

# October 2010 ECONOMIC REPORT

November 8, 2009

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President

Term of the Month: **Compromise**

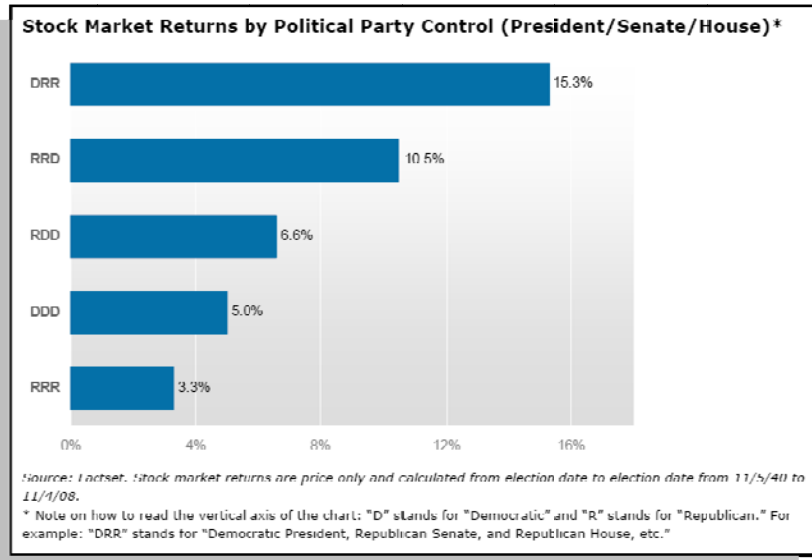
The action both sides of Congress will need to take if they are to pass a single piece of important legislation.



## Domestic Equities: Elections, QE2 and Earnings

Domestic equity markets rose last month supported by strong third quarter earnings data. However, the recent election garnered most of investors' attention for much of the month.

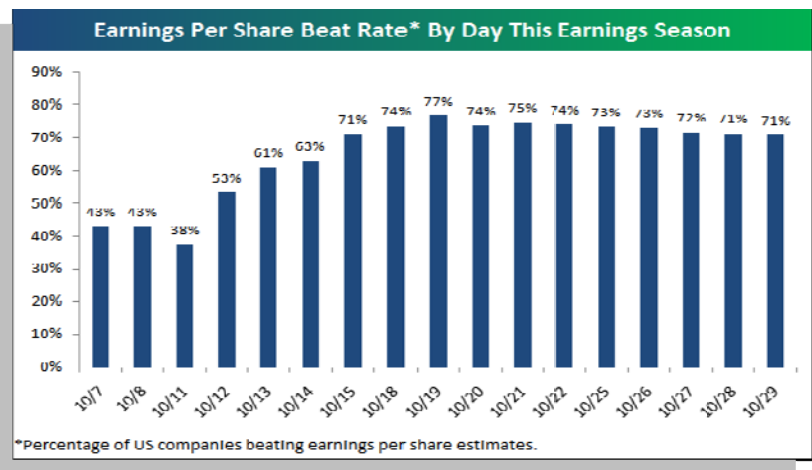
So, how will the markets react with the Republicans in control of the Congress? A significant amount of research was conducted on market performance during the various splits in party control of the White House, Senate and House. The result - when a single party is in power, equities do worse relative to when there is a party split. Interestingly, a Democrat controlled White House and Senate, and Republican House has not been experienced in recent history (data going back to 1942).



A second round of quantitative easing or QE2 was another source of market uncertainty. Since mid-summer, Ben Bernanke and company had openly discussed a willingness to implement a second round of quantitative easing to spur growth and quell disinflationary pressure. Round one of QE was very supportive for equities with the S&P 500 up more than 30% from the fourth quarter of 2008 to the first quarter of 2010, and many believe that round two will have a similar effect.

**Earnings:** Both US corporate earnings and revenues were up during the quarter due to operating efficiencies created during the cost cutting wave of 2008-2009. If revenue or sales growth re-emerges, even at a slower pace, a second surge in earnings can be expected.

Additional support for equities came from equity-friendly corporate finance decisions. Cheap debt financing options have spurred a wave of share buy-backs, special dividends, leveraged buy-outs and debt-funded merger & acquisition activity. According to Dealogic, nearly 2,300 deals worth more than \$210 billion were announced in the third quarter of 2010, compared to \$120 billion in the third quarter of last year. On the dividend front, payments in



October were 5.5% higher than last year, with 14 of the S&P 500 companies raising dividends during the month. Despite the persistent rise in dividends, dividend payout ratios, the percentage of earning paid to shareholders in dividends remain low relative to historical norms – 27% as of quarter end relative to a ~45% average since 1977. This ratio reflects additional payout capacity, which may indicate higher dividends going forward.



## US Sectors:

**Materials & Energy:** Materials and energy stocks were on top during the month with the help of strong commodity prices. Energy stocks benefited from continued crude oil strength, while materials companies profited from rising industrial metals and agricultural commodity prices. Commodities on the whole are meeting resistance from reduced capacity, QE2 concerns, and worries about the future of the US dollar.

**Utilities & Telecom:** Utilities and telecom stocks, which were amongst the strongest performers heading into October, lagged during the month. Of the 16 utilities within the S&P 500 that reported earnings, only 5 outpaced revenue expectations. Within telecom, Verizon dragged on performance after reporting operating earnings below last year's level. Both sectors remain the top dividend yielders within the S&P 500 with telecom and utilities yielding 5.4% and 4.4% respectively.

*Sources: Standard & Poors, Bespoke, Morningstar, ICI, SeekingAlpha; Bloomberg; Dealogic, Wells Fargo, Leuthold, FactSet*

## Fixed Income: QE2's Maiden voyage

**Economy:** While the economic outlook held fairly steady during the month, some deterioration in certain indicators was enough to cause the Federal Reserve to engage in additional measures to bolster the economy, namely QE2.

**Unemployment:** Unemployment is a stubbornly difficult problem to fix. For the week ending October 30th, nearly 450,000 people filed first time claims for unemployment and another 4.3 million are on the continuing unemployment claims roster. The initial claims figure is down significantly from its August peak, but as long as releases hold steady above 400,000, sustainable job growth will be difficult to achieve. In one encouraging sign, nonfarm payroll employment rose by 151,000 in October, and private sector employment picked up by 159,000. That is a solid monthly gain, and well in excess of economists' expectations. However, the unemployment rate held steady at 9.6% and it was announced that 6.2 million individuals have been without a job for 27 weeks or longer.

**Manufacturing:** From a more positive standpoint, manufacturing activity rose to a higher than expected level. The ISM Manufacturing Survey showed that activity for the month of October jumped to 56.9 from 54.4 in the prior month. Any reading above 50 is indicative of expansion in the manufacturing sector. The best news came from the new orders and employment components, which jumped to 58.9 and 57.7, respectively. This is encouraging because it suggests that manufacturers are not only becoming confident enough in the recovery to begin hiring new workers, but also that orders are keeping pace with the rate of hiring, which will push the recovery further ahead.

**Housing:** Housing activity has been a bit of a mixed bag. Existing home sales, up 10% in September to a seasonally-adjusted annual rate of 4.5 million, occurred as a result of a 3.3% decline in the median sales price. More recent data from the Mortgage Bankers Association, which looks at weekly refinancing and purchase activity, shows that activity was stagnant during October despite a 30-year mortgage rate of 4.3%.

**Federal Reserve:** The Federal Reserve's actions during the month were relatively unimportant compared to their announcement following the November 2nd and 3rd FOMC(Federal Open Market Committee) meeting. After signaling its intention for several months now, the Fed officially announced that it would purchase up to \$600 billion in additional Treasury securities while also reinvesting up to \$300 billion of mortgage-backed security maturities into Treasuries. The Fed expects to complete these purchases by the end of the second quarter in 2011, translating into roughly \$110 billion worth of purchases per month. At this juncture, the Fed was very transparent in signaling its intentions far in advance, so none of this should be a surprise.



According to a release on the Federal Reserve Bank of New York website, 86% of overall purchases by the Fed will be Treasuries with a maturity between 2.5 and 10 years. The long-term implications of such actions will be a huge unknown for years to come and investors need to stay attuned to any sudden and rapid changes that occur in the marketplace. One indication that long-term inflation implications are a real possibility came from trade activity at the long end (20 to 30 years) of the Treasury curve. Bonds with a maturity of 30-years began to sell off immediately following the announcement and the yield on 30-year treasuries rose from an open of 3.9% on Wednesday the 3rd to more than 4.1% by Friday.

**Treasury Inflation Protected Securities:** Treasury Inflation Protected securities (TIPs) investors received a pleasant surprise from the Fed's efforts. Yields for TIPs fell sharply across the all terms reflecting speculation the Fed's upcoming purchase program would include TIPs. This yield adjustment may also be a reflection of burgeoning inflation concerns. For example, the 10 year TIPs yield dropped 25 basis points in the month to a yield of 0.45%. With this adjustment the implied inflation rate grew from 1.8% to 2.2% - notably back into the Fed's unstated inflation range of 2% to 3%.

One interesting development was the US Treasury issuance of a 5 year TIP at -0.45% yield – the first time the Treasury issued a bond with a negative yield. Investors paid \$105.50 for every \$100 of bonds. These investors are betting that inflation, now at a 1% annual rate will rise to more than compensate them for the premium they paid now.

**Municipal Market:** New bond issuance remained on track to produce similar levels as 2009 with a total of \$335 billion in new bonds issued year-to-date. For the twenty-second month, another \$2.7 billion came into the Muni market with the bulk of this going into High Yield and short duration strategies.

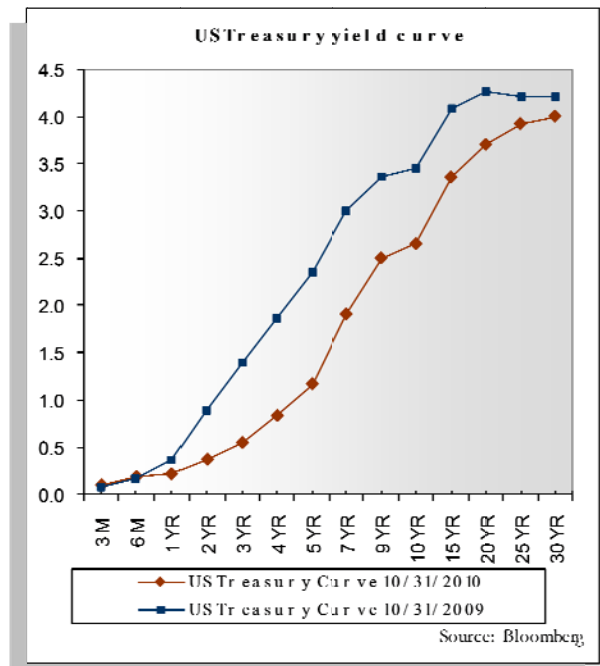
AAA rated 10 year Munis saw a 10 basis point increase in yield to 2.5%, while 2 year AAA's saw really no movement. BBB rated and high yield Munis were up 0.70% and 0.60% respectively for the month.

**Corporate Markets:** Low quality bonds continued to perform well in the month. High Yield taxable bonds (up 2.6%), BBB rated bonds (up 0.43%) and leveraged loans (up 1.64%) all did well, while anything rated A or better was flat to slightly negative.

High Yield bonds had healthy monthly performance even though new issuance (greater supply) was strong: \$30 billion in the US and the fourth largest month on record.

**Looking Ahead:** Glassman Wealth Services continues to take profits in this area. We are also closely monitoring the investment grade bond market as we believe changes could take place more quickly than they have historically.

**Sources:** Bank of America, Barclay's, Bloomberg, JP Morgan





## International Equities: Global Stocks Rise in Tandem

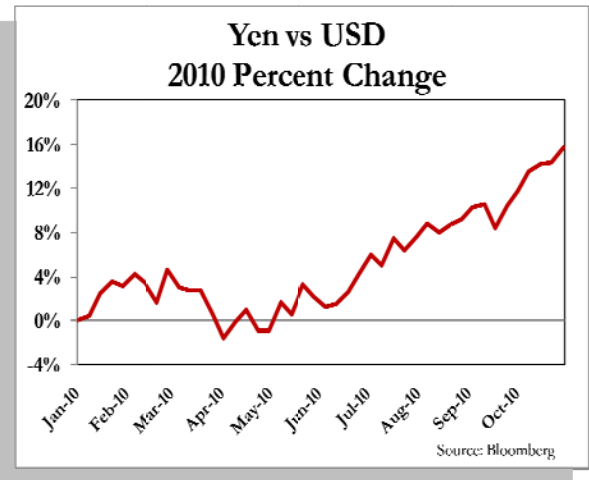
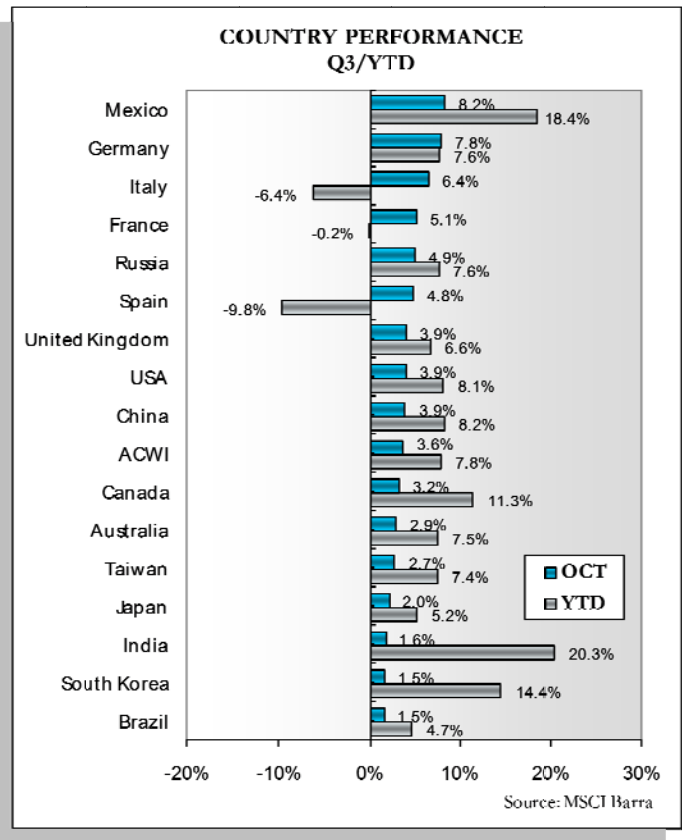
Global equities like the major stock indices around the world advanced between 3% and 4%. US equities were slightly higher than international during the month, though currency continues to play a large role in stock returns. The broad all country index, MSCI ACWI ex US, affected by yen and euro strength returned a more modest 2.0% in local currency terms.

**Europe:** Europe was the top performing global region in October. Several European countries were among the All Country World Index (ACWI) performance leaders, most notably the troubled “Club Med” countries Portugal up 9.2%, Greece up 8.1%, and Italy up 6.4%, reflecting either investor’s increased appetite for risk, or higher confidence in Europe’s ability to solve its fiscal problems.

**Germany:** Germany was also a top performer at 7.8%. The country’s October return was propelled in part by double-digit returns from materials stocks as their exports continue to fuel Germany’s economy. In the past 12 months, the country has seen net exports of tangible goods amount to \$208billion outpacing even that of China. Yet, even with better fiscal health and lower unemployment than other developed economies, the broad German equity index trails the S&P 500 by 0.2%, at 7.6% vs 7.8%, respectively.

**United Kingdom:** Austerity measures in the UK announced mid-month did not dissuade investors from pulling out of British equities. Short-term concerns from the reduction of \$128billion in government spending did weigh on the country’s (very public-dependent) health care sector, down .5%, but strength in higher yield-producing “bond proxies” offset that weakness, with telecom up 9.3% and utilities up 7.4%. The UK government’s report of 3.2% annualized GDP growth – double that of consensus estimates – helped to mitigate some of those fears. At 7.7% unemployment, the UK labor market is relatively healthier than the US or broad Europe markets.

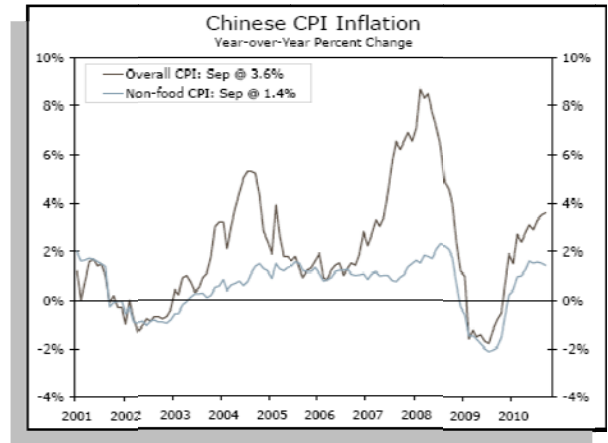
**Japan:** While Japanese equities continue to be left behind in the rally that started in late August, demand for the country’s currency persists. Now ten months into 2010, the MSCI Japan index has increased an astounding 14% because of currency valuations. The country’s year-to-date return of -9% in local terms trails only Ireland and Greece as the worst performers in the ACWI (All Country World Index) universe. As the global recovery gains traction in the coming months and years, the flight to quality that has benefitted the yen is likely to wane. Given Japan’s otherwise weak fundamentals, passive exposure to the index is not desirable.





*China:* Emerging economies continue their attempts to rein in rampant growth and inflation, punctuated by China's first increase in lending rates in nearly three years in mid-October. Inflation continues to be a concern for the country, which has risen rapidly since the middle of last year. September's 3.6% rise in prices was the largest increase in nearly two years.

The World Bank announced in a report released early this month that China needs to continue raising rates and allow the yuan to strengthen to mitigate unwanted asset price growth. The country has been slow to raise rates and stem the tide of inflation relative to other Asian economies. India, for example, raised lending rates for the sixth time this year. The country has been extremely proactive in its attempt to limit the effects of foreign capital inflows on already rising prices, as loose monetary policy in developed nations has driven inflationary foreign liquidity into India and other emerging markets.

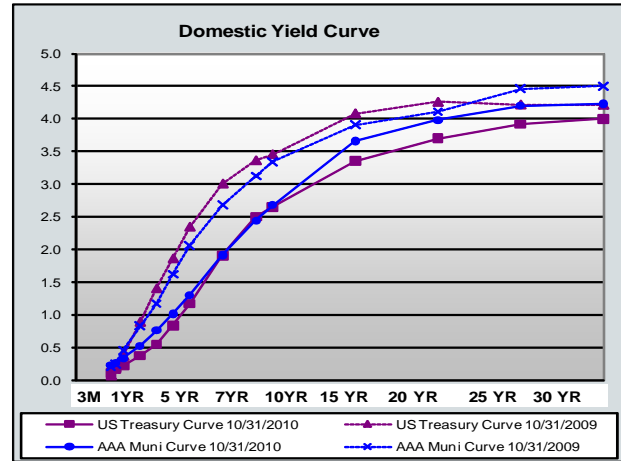
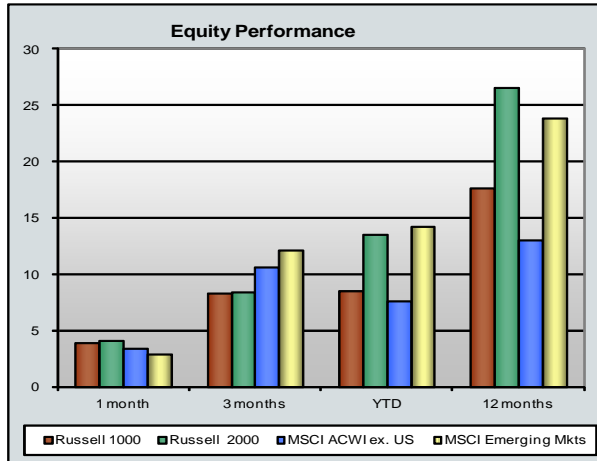


*Looking Ahead:* Europe continues to look cheap and may present good opportunities. Japan remains a concern, while emerging markets and Asian equity valuations still don't appear to be over-valued.

Sources: MSCI Barra, Bloomberg, WSJ, The Economist, Wells Fargo Economics Group, New York Times, World Bank, Financial Times



**MONTHLY PERFORMANCE FLASH REPORT**  
October 31, 2010



	1 month	3 months	YTD	12 months
<b>Large Cap</b>				
S&P 500	3.80	7.96	7.84	16.52
DJIA	3.21	6.96	8.96	17.62
Russell 1000	3.89	8.36	8.48	17.67
Russell 1000 Value	3.00	6.24	7.63	15.71
Russell 1000 Growth	4.78	10.52	9.35	19.65

	1 month	3 months	YTD	12 months
<b>Small/Mid Cap</b>				
Russell 2000	4.09	8.39	13.58	26.58
Russell 2000 Value	3.87	6.38	12.10	24.43
Russell 2000 Growth	4.30	10.39	14.97	28.67
Russell Microcap	5.64	7.74	14.02	25.07
Russell Midcap	3.87	9.80	15.26	27.71
Russell Midcap Value	3.83	8.36	15.41	27.49
Russell Midcap Growth	3.91	11.46	15.19	28.03

	1 month	3 months	YTD	12 months
<b>International Markets</b>				
MSCI EAFE	3.62	10.28	5.13	8.82
MSCI ACWI ex. US	3.42	10.63	7.61	13.08
MSCI Europe	4.34	11.57	4.27	8.97
MSCI Japan	2.04	4.33	5.19	4.92
MSCI AC Asia Pacific Ex - Japan	2.71	13.11	13.12	20.45
MSCI EAFE SMD	3.40	11.27	11.11	13.26
MSCI ACWI ex. US SMD	3.62	12.81	14.47	20.08
MSCI Emerging Mkts	2.91	12.18	14.26	23.89
MSCI EMEA	3.40	11.69	16.09	25.07
MSCI Latin America	3.22	11.59	11.81	23.75
MSCI Frontier Markets	4.05	12.30	19.69	11.46

	1 month	3 months	YTD	12 months
<b>Sectors (S&amp;P 500 GICS)</b>				
Consumer Discretionary	5.38	12.56	19.44	33.49
Consumer Staples	3.01	7.46	10.78	14.91
Energy	5.65	10.41	4.77	7.14
Financials	1.44	(0.79)	1.94	4.83
Healthcare	2.13	9.70	1.40	13.14
Industrials	2.64	6.32	16.34	28.52
Information Technology	6.47	11.03	6.43	18.24
Materials	6.66	11.87	9.50	24.12
Telecom Services	1.02	11.71	11.96	24.77
Utilities	1.13	5.63	5.50	16.70

	1 month	3 months	YTD	12 months
<b>Fixed Income</b>				
BarCap US Agg	0.36	1.76	8.33	8.01
BarCap 1-10 Muni	(0.03)	0.94	4.66	5.90
BarCap HY Muni	0.58	3.73	12.81	13.86
BarCap Inv. Grade Credit	0.12	2.82	10.90	11.61
BarCap Muni Long Bond (22+)	(0.24)	3.09	8.91	10.03
BarCap US Agg Securitized MBS	0.98	0.75	6.14	5.99
BarCap US Treasury Interm	0.34	1.88	7.55	6.69
BarCap US Treasury Long	(3.31)	1.64	15.15	10.56
BarCap US High Yield Loans	1.64	3.41	7.90	11.48
ML US High Yield BB/B Rated	2.17	5.51	14.00	17.50
JPM GBI Global Hedged	(0.46)	1.24	6.14	6.10
JPM GBI Global Unhedged	1.33	5.78	9.79	7.69
JPM GBI-EM Global Div	1.28	7.85	17.63	19.81
JPM ELM+	1.34	5.36	6.65	7.56
JPM EMBI+ Composite	1.82	6.23	16.54	18.02

	Latest Month end (10/31/2010)	3 Months ago (7/31/2010)	Latest Year end (12/31/2009)	12 Months ago (10/31/2009)
U.S. Dollar Index Value	77.27	81.54	77.86	76.30
USD vs. Yen	80.40	86.47	93.02	90.09
Euro vs. USD	1.39	1.31	1.43	1.47

	Latest Month end (10/31/2010)	3 Months ago (7/31/2010)	Latest Year end (12/31/2009)	12 Months ago (10/31/2009)
<b>Currency</b>				
U.S. Dollar Index Value	77.27	81.54	77.86	76.30
USD vs. Yen	80.40	86.47	93.02	90.09
Euro vs. USD	1.39	1.31	1.43	1.47

	Latest Month end (10/31/2010)	3 Months ago (7/31/2010)	Latest Year end (12/31/2009)	12 Months ago (10/31/2009)
<b>Commodities</b>				
Gold (\$ per troy ounce)	1359.40	1181.00	1096.95	1045.40
Crude Oil (\$ per barrel)	81.43	78.95	79.36	77.00

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