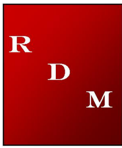

RDM CAPITAL ASSOCIATES

WEALTH MANAGEMENT

Bruno LaRocca
President
blr@rdmcapital.com

Matthew L. LaRocca
Vice President
matthew.larocca@rdmcapital.com

(732) 544-4707
(732) 544-4706
(732) 544-4705 (fax)

THIRD QUARTER MARKET COMMENTARY

October 4, 2011

TO	**:**	**CLIENTS AND FRIENDS**
FROM	**:**	**RDM CAPITAL ASSOCIATES**
RE	**:**	**THIRD QUARTER MARKET COMMENTARY**

In our last quarterly market commentary delivered to you at the end of the second quarter, we reviewed a series of economic data that suggested that the U.S. economy was undergoing a significant slowdown, particularly when compared to the generally positive data that had been published in the two quarters preceding. During the third quarter that came to an end last week, we continued to see similar economic data that suggested a sluggish economic recovery. However, the U.S. equity markets experienced a substantial and somewhat unexpected correction of 12-13% as measured by the S&P 500 Index. As we reviewed in two recent special client letters in July and August, the U.S. debt ceiling debate and U.S. credit downgrade by Standard & Poor's served as a turning point for investor confidence in the market in the third quarter, causing a period of historically extreme volatility that was exacerbated by fears over Greece. In this market commentary, we will review the latest key economic fundamental data, analyze some of the key contributors to the third quarter market volatility, and discuss how we are currently managing client portfolios to maximize value and safety in a volatile environment.

ECONOMIC DATA REMAINS PERSISTENTLY SLUGGISH

The U.S. economy has been undergoing a slowdown since the beginning of the second quarter, as measured by the major economic data available. Up until the third quarter 2011, the U.S. equity markets were buoyed by strong corporate earnings reports as domestic businesses profited greatly from cost-cutting measures taken during the recession of 2008-2009 and strength in emerging market economies. Stock prices remained relatively stable despite this seemingly paradoxical phenomenon of strong corporate earnings and sluggish economic growth. As the slow drip of mediocre economic data reports persisted however, investors became more and more suspicious of the sustainability of the U.S. economic recovery.

United States gross domestic product, which had grown at approximately a 2.5 – 4.0% rate throughout 2010, increased at merely a 1.3% annualized rate in the second quarter 2011, following an even smaller annualized increase of 0.4% in the first quarter 2011 (Figure 1).

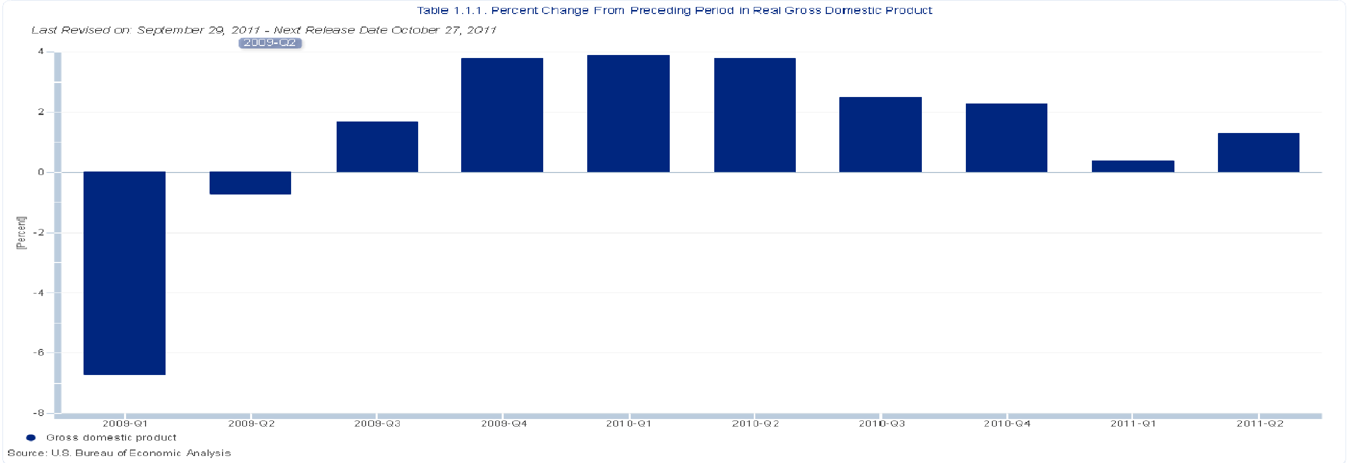

Figure 1

Additionally, industrial production has increased by a reasonable amount in recent months – after an increase of production at a rate of 5.3% for the year 2010, the industrial production index published by the Federal Reserve has increased by 3.4% between August 2010 and August 2011 (Figure 2) and now sits at 97% of its 2007 pre-recession average.

Figure 2 *Source: Econoday; Federal Reserve.*

Meanwhile, the housing market remains an area of weakness, and relatedly, the unemployment rate remains elevated at approximately 9.1%, having dipped below 9% in only two months (February and March 2011 at 8.9 and 8.8%, respectively) out of the last two years (Figure 3).

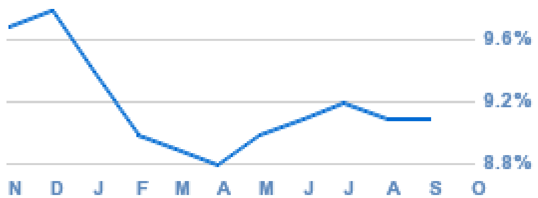

Figure 3 *Source: Econoday; U.S. Bureau of Labor Statistics.*

Nevertheless, the U.S. consumer has remained one of the economic bright spots, perhaps surprisingly, accounting for approximately three-fifths of the economic growth during the recovery. For example, same-store retail sales have increased at a 3-5% level over the past year. Hampering even greater spending is the fact that disposable personal income has begun to flatten out, when factoring in inflation. Yet, the decline in oil prices and Japanese economic recovery and consequent production increases may counteract any near-

term inflationary threat to the consumer. Overall, the economic picture has been one of persistently sluggish economic growth out of the recent recession.

POLITICAL AND FISCAL UNCERTAINTY REMAINS KEY BARRIER TO GLOBAL ECONOMIC GROWTH AND INVESTOR CONFIDENCE

We believe that the most significant impediment to improvement in the equity markets currently is a tremendous crisis of investor confidence in the marketplace. The State Street Investor Confidence Index tied a post-recession low of 88.1 in August, yet rebounded somewhat in September. Investors are significantly discounting global political risk and European financial system risk. Investor confidence or sentiment is a very fickle and difficult concept to measure, anticipate or capitalize on. When the public becomes gripped with fear, the markets can take undisciplined investors for a wild ride as it whipsaws jittery investors that are attempting to time the swings to either buy a perceived low point or sell out of a perceived peak in the market. One can easily lose perspective and the volatility plays on human emotions that lead to irrational decisions. We believe the volatility that gripped the equity markets in the third quarter was a function of a crisis of confidence caused by several major factors:

1. **U.S. politicians have grown increasingly combative in the election run-up reducing investor confidence in the political process.** Whether it was the debt ceiling debate or otherwise, investors have lost confidence that republican and democratic policymakers can work together cohesively to solve the nation's financial problems.

2. **The political bickering over the debt ceiling, while harmful in its own right, shed light on the much bigger problem of our nation's unsustainable debt and spending patterns.** Tremendous amounts of stimulus and accomodative monetary policy have yielded debatable results but caused much more anxiety over the massive amount of borrowing needed to finance it on top of already mounting public debt. In February 2009, the Congressional Budget Office estimated that the $787 billion stimulus package passed by Congress would create 1.2 million to 3.6 million jobs by the end of 2010. It is unclear whether that stimulus package, further rounds of stimulus and Fed liquidity measures have added or subtracted jobs overall, as it is impossible to know what would have happened without these measures for comparison. However, as of the August preliminary employment numbers published by the Bureau of Labor Statistics, the economy has actually lost 1.7 million non-farm jobs since February 2009. With the unemployment rate stuck around 9% since that time (Figure 3 above) and with many more Americans underemployed or out of the labor force entirely, it is a tough sell that these measures have had a net positive impact on the economy. When you consider the costs of these debatable results added onto an already large debt burden – i.e. the U.S. government borrows forty cents of every dollar that it spends – fiscal restraint will have to replace additional spending measures to inspire investor confidence going forward. Investors know that the U.S. economy will not be hurt by a lack of liquidity going forward (thanks to the Federal Reserve); rather, a fiscal crisis looms.

3. **Greece has shown incredible lack of fiscal discipline over the years, hid the ball on its finances to gain admission to the European Union, and European leaders struggle to agree on a solution.** Seemingly daily, there is a mixed bag of rumors that spook the markets as the European Union member nations attempt to garner some consensus on how to tackle the European debt crisis. We believe that ultimately a Greek default is inevitable and European leaders should guide a "soft" default where Greek debt can be restructured in an orderly manner. Greece is currently insolvent and incapable of paying its creditors in full, with Greek debt at 143% of its GDP as of year end 2010. Just this week Greek leaders have signaled that they will not be able to meet their cost-cutting targets for more EU financial aid due to a deeper recession than anticipated. The Greek economy is the size of Colorado's economy and is relatively uncompetitive and reliant on government spending, meaning that it is very unlikely to "grow" out of its financial problems. Euro-zone leaders can go a very long way to re-inspire confidence by signaling to the world that it has a realistic plan of some sort to deal with the problem. The inherent complexities and varied conflicting interests of the European Union make it easier said than done and this disunity makes the likelihood of a European recession higher.

4. **The specter of an increased regulatory burden in 2 – 3 years and uncertain tax policy has caused business leaders to cut back on business spending, reducing overall growth in the economy.** From Dodd-Frank to Obamacare to the National Labor Relations Board's fight with Boeing, increased regulatory oversight has impeded business investment and rational profit maximizing business practice. Major banks have been devising new ways to raise revenue in an environment where Dodd-Frank has imposed over 500 new regulatory regimes in over 2,300 pages of regulations to be imposed at an uncertain time with an uncertain cost. Businesses across the country of all sizes are grappling with the choice of either higher employer-sponsored health insurance for employees or relegating such employees to the government run exchange bureaucracy. The NLRB has taken the fight to Boeing, which is attempting to lower labor costs by switching some production of 787s to South Carolina, which is a "right to work" state. At the end of the day, prospective regulatory burdens and tax hikes, necessary as they may be in some cases, create cost uncertainty and hurt current investment.

5. **High frequency traders are intentionally or unintentionally manipulating some of the market volatility, which causes a vicious cycle that scares other investors and creates more volatility as a result.** The proliferation of algorithm-based trading programs utilized by high frequency traders to rapidly trade securities in the market place in large quantities with little human thought has acted as a volatility catalyst over the past two months. The Dow Jones Industrial Average experienced daily 100 point increases or decreases on more than half of the trading days in the third quarter. In August and September, the Dow experienced 15 days with moves greater than 2%. This degree of volatility can exacerbate the dips as the markets' downward momentum can cause a "sell first, think later" attitude among many investors.

INVESTORS SHOULD REMAIN CAUTIOUSLY OPTIMISTIC FOR LONG-TERM AND PREPARED FOR CONTINUED VOLATILITY IN SHORT-TERM

While overall U.S. economic data and corporate fundamentals signal that the U.S. economy is not heading into a double dip recession as of yet, there is a risk that all of the global uncertainty will lead to a "tail wagging the dog" scenario where global financial markets are impacted by the factors outlined above, perhaps most likely by a problematic Greek default, which then causes a ripple effect that causes the economic and corporate fundamental picture to take a turn for the worse. Therefore, it is highly likely that the volatility experienced over the past two months will continue in the short-term as fearful investors get whipsawed by the latest news released daily on the factors discussed above. In the long-term, we are cautiously optimistic that the U.S. will avoid a double-dip recession, even if Europe falls into a moderate recession in the short-term, but we believe certain asset classes and equity sectors are more attractive than others over that time frame. Our outlook is based on the following insights:

1. **Fed policy has all but assured that the only asset class for meaningful overall return and yield <u>over the long-term</u> is equities.** The Federal Reserve has signaled that short-term interest rates will remain at near zero percent through at least the middle of 2013. Additionally, the Federal Reserve has implemented the much publicized bond purchasing programs known as "quantitative easing" and "operation twist" to depress long-term interest rates. Through these measures, the Fed is trying to force portfolio managers to take more risk, by making interest rate-based investments unattractive, in an effort to stimulate investment in the companies that drive the economy. However, due to speculation over the concerns we discussed above, portfolio managers are first squeezing every last cent out of other asset classes, such as commodities and fixed income, or simply leaving cash on the sidelines. When some of the uncertainty in the market place fleshes out, the only asset class with the potential for upside gain will be equities. It is impossible to predict exactly when that will occur, but important to position yourself for the inevitable if you are in the markets for the long-term.

2. **U.S. corporate fundamentals remain strong and equity valuations are cheap.** Most fundamental data on U.S. companies reflect that the corporate picture is not as bleak as many think. Corporate revenue and profits remain strong. Earnings expectations for the coming quarters have only been reduced slightly recently. Current stock valuations are at very attractive levels compared to the recent past. The market is a forward-looking discounting mechanism that is currently priced for a future recession. Indeed, some economists are predicting up to a 40% chance of a U.S. recession. As a reminder, a traditional technical rule of thumb that an economy is experiencing a recession is two straight quarters of negative economic growth, as measured by a country's GDP. In contrast, we have seen eight straight quarters of economic growth in the U.S. While admittedly growth has been sluggish over the past two quarters, as long as the economy is growing it will avoid a double dip recession and the current valuations will be seen in hindsight as a very attractive buying opportunity.

3. **U.S. companies will be forced by their stockholders to do something with the record amounts of cash on hand**. As we mentioned above, the U.S. corporate picture has remained positive throughout all of the recent macroeconomic concerns. According to the Federal Reserve, corporate cash balances reached an all-time high of $2.05 trillion in June. All potential options for corporate spending with that cash are either neutral or positive for stockholders: dividends, stock buybacks, corporate reinvestment or M&A. At the moment, stock buybacks appear to be the most popular use of this cash. With interest rates at all-time lows, companies can easily replace cash spent with more cheap cash.

4. **Most indications are that a Greek default would not have a "Lehman effect" on the global economy, although no one really knows for sure.** Many U.S. based large financial institutions have somewhat limited direct exposure but the extent of indirect exposure is unknown and hard to quantify. An orderly Greek default seems inevitable and, if it occurs, will be orchestrated by stronger Euro nations in a painful, but controlled manner.

PORTFOLIO IMPLICATIONS

Many of our clients are concerned about how we are and will be managing their portfolios in light of all of this market uncertainty. Earlier this year we believed that the equity markets had gotten a bit too pricey and, in accordance with our value-driven philosophy, decided to defer much further investment of client funds until later in the year when prices became more attractive. Over the summer, as prices have declined considerably, we have used the market dips to jump at opportunities for our clients to buy stocks of solid companies that are temporarily depressed. We cannot, and do not attempt to, time the market by trying to predict the absolute lowest point at which to invest. However, we will continue to take advantage of the opportunities to buy good stocks at cheap prices when they become available. We will avoid over-valued asset classes like certain commodities, particularly precious metals, low-yield fixed income products and government bonds. Regarding the equity sectors that are most attractive at the moment, we will focus on large cap dividend payers, particularly in defensive sectors. These stocks will be very popular if there is an extended downturn and will provide an attractive dividend yield with the likelihood of capital appreciation as well.

As usual, all comments are welcome.

Sincerely,

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- Matt LaRocca, Vice President