HOWE & RUSLING

Investment Strategies

Providing professional investment management to individuals, retirement plans, and charitable organizations since 1930.

10
OCTOBER

Craig Cairns,
President

The Equity Market

Scintillating September

By Craig Cairns

The stock market finally gained traction in the third quarter after some of the wildest swings up and down in a single year in recent memory. The market move was backed by pretty good company earnings with a little bit of mid-term election anticipation thrown in, but mostly by talk of the Fed attempting to ease the money supply (or quantitative easing) by artificially lowering longer term interest rates again. The move up happened even in the face of decidedly mixed economic news.

It is difficult to remember a year where the markets have whip-sawed up and down more than in 2010 and the quarter just past is a good illustration of this: after a market peak on April 23rd of +9.78% (year-to-date), the stock market experienced its worst May in 40 years and on June 30th the S&P was down -6.65% for the quarter. September's performance of +8.92% for the S&P 500 Index was the best September for the stock market in 70 years and moved the Index back up into positive ground for the year-to-date.

Company earnings have been a bright spot in 2010 and continued the positive momentum as companies reported their second quarter earnings. For all the companies in the S&P 500 Index, 73.7% of them reported positive surprises during the quarter and analysts expect that earnings grew at better than 10% over the third quarter of 2009.

A Perspective on Valuations:

After two quarters of a momentum-based stock market where valuations and earnings growth mattered much less than the overall market momentum, we were pleased that selective stock picking was once again rewarded and helped Howe & Rusling's stock performance in the third quarter.

continued on page 2

Vince Russo,
Vice President, Director of Fixed Income Research

The Bond Market

3rd Quarter Overview

By Vince Russo

Bonds continued to demonstrate strong positive performance this past quarter in spite of all the talk of "bond bubbles" and equity dividend yields surpassing most bond yields. The outperforming sectors were without question bonds of lower credit quality and longer final maturities.

Start Date: 6/30/2010 End Date: 9/30/2010

Index	Return for Period
Intermediate U.S. Government / Credit	2.76%
U.S Treasury: Intermediate	2.33%
U.S. MBS Agency Fixed Rate MBS	0.62%
U.S. Agency: Intermediate	1.35%
Intermediate: Corporate	4.21%
Intermediate Utility	3.93%
Invest. Grade: Industrial - Intermediate	3.89%
Invest. Grade: Financial Institutions - Intermediate	4.69%
U.S Treasury Inflation Notes: 5+ Years	3.45%
Municipal Bond: 1-10 Yr Blend (1-12)	2.40%

Source: Bloomberg LLP

The major themes underlying the continued strong performance of bonds were the same ones influencing the bond market last quarter:

- Strong demand for newly issued bonds
- Weakening economic conditions in the U.S.
- Federal Reserve resuming asset purchases (Quantitative Easing)
- Prospects for further expansion of asset purchases

continued on page 3

Howe & Rusling | 120 East Avenue, Rochester, New York 14604-2561 | 585-325-4140 | 800-325-4693 | www.howeandrusling.com

Scintillating September *continued from page 1*

There are periods of time where valuations and being careful with picking individual stocks do not matter, and what matters most is avoiding sectors that are out of favor.

Prior to this recent change, according to Barclays Capital Research Quantitative Strategist Matthew Rothman, "…the proportion of stock returns explainable by stock [or company] specific factors has been approximately zero and since 1950 was only lower in October 1987 and May/June 1962." Despite time periods where momentum drives all stocks up or all stocks lower, regardless of the quality of the company, we expect the market to return to rewarding how well the underlying company is performing.

Ben Bernanke, the Federal Reserve Chairman, made probably the biggest news in the quarter at a speech in Jackson Hole, Wyoming on the 27th of August with this quote "we will continue to monitor economic developments closely and to evaluate whether additional monetary easing would be beneficial. In particular, the Committee is prepared to provide additional monetary accommodation through unconventional measures if it proves necessary, especially, if the outlook were to deteriorate significantly."

This potential Fed effort was quickly dubbed QEII (Quantitative Easing for the second time) and the Fed would most likely try buying fixed income securities as they did coming out of the downturn in 2008. Buying fixed income securities will increase the money supply, lower interest rates, and potentially "inflate" our way out of our economic malaise. Inflation is a lesser evil than deflation, and therefore offers a relatively more attractive outlook for stocks.

Since Bernanke's Jackson Hole speech, the S&P has rallied +9.4% although the dollar has declined -5.8% (for a total decline of -11.7% from its June peak). Other Central Banks including Japan and the European Union have talked about their own forms of easing.

More Gain, Less Pain

We appreciate the surge in the stock market, but we have concerns about the unintended consequences of the easing and what impact it will ultimately have on the economy longer term. Unemployment has not eased and the housing market has not yet bottomed. Confidence is still lacking both among consumers and employers for a variety of reasons—uncertainty about the regulatory environment and the cost to add employees and the sustainability of the recovery. In the meantime, we think there are no easy answers, but the country, after a period of mediocre growth and through fits and starts, will slowly make its way toward a better recovery.

Let's Polish up the Crystal Ball: Potential Impact of the Mid-terms on the Markets

Regardless of where our clients stand politically, we find it informative and helpful (as well as extremely interesting) to dig up information on stock market returns in the various election cycles as we approach a mid-term election that is dominating the headlines. We rely on some of our research partners for the information.

From Barclays Capital Research the following chart shows stock market returns for mid-term election years since 1942 and seems to bode well for returns for the next six months. We might presuppose that the stock market favors a reduction in uncertainty.

S&P 500 Performance in Mid-Year Election Years

	Oct 1- Dec 31	Jan 1-Mar 31	Oct 1-Mar 31
2006	6%	0%	6%
2002	8%	- 4%	4%
1998	21%	5%	26%
1994	-1%	9%	8%
1990	8%	14%	23%
1986	5%	20%	26%
1982	17%	9%	27%
1978	-6%	6%	0%
1974	8%	22%	31%
1970	9%	9%	19%
1966	5%	12%	18%
1962	12%	5%	18%
1958	10%	0%	11%
1954	11%	2%	13%
1950	5%	5%	10%
1946	2%	-1%	1%
1942	10%	19%	31%
AVG	8%	8%	16%
MEDIAN	**8%**	**6%**	**18%**
UP	15	15	16
DOWN	2	2	1
% UP	**88%**	**88%**	**94%**

Source: Barclays Capital

As you can see from the chart above, stock market returns from October to March in mid-year election cycles have been positive in all but one of those years and the only year it was not was in 1978 when the stock market return was 0%. The sample size is not huge and past performance is no guarantee of future results, but in the two quarters surrounding the midterm elections the stock market tends to be positive.

A second chart (below) put out by Ned Davis Research breaks stock market returns down further by the political party in power.

Dow Jones Industrial Average Gain/Annum When:

Political Power Lies with:	Gain/Annum	% of Time
Democratic President, Democratic Congress	7.0	36.0
Democratic President, Congress Split	N/A	0.0
Democratic President, Republican Congress	9.6	9.1
Republican President, Republican Congress	7.0	23.7
Republican President, Congress Split	-4.2	11.0
Republican President, Democratic Congress	2.2	20.1

Source: Ned Davis Research

First of all, there are no data points in the past 100 years for a Democratic President and a Congress that is split between Democrats and Republicans because it has not happened. Based on the polls as of this writing this split between the President and Congress seems to be the most likely outcome. Interestingly, although it is the smallest sample size (happened 9.1% of the time in the past 100 years), the best returns are gained when there is a Democratic President and a Republican Congress. Investors like when neither party is allowed to overdo their political priorities. The market tends to like gridlock.

continued on page 3

The mid-terms might be the catalyst that helps keep confidence and momentum moving in a positive direction although it will take a while for investors to figure out whether gridlock will ultimately be bad or good for the markets. The next few weeks should provide fascinating viewing.

Like Ben Bernanke at the Federal Reserve, we will continue to monitor economic developments closely, poised to act on the behalf of our clients by changing allocation and types of securities if necessary that we believe will meet our client objectives over the long-term.

Bond Market Overview *continued from page 1*

New U.S. bond issuance (excluding U.S. Treasury securities) in the third quarter surpassed $520 billion compared to the $336 billion issued in the second quarter of this year.[1] While new issuance for the first three quarters of 2010 trails 2009 issuance over the same period of time, it is higher than pre-crisis levels seen in 2007.

Weakening trends in GDP (Gross Domestic Product) and employment continue to create concerns regarding the health of the economic recovery. Final 2nd quarter GDP was 1.7% versus 3.7% in the 1st quarter and 5.9% in the 4th quarter of 2009. The trend is disappointing given the amount of fiscal and monetary stimulus already injected into the economy. Unemployment continues to disappoint as well and remains stubbornly in the 9.5% range. The trend in new private sector jobs continued to decline over the last three months raising more doubts about the consumer recovery and the housing market.

In an effort to provide liquidity and keep money supply from decreasing, the Federal Reserve authorized the reinvestment of principal repayments from their portfolio of Mortgage-backed securities in new purchases of Treasury Notes. This action reinforces the notion that the Federal Reserve Board is concerned about deflationary trends and is committed to more asset purchases as part of the quantitative easing strategy adopted after the economic crisis. With almost $2 trillion worth of securities on their balance sheet, the Federal Reserve is prepared to provide further accommodation in support of the economic recovery, i.e. - more quantitative easing.

Expanding on the notion of quantitative easing is not what I am going to do here. Let's make it simple, and just say that it is another tool that the Federal Reserve uses to increase the supply of money in an effort to decrease the cost of money, primarily through lower interest rates. We will examine one example of how effective this strategy has been in the next section.

To summarize, we continue to evaluate the economic prospects to give us a leading indication of how interest rates will react. We continue to feel relatively comfortable with the expectation that inflation and interest rates will not be rising in the near future. We continue to feel comfortable with our sector allocation between government bonds and corporate bonds and do not foresee any significant changes on the horizon.

Turning Japanese?

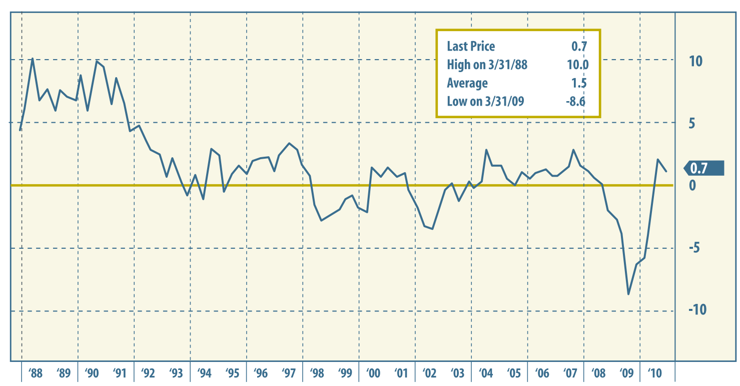
The positive bond performance that we have experienced over the last couple of years has been possible because of declining interest rates during that period of time. However, with rates at historic low yields, how much lower can they go? Can we continue to expect bonds to perform positively in the near future? Those are perhaps the very same questions Japanese bond investors were asking themselves more than a decade ago.

Over the past two years, since the financial crisis in the fall of 2008 provoked the seizure of global capital markets, there has been a variety of possible economic outcomes discussed in its aftermath. The scenarios range from a downward deflationary spiral and subsequent depression, to the rekindling of inflation leading to hyper-inflation and a worthless currency. Those would be the two extreme cases. However, there has been considerable discussion of a prolonged period of slow, below potential growth that has been likened to the "lost decade" that Japan experienced in the 1990's.

Since the early 1990's Japan's economy has struggled to maintain a sustainable growth rate consistent with a stable economy. The chart below illustrates Japan's difficulties at consistently growing its economy since the late 1980's. What happened that caused this stagnation? The primary catalysts for the sub-par growth over such a long period of time were a bursting asset price bubble in real estate and stocks and the subsequent responses by the government and the central bank of Japan. The bursting asset price bubble led to the insolvency of many individual and institutional investors. As a result, many of the bank loans made to these investors could not be repaid, and Japanese banks were also faced with assets that were worth less than their liabilities, which is one definition of insolvency.

Japan GDP YOY % Change

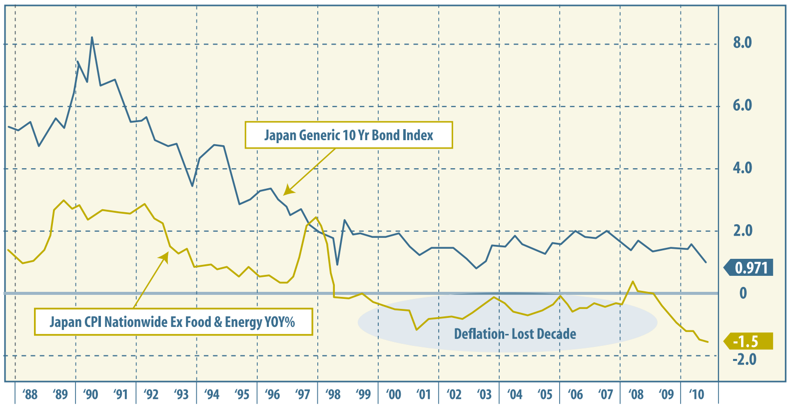
9/30/87- 6/30/10



Source: Bloomberg LLP

During this period, the Japanese government attempted a number of fiscal stimulus programs and bailed out banks. Loan demand was greatly reduced as individuals, companies, and banks all continued to reduce their borrowings (de-leverage). The lack of demand put downward pressure on prices which became deflationary and as we can see from the graph below, remained below the red line (0%) for nearly a decade. In addition to the fiscal policy responses adopted by the Japanese government, the Japanese central bank (the equivalent to the Federal Reserve Bank of the U.S.) established monetary policy that kept short-term interest rates at zero and supplemented this policy, beginning in 2001, with the outright purchase of assets; better known as *Quantitative Easing*. (see chart on next page)

12/31/1987- 8/31/2010



Source: Bloomberg LLP

Do Japan's recent economic history and the attempted solutions sound familiar? Pardon the rhetorical question, but the similarities between Japan and the recent economic conditions in the United States are compelling. While there's always the risk that making comparisons between the United States and Japan may not be exactly appropriate, the evidence begins to point to the same causes and effects with the passing of time. So, if the solutions implemented by the Japanese government and central bank are similar to those being adopted by the U.S. Government and Federal Reserve Bank, why would anyone expect the outcome to be different? That is precisely the uncertainty facing our own markets today and that we addressed earlier in our article. Some insight into why expected results could be different may lie with the thinking of our own Chairman of the Federal Reserve Bank, Ben Bernanke.

In a now famous speech[2] given by (then Federal Reserve Governor) Bernanke in November, 2002 to the National Economists Club, he attempted to answer the same question we posed above. We have taken some relevant parts of that speech to highlight similarities and differences:

"The claim that deflation can be ended by sufficiently strong action has no doubt led you to wonder, if that is the case, why has Japan not ended its deflation? The Japanese situation is a complex one …. I will just make two brief, general points. First, as you know, Japan's economy faces some significant barriers to growth besides deflation, including massive financial problems in the banking and corporate sectors and a large overhang of government debt."

This too sounds much like the situation in the United States. The financial problems of banks are widely known and we are all aware of the mounting concerns with all levels of government debt: local, state, and federal.

"… the heavy overhang of government debt has made Japanese policymakers more reluctant to use aggressive fiscal policies. Fortunately, the U.S. economy does not share these problems, at least not to anything like the same degree, suggesting that anti-deflationary monetary and fiscal policies would be more potent here than they have been in Japan."

Here too we have public sentiment that government debt is "out of control" and our policymakers are also reluctant to use more fiscally stimulative policies. Contrary to Chairman Bernanke's past belief that the U.S. does not share these problems (to the same degree), would also imply that his conclusion about the effectiveness of monetary and fiscal policies here versus Japan could be in doubt.

"Second and more important … the failure to end deflation in Japan does not necessarily reflect any technical infeasibility of achieving that goal. Rather, it is a byproduct of a longstanding political debate about how best to address Japan's overall economic problems. … restoring banks and corporations to solvency and implementing significant structural change are necessary for Japan's long-run economic health. But in the short run, comprehensive economic reform will likely impose large costs on many, for example, in the form of unemployment or bankruptcy."

The second point Chairman Bernanke made rings true today in the United States. We know that structural changes to the banking and financial sector of our economy is in our long-term best interest, but in the meantime we are experiencing the higher costs of unemployment and increased bankruptcies. The conclusions we can draw from Japan's history lead us to believe that attempting to fight deflation, in theory can be remedied through monetary and fiscal policies designed to lower the cost of money and create demand. However, in practice we can see that it is not easily achievable. So, to get back to the original question on everyone's mind about how long can rates remain so low? Well, just look at Japan for one very likely answer. The chart above also illustrates that during Japan's quantitative easing period (approximately 5 years) the 10 yr Japanese Government bond yield never quite made it above 2% and is much closer to 1% today. I guess low bond yields in Japan did not create a bubble in government bonds either.

[1] Bloomberg LLP

[2] Federal Reserve Board - *Remarks by Governor Ben S. Bernanke Before the National Economists Club, Washington, D.C. November 21, 2002 Deflation: Making Sure "It" Doesn't Happen Here* - http://www.federalreserve.gov/boarddocs/speeches/2002/20021121/default.htm