cage match. At issue is the Fed's role in creating full employment in a post-recession environment. In a speech in Missoula on September 8th, Fed Bank of Minneapolis President Kocherlakota expressed concern that current levels of unemployment are due to increasing levels of mismatch between the skills and locations of workers vs. the needs and locations of employers. Although he never actually used the term, he raises the issue of "structural" unemployment; in the field of political economics it is a hotly debated issue, and it tends to surface regularly after recessions, as employment growth lags expectations. Recessions tend to eliminate less productive companies, and cause the survivors to become more efficient; in the process, the skills required of the workforce often change and generally increase. If workers do not improve their skills commensurately, they can be left behind – unemployed or underemployed. The housing crisis underlying the recent recession may increase the effect, argues Kocherlakota – "For example, there may be jobs available in eastern Montana and western North Dakota because of the oil boom. But a household in Nevada that is underwater on its mortgage may find it difficult to move to those locations."

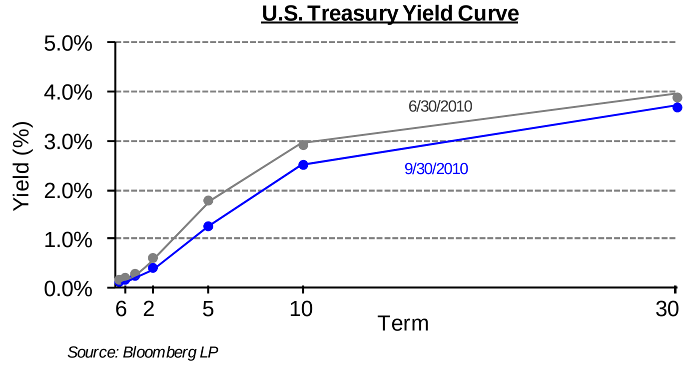
Why is the notion divisive? It is often used to argue against loose money and spending. Fed Bank of Boston President Rosengren responded in a speech on September 29th by arguing the Keynesian line, that current unemployment is driven by slow aggregate demand, and therefore vigorous policy responses are appropriate. Growth of 3% seems necessary to drive down unemployment to levels we've come to expect as a society; and, it appears near-full employment is necessary (but not sufficient) to sustain high levels of growth; hence the call for stimulus following last quarter's decline.



It seems the consensus of the Fed is to ease further as long as growth is below 3% and consumer prices are not rising. However, our point is that there is in fact dissent. Currently market participants are as certain of large-scale easing as they are of the sun rising; we think the Fed's actual conviction on stimulus is lower than the markets perceive.

The US Bond Market

At the close of the third quarter, treasury yields remained pinned on the short end of the curve and had moved down 20 basis points on the very long end. The most significant yield drop was 50 basis points in the 5 to 7 year range. The benchmark 10-year yield ended the quarter at 2.51%, very close to its January 2009 lows. Five-year yields ended the quarter at 1.26%, back at 2008 levels. The difference in yields between the 2-year and 10-year notes was 201 basis points, narrowing 22 basis points from the end of 2Q 2010, as the yield curve flattened modestly. As investors have flocked into the relative security of fixed income investments, concerns have surfaced that a bond bubble is building, especially in Treasuries.



The Fed made headlines during the quarter, acknowledging that their confidence in the recovery had dimmed, with the release from their August 10 meeting stating that the nation's economic recovery was "likely to be more modest in the near term than had been anticipated." The Fed kept interest rates low in an attempt to encourage economic growth. They also signaled that more aggressive measures could follow if the job market and other indicators continued to weaken and announced they would begin to purchase longer-duration Treasury securities, the first outright purchase of U.S. government debt since October 2009. Presumably an attempt to put downward pressure on long-term rates and stimulate borrowing, the purchases will be funded with principal payments from the $1.25 trillion in mortgage-backed securities and $175 billion in government agency debt (primarily from the housing finance entities Fannie Mae and Freddie Mac) the Fed purchased from January 2009 to March 2010, a reversal of its plan to allow the size of that portfolio to shrink gradually.

Q3 Index Total Returns	
BarCap Aggregate	2.48%
BarCap Interm. Gov't	2.13%
BarCap Long Gov't	5.26%
BarCap Interm. Credit	4.07%
BarCap Long Credit	6.33%
BarCap High Yield	6.71%

Bond investors willing to take on some risk were rewarded during the quarter. Corporate bonds outperformed their like-maturity government peers as both investment-grade and high-yield corporate bond spreads narrowed over the course of the quarter. Driven by investor demand for bonds and the low-yield environment, companies have been accelerating their issuance of debt. September saw the issuance of over $125 billion in bonds, according to Informa Global Markets, the highest amount of the year.

In mortgage-backed securities, spreads widened in the third quarter. Issuance jumped to $328 billion year-to-date, according to Thomson Reuters. This figure was up 58% from the same period in 2009. However, at $91 billion, third quarter issuance represented a slow-down from the prior quarters in 2010. Not surprisingly, 95% of new issuance this year was by government-sponsored Fannie Mae, Freddie Mac, and Ginnie Mae, as investors refuse to buy securities backed by loans where payments are not guaranteed.

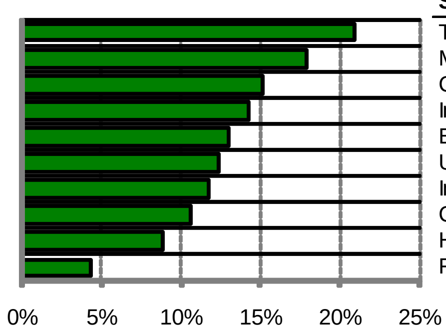
The US Stock Market

In a turnaround from the second quarter, the stock market ended the third quarter firmly in the black, with most major indices posting double digit positive returns after a September rally. By all accounts the Fed's August announcement that it would try to bolster the economy by buying long-term Treasuries along with subsequent talk of additional quantitative easing was the trigger for a bull market that yielded the best September for the S&P 500 since 1939 and moved the broad market indices into positive territory for the year to date. After returning 8.92% for September, the S&P 500 ended the quarter at 1,141. The NASDAQ, which had its best September since 1998 returning 12.10%, closed the quarter at 2,368, while the Dow ended the quarter at 10,788.

Q3 Index Total Returns			
Largecap Stocks		**Midcap Stocks**	
S&P 500	11.29%	S&P Midcap 400	13.12%
Russell 1000	11.55%	Russell Midcap	13.31%
Growth	13.00%	Growth	14.65%
Value	10.13%	Value	12.13%
Broad Markets		**Smallcap Stocks**	
NASDAQ Comp.	12.54%	S&P Smallcap 600	9.62%
DJ Wilshire 5000	11.07%	Russell 2000	11.29%
		Growth	12.83%
		Value	9.72%

In the capitalization sectors midcap stocks took the lead for the quarter, with largecap stocks also posting stronger returns than their smallcap counterparts. This led to some speculation about an imminent blue-chip rally, a prediction that has been regularly surfacing since the tech bubble burst especially after the global financial panic in 2008. The theory that investors would increase their appetites for industry-dominating firms with steadier growth in uncertain times seemed to make sense, but it has not happened to date. Both 2008 and 2009 saw smallcap stocks outpacing their largecap counterparts, and the relatively modest edge largecaps had over smallcaps in the third quarter was not enough for them to take the lead year-to-date in 2010. Since largecap stocks tend to have greater exposure to foreign markets, including emerging markets like China, and many of these firms have been accumulating cash since the financial crisis, it would stand to reason that they would be positioned for greater growth. As always, predicting the timing on an eventual comeback is tricky. Historically, smaller, more nimble companies on average have outpaced blue chips in the early part of most rallies.

S&P 500 Economic Group Components - Total Return



Sector	3Q2010
Telecom	20.96%
Materials	17.84%
Consumer Disc.	15.17%
Industrials	14.31%
Energy	12.95%
Utilities	12.35%
Info Tech	11.78%
Consumer Staples	10.63%
Health Care	8.86%
Financials	4.33%

Source: Standard & Poor's

All industry sectors of the S&P 500 had a positive quarter, although there was a big difference between the top-performing Telecom sector and the worst-performing Financials sector. Performance in Financials was hampered by bank stocks, which were the worst performing group in the S&P 500 (and the S&P 400 as well as the S&P 600) as the impact of the new global banking regulations agreed upon in Basel, Switzerland earlier in September and the associated rise in required capital ratios concerned investors. The rules are to be phased in over an extended period with the first rules taking effect in 2013 and the remaining standards in place by 2020. The Bank for International Settlements, an international organization of central banks which fosters international monetary and financial cooperation and serves as a bank for central banks, produced research that showed these increases should lead to a reduction in the frequency of financial panics at a minimal cost to growth.

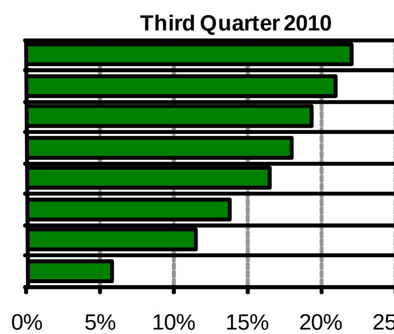
Finally, data released during the quarter showed a backlog building in IPOs, as industry researchers noted the highest number of firms in the IPO pipeline (161 companies toward the end of the quarter) since the 2000 peak of the dot-com boom and the largest dollar amount ($56 billion) on record. Industry analysts point to the backlog as a function of stock market volatility over the past 3 years and the financial crisis resulting in an 18-month capital markets freeze that prevented companies from raising money. Unlike 2000, many of the firms in the pipeline are larger established companies that were taken private during the buyout boom in 2005 – 2007.

Overseas Markets

In a quarter that continued to be marked by significant volatility global developed and emerging markets performed well. Markets were able to shrug off continued sovereign debt concerns, failed “stress tests” by some Eurozone banks, forecasts of subdued Eurozone growth, and a slowdown in growth in China.

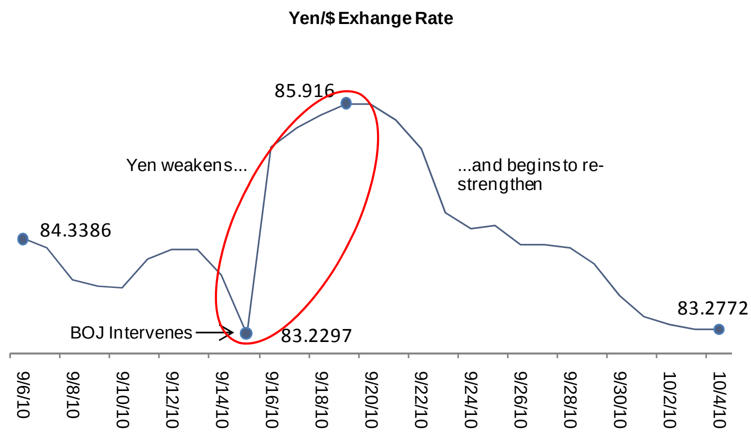
Mixed news out of the Eurozone did not seem to hamper performance. The quarter began with the IMF projecting fiscal consolidation of about a half a percent of GDP that would lead to a cut in growth in Europe by about a quarter percentage point in 2010. However, the negative impact from tighter financial conditions would be offset by depreciation of the euro. Eurozone banks tightened credit standards for loans to businesses and households, according to the European Central Bank's July bank lending survey. The degree of tightening in lending to households and businesses exceeded forecasts as tighter policies were put in place to control funding and liquidity management by banks. According to the ECB, loan demand continued to recover in the second quarter. As the quarter drew to a close, the cost of insuring European corporate and sovereign debt against default rose again driven by fears about global growth and rising government deficits. ECB President Jean-Claude Trichet warned that the current rate of economic expansion in Europe is unlikely to be sustained after the summer, reigniting fears around government debt. Concerns centered on Ireland (due to the cost of bailing out its banks), and widening spreads on Greek CDS (30 basis points) after Greek GDP fell 1.5% in the second quarter. The ECB extended its program of emergency loans into early 2011 and left its key lending rate at a record low of 1%. The ECB will continue to fully meet demand for collateralized one-month and one-week loans at an interest rate of 1%. Germany and France both saw improving confidence, albeit in different sectors. In Germany, service sector confidence improved over the quarter, while in France there was improvement in the manufacturing sector. Both countries saw an improvement in forward looking consumer confidence. The MSCI Germany Index and France Index were up 16.65% and 20.84%, respectively.

Net Total Return of Selected MSCI Regional Indices



Region	3Q10
Pacific ex Japan	22.11%
Latin America	20.96%
Europe	19.35%
Emerging Markets	18.03%
EAFE	16.48%
World Index	13.78%
North America	11.54%
Japan	5.83%

In Japan, consumer confidence edged higher to 43.6 from 43.0, as the index of industrial output also made a surprise jump forward. Expected income growth and employment and the willingness to buy durable goods each improved. In early August the Bank of Japan voted unanimously to leave its policy interest rate unchanged, as widely expected, while also keeping its economic outlook steady. No additional major monetary easing moves were announced. According to a statement issued by the Central Bank, "Japan's economy shows further signs of a moderate recovery, induced by improvement in overseas economic conditions, the employment and income situation has remained severe, but the degree of severity has eased somewhat." The bank acknowledged the challenges of combating deflation and moving the economy towards sustainable growth and vowed to keep monetary policy accommodative. Government officials continued to press the BOJ to take action against deflation and the rising Yen, which continues to hamper exports. Another election returned Prime Minister Naoto Kan to office avoiding a 3rd change to the prime minister's office in one year. The former finance minister immediately vowed to focus on the economy. Within one day post election, the Central Bank intervened in the currency market to attempt to halt the yen's continued rise. The BOJ sold over $20 billion in yen, causing it to fall around 3% versus the dollar. Criticism flowed from all corners of the world over the move as it is generally believed that unilateral intervention has a short-lived impact.



China reported slowing second-quarter growth and an easing in a number of other indicators for June, showing that its rapid expansion was beginning to cool in response to withdrawal of some accommodative policies. The slower growth appeared to be in line with PBOC goals coming after a period of rapid expansion driven by government-led stimulus and expansive bank lending. Analysts believe that monetary and fiscal policies will be tightened less than had been anticipated as an engineered "soft landing" appears to be in the cards. Second-quarter GDP grew 10.3% year-over-year, slowing from the 11.9% annual growth from Q1, and was lower than the consensus expectation. CPI for June was up 2.9%, while the PPI expanded 6.4% from a year earlier. Both measures fell below economists' expectations for rises of 3.3% and 6.8%, respectively, according to a Dow Jones Newswires survey. Relative weakness across the data points suggests that lending rates may be less aggressively increased by the PBOC. During the quarter, China passed Japan, becoming the world's second largest economy. The quarter ended with China, again, coming under scrutiny for its currency positions relating to both the U.S. and Japan. The MSCI China Index was up 10.68%.

Brazil was positively impacted by news that manufacturing activity in China (its largest trade partner) rose 14% in August from a year ago. A survey of economists released by the central bank showed GDP growth expectations for the year have increased to 7.4% versus the 7.3% previously forecast. The census bureau said consumer prices rose 0.04% in August from July, half of the consensus estimate, according to Barclays Capital. Inflation fell to 4.4%, below the bank's inflation target of 4.5%. The central bank also held its key Selic interest rate at 10.75% in August. The bank engaged in two auctions to purchase dollars, a move aimed at limiting the real's rise. Brazil's finance minister has said that officials will work to keep the currency from posting significant gains. The MSCI Brazil Index was up 21.71%. In Argentina, the economy expanded 11.1% in June from a year earlier and may grow as much as 8.9%, the fastest growth since 2005. The cost of protecting Argentine debt against non-payment for five years with credit-default swaps slid 24 basis points to 769 basis points, according to data compiled by CMA DataVision, near the end of the quarter. The 2011 budget forecasts that consumer prices will rise almost 9% from this year and GDP will expand 4.3%. The MSCI Argentina Index was up 41.46%.

Focus On: *Foreign Exchange & Trade*

Over the last few years we have entered a period of increased rhetoric regarding foreign exchange and trade; the focus on currencies has come to a head between major trading partners (U.S. & China) in the aftermath of the recession and the global search for economic growth. Currency exchange rates are pricing mechanisms that equate the supply of, and demand for, goods and services across international borders. The question is whether free markets (i.e. the forces of supply and demand) should be used to set the value of a currency or whether government policies (i.e. intervention) can and should be used to set currency price levels, given their impact on domestic and foreign economies.

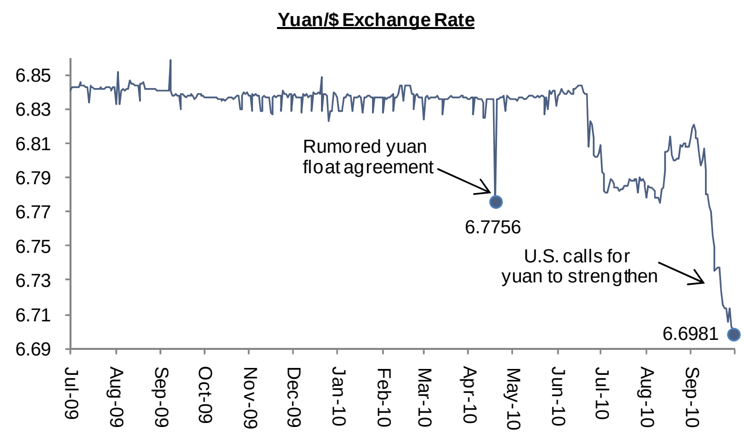
A Little History

A formalized, modern system of exchange rates was created under the Bretton Woods Agreement shortly before the end of World War II. The agreement established the rules under which the world's industrialized nations' monetary relations were governed. Prior to Bretton Woods market forces, generally, were the mechanism used to set exchange rates between major countries (with occasional, cooperative intervention usually in response to wars or other crises). Under Bretton Woods, nations agreed to a system of exchange rates where currencies were pegged against the dollar, with the dol-dollar convertible into gold. The system remained in force for about 25 years. However, international demand eventually forced the US to run a persistent trade deficit, undermining confidence in the dollar. The growing deficit and the emergence of a parallel market for gold, where the price soared above the officially mandated price, led to a rundown of U.S. gold reserves. In 1971 President Nixon closed the gold window, effectively ending the Bretton Woods System. Post Bretton Woods, a mix of pegged and floating currencies have been influenced by government policies to achieve desired economic outcomes.

Why Does Foreign Exchange Matter?

Often we hear vitriolic reports of jobs being exported overseas to less developed nations that have lower costs of production. In the media we also see and hear terms such as currency manipulation and intervention thrown about. The manipulation of exchange rates can lead to a number of negative economic outcomes: increases in domestic trade deficits, foreign financed budget deficits, extreme levels of interest rates, and export competition. Concerns over foreign exchange rates drive trade policy decisions.

China, with its weak yuan, has become a producer and exporter of (cheap) goods to much of the world. While its largest trading partner (the U.S.) has stopped short of accusing China of outright currency manipulation to keep a competitive advantage, it has gone on record as saying that China needs to let the renminbi appreciate versus the dollar to try to "rebalance" the trade differentials between the two countries. A strong dollar, or a weak yuan, puts U.S. manufacturers in a less competitive position versus its foreign counterparts. This pressure also impacts the ability of U.S. firms to create new jobs as the economy struggles to gain momentum coming out of the recession.



Source: People's Bank of China

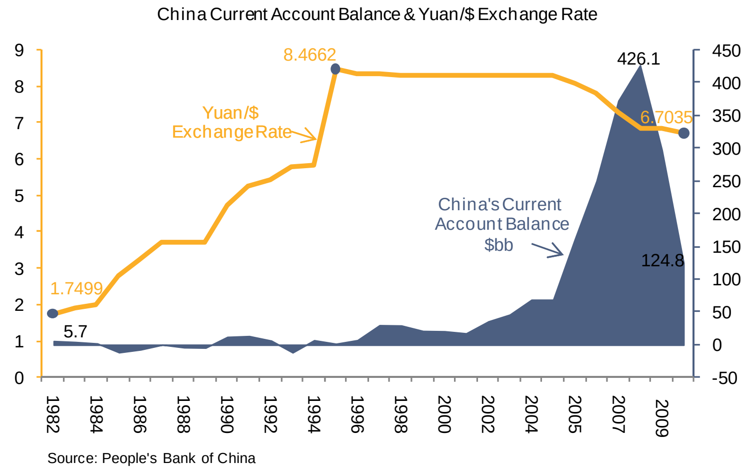
Growth in China has generally been export driven. The lower the value of the yuan relative to other currencies, the better it is for the export business. Financial news estimates suggest the yuan is undervalued in the range between 10% - 40%. A less partisan, and highly more entertaining, estimate of the value of the yuan versus the dollar can be gotten from the Economist's "Big Mac" Index. The index compares the strength of different currencies by looking at the prices of a Big Mac in different countries around the world, translated from original currency into the US dollar. We can use this to compare the strengths of different national currencies (assuming similar costs of production). For example, based on the index, a Big Mac in Britain costs £2.29 or $3.84 based on the U.S. Dollar exchange rate in July, 2010. In the U.S. a Big Mac cost $3.73 meaning that the British Pound is undervalued versus the U.S. dollar by approximately 7%. Using the same methodology, the Chinese yuan is undervalued by approximately 48% versus the dollar.

Does Manipulation Work?

It's no surprise that governments intervene in the currency markets. Policymakers covet having the "cheapest" currency – this helps promote exports and employment. Official rates and pegs are one form of price control; open market operations are another. Buying dollars in the foreign exchange market increases demand for dollars and supports its value relative to the intervening government's own currency. Conversely, foreign currency can be sold to decrease demand for dollars and increase the value of a country's currency. Often interventions into the currency markets are done not to keep markets and foreign exchange orderly, the aim of Bretton Woods, but to support an economic advantage.

It is a view held by many economists that currency intervention for large countries with floating exchange rates only slows the rate of currency appreciation or depreciation over the short run, but has little effect over longer periods. The impact is muted by the sheer size of the foreign exchange market, estimated to be approximately $4 trillion. Based on the size of the market, a single, unilateral intervention will generally not be large enough to have a sustained impact on exchange rates. For example, Japan's recent intervention on September 15 weakened the yen by approximately 3% over 4 days. Within 20 days the yen had re-strengthened and approached its "stronger" pre-intervention level. In theory, intervention by buying dollars and selling domestic currency should keep the domestic currency cheaper helping exporters by allowing them either to lower export prices or to maintain an export price while increasing profits. Conversely, it makes imports relatively more expensive. Lower export prices and higher import prices will tend to increase a country's trade surplus which should translate into a higher growth rate. There is also a lag in response to changing exchange rates and production. It is both difficult and costly for companies to make process changes or to move as currencies fluctuate.

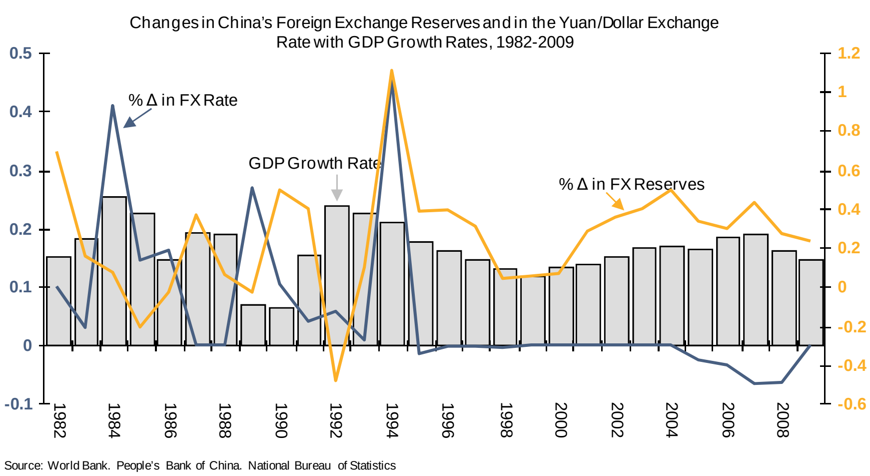
Over the last decade there are estimates that China has intervened in the foreign exchange markets to the tune of around $1 billion a day, buying dollars with yuan. During this time period, China's foreign exchange reserves have surpassed $2 trillion and GDP growth has been on a fairly strong and sustained upward trend. China, with its huge trade surplus, is able to buy dollars in the open market to keep dollar demand high, pushing up the value of the dollar and keeping the yuan undervalued.



While there may be benefits to keeping a currency artificially weak, there are also consequences. A weak currency discourages imports which hurts trading partners. It also discourages domestic consumption equating to higher savings rates since consumers won't spend. However, allowing an artificially weak currency to revalue also comes fraught with risk in the form of slowing domestic growth and more expensive exports as the weaker currency appreciates. In addition, there is a risk of an increase in inflation as more local currency is injected into the market through foreign currency purchases.

We've Been Here Before

In the early 1980s the dollar became very strong as the U.S. Federal Reserve raised interest rates to fight inflation. Borrowing to finance deficits also contributed to the problem. The trade beneficiaries were Japan and, at that time, West Germany. By the mid-1980s there was growing concern over the level of Japanese imports to the United States – automobiles, technology hardware (semiconductors) and telecommunications equipment were the "troubling" sectors under scrutiny at the time. The U.S. needed to apply diplomatic pressure in an attempt to get Japan to let the yen appreciate. Japan relented in the face of threatened Congressional protectionist action and let the yen rise. The Japanese currency appreciated nearly 50% between 1985 and 1987. Curiously, the strengthening yen did not immediately reduce the U.S. trade deficit with Japan; in fact, the deficit widened during the time the currency was appreciating.



Today there's a similar situation brewing with China. China has grown into our largest trading partner and the U.S. is carrying a rather large trade deficit with China. China continues its daily interventions in the currency markets, buying dollars (U.S. Treasuries), allowing the U.S. to continue to fund its deficit. The U.S. Congress recently passed legislation that would allow punitive tariffs to be put in place if China does not allow faster appreciation of the yuan. The last time such measures were threatened, in 2005, the Chinese agreed to remove the fixed-peg to the dollar and allowed the currency to appreciate by more than 20%. However, in 2008, the dollar-peg was re-instituted. China is starting to flex its economic muscle as it becomes a larger player in the global economy. It recently cut-off rare earth shipments to Japan. China holds a strong hand with regard to the U.S. – it can retaliate by instituting tariffs of its own (such as the recent tariff against U.S. poultry) – restricting access to its large consumer markets. Are we seeing the opening salvos of a trade war? At this point it's hard to say; stay tuned.

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