

Quarterly Market Review

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Financial Markets and Economic Analysis, Third Quarter 2009

Perspective: 2000-2009, The U.S.'s Lost Decade?

The U.S. equity and fixed income markets have rallied sharply since March 10th of this year, the Russell 1000 Index is up 59.7% since that date and the Russell 2000 Index is up 77.6%. Yet this has still left both indexes well in the red for the 12 month period ended September 30th. It has also left the large cap index in the red for the decade. With just one quarter remaining in the 2000's, the Russell 1000 would need an 11.5% return in the fourth quarter to simply give investors a 0% return for the past 10 years. While the small cap index has managed a small 3.2% per annum return over the decade, this is small comfort with a 3.0% return for T-Bills over the same period¹.

The bear market losses in the U.S. equities market bookending this decade (2000-2002 and 2008) have far outweighed the gains from the other six years. If the decade does go down in the books as a losing one, the timing could have long reaching implications. The leading edge of the Baby Boom generation turns 65 in 2011, representing a significant portion of the U.S. population that is slated to retire in the next five years, if they haven't already. With virtually no growth in the financial assets of the final working decade of these retirees, the choices left to them begin to shrink rapidly. Delaying retirement may give them a few more years in which to rebuild a nest egg, but this will also continue to put upward pressure on unemployment if they fail to make room for the next generation. Some Boomers may choose to retire on schedule, but will likely have to make do with less disposable income in the interim, which may put downward pressure on the economy if this massive group saves rather than spends. Finally, some may be forced to rely on their families or the government to make up the gap between retirement needs and current financial assets. Again, this would likely place a strain on the overall economy as the younger generation is forced to reduce their consumption spending. Additionally, this could result in resources diverted from other necessary, government programs as Medicare soaks up more funds.

Domestic Equity Markets Overview

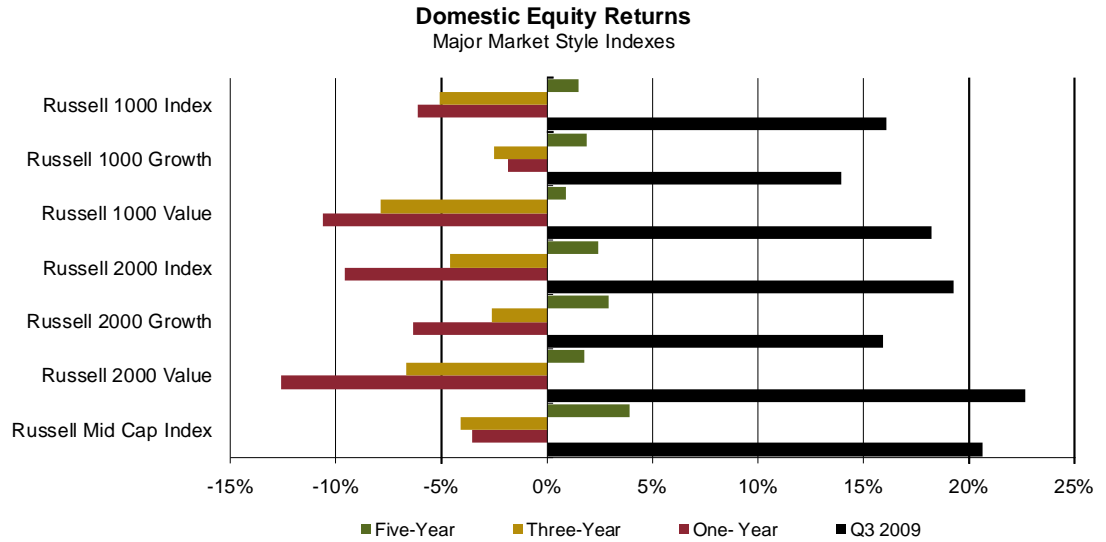
The domestic equity markets were up sharply again in the third quarter, with returns ranging from 14.0% for the Russell 1000 Growth Index to 23.6% for the Russell Midcap Value Index. Across the market cap spectrum the value style indexes outperformed their growth counterparts, though the growth style indices are still well ahead for the year. The growth style indices were hampered by relatively modest returns in both the Technology and Healthcare sectors. Despite the enormity of the rally touched off in March, the 1-year and 3-year numbers for all of the domestic Russell indexes remain well into negative territory.

Looking to the sectors in the domestic equity markets for winners and losers is much more relative in the third quarter, with all 10 sectors in both the large and small cap indices turning in positive returns for the quarter. The rebound in the general health of the financial services industry was one of the keys to the large cap markets in the third quarter. After many of these stocks took a beating in the first quarter, Financials were the best performer in the Russell 1000 during the third quarter, up 24.9%, and pulling the year to date number back into positive territory at 19.8%. The Materials sector was also a major component to the quarter's success up 22.1%. The smaller Utilities (+6.7%) and Telecomm (+6.6%) sectors were the quarter's laggards, along with the Healthcare sector (+9.8) which was held down by potential impacts of the health care reform bill working its way through Congress. The Materials sector

¹ Russell Investment Group and Barclays Capital data

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was the best performer in the Russell 2000 Index, up 36.1% for the quarter and 45.9% for the year to date. The Consumer Discretionary sector continued its run from the second quarter, as it was up 26.4% for third quarter and 54.5% for the year, second best in the index for that period. Small cap Financials is the only sector with a negative return (-3.2%) for the year.



Source: Russell Investment Group

International Markets Summary

The international developed markets continued their rally as well in the third quarter with the Russell Developed Large Cap ex-North America Index up 20.2% in dollar terms. This was well ahead of the domestic large cap market; however, the relative outperformance is largely due to the weakening dollar over the course of the quarter. The currency effect added just under 3% to returns in Europe and just under 8% against the Asian markets². As it was in the U.S., the international developed markets were driven by the rebound in the Financial sector, though all 10 sectors had double digit returns³. The individual country leaders, in dollar terms, were Austria (+34.5%), Australia (+34.0%) and the Netherlands (+31.5%), while Japan was the biggest laggard (+6.5%)⁴.

Although the emerging markets had a similar return to the developed markets, it was far less orderly and more dependent on both country and sector selection. The Russell Emerging Markets Index was up 21.3% in dollar terms, led by both Financials and Technology. Telecomm was the index “laggard” at just 10.6%. From an individual country view, two former Soviet states, Kazakhstan (+69.2%) and Lithuania (+66.8%) were the biggest gainers while index heavyweight China (+8.7%) lagged after a pull back in August⁵. Most of the managers interviewed by Prima over the course of the third quarter believe that the recovery in the emerging markets will have a greater longevity and that the larger emerging market countries have the ability to sustain growth even if there is a pullback in the developed markets.

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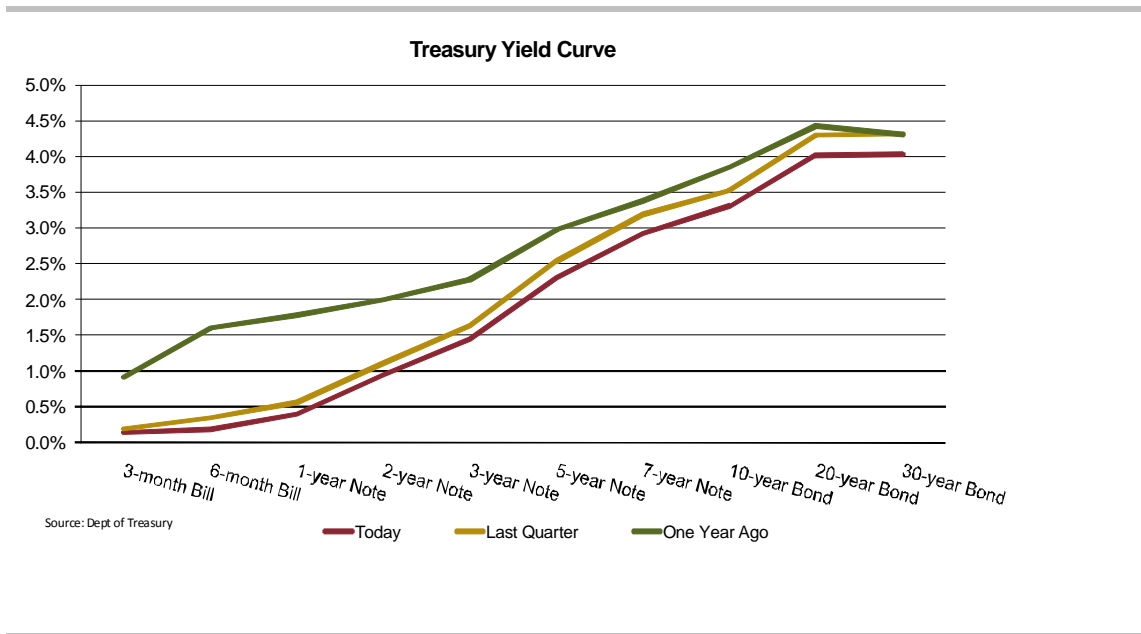
² MSCI Barra data
³ Russell Investment Group data
⁴ Russell Investment Group data
⁵ Russell Investment Group data

Fixed Income Summary

As was the case in the first half of the year, the corporate sector of the market, both investment grade and high yield, was the top performer and driver of returns for most managers in the space.

The domestic yield curve reversed course in the third quarter, flattening slightly as yields fell from 5 basis points at the short end to 29 basis points at the long end⁶. This created an environment for positive returns across all sectors of the fixed income market. The Barclays U.S. Treasury Index had its first positive quarter of the year, rising 2.1%. This was strongly aided by the returns of the long bonds, represented by the Barclays 20+ Year Treasury Index, which was up 5.3% for the quarter. However, that index is still down 15.0% for the year. As was the case in the first half of the year, the corporate sector of the market, both investment grade and high yield, was the top performer and driver of returns for most managers in the space. The Barclays Corporate Index was up 8.1% for the quarter, and stands at 17.1% for the year. All three segments of the index (Financial, Industrial, Utility) showed strong returns, with Financials leading the way, up 9.4%. As of the end of the third quarter the corporate bond market has come full circle, with average spread over Treasuries for the index 54 basis points less than at the end of the second quarter of 2008. In the non-investment grade sector, the Barclays U.S. Corporate High Yield Index was up 14.2% for the quarter and 49.0% for the year to date. As in the second quarter, the sector was led by the lowest rated credits, with the triple-C rated index up 20.6% and the double-C and below index up 34.8%. Many of the investment managers Prima interviewed over the course of the third quarter expressed concern over the speed with which the fixed income markets have recovered this year, and noted that most market sectors, generally, were very near to fully valued. However, with few exceptions, there was generally little concern expressed for rising inflation for the remainder of this year or the early part of 2010.

The municipal market had a breakout quarter in the third quarter, with the Barclays Municipal Index up 7.1% for the period. The more popular 1-12 year segment of the market was up just 3.9% however. The municipal market continues to see substantial inflows even as new issuance has been well below average. This has pushed prices higher (and yields lower) for most of the year. As of the end of the quarter, the majority of the market traded at a premium, with the exception of the longest maturities. The new issuance of Build America Bonds, federally backed taxable municipal issues, is also reducing issuance of traditional bonds. Lower rated issues continued to outperform in the third quarter as well, as these issues recover from the losses in the second half of 2008.



⁶ U.S. Treasury Daily Yield Curve Rates

Outlook

Short of a sharp reversal in the final quarter, 2009 will have the best calendar year performance since at least 2003.

The world financial markets continued their respective rallies during the third quarter and short of a sharp reversal in the final quarter, 2009 will have the best calendar year performance since at least 2003. But unemployment continues to rise in the U.S. and the federal rescue programs (TARP, TLGP, TALF, MBS buying program) are beginning to taper off with many programs ending in the fourth quarter, potentially limiting upside potential from here. Only a few of the investment professionals Prima spoke with during the quarter showed even low levels of concern for inflation in the next six to nine months, but many are worried about the continuing weakness in consumer spending and need for the federal government to continue its spending in support of the economy. The general consensus is that the disaster scenario had been averted, but that true economic growth may take some time to materialize.

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