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Review and Outlook
Third Quarter 2011

The third quarter was painful for stock investors. The S&P 500 Index's total return was -13.9%. The issues that bedeviled investors at the end of the second quarter came to a head in the third quarter, depleting investor and business confidence. Unemployment continued to dog the economy as local and state governments shed employees, even while private business added jobs at a slowed pace. High unemployment combined with higher consumer savings rates crimps consumer spending, and lower consumer spending impedes job growth. While consumer deleveraging is good for the economy in the long run, it is not helping the economy now. Consumer spending also is negatively impacted by the high level of underwater mortgages. Consumers seem to spend less if they owe more on their mortgage than the house is worth. The high levels of underwater and defaulted mortgages have also cut the demand for new construction. This, in turn, has hurt employment in construction and related industries.

Greece's financial meltdown threatens the financial stability of Western Europe and is creating high anxiety on this side of the Atlantic. Greece is of little economic importance in the world, except with respect to who has loaned what amount to Greece and to Greek banks. Prior to Greece joining the euro area, their problems would have been resolved (at least temporarily) with a simple devaluation; a tactic utilized many times by Greece in the not too distant past. When Greece joined the euro area, devaluation ceased to be an option. Since Greece has become a member of the euro area many European banks have loaned huge sums to Greek banks and have bought enormous quantities of Greek debt. Now Greece cannot pay back what it owes, and investors fear that European banks cannot afford the losses if Greece defaults.

While American financial institutions' direct exposure to Greek debt appears limited, they have substantial exposure to European banks. In addition, American financial institutions may have underwritten substantial insurance against losses on Greek debt through the sale of esoteric credit default swaps. Hence, little Greece is causing major stomach ulcers around the world. The "austerity" programs being imposed on the Greek economy are not likely to resolve this issue. They may help to change Greek society's expectations relative to public support, but the austerity programs will not by themselves enable Greece to repay its debts. What will probably be required is a structured, partial default on Greek debt, where European taxpayers and European banks will share the pain. This may have significant political impacts, particularly in Germany. However, such a structured resolution may avoid the contagion similar to the collapse of Lehman Brothers. It is the fear of the latter scenario that has resulted in some of the worst days on the US stock markets this past quarter.

Stock prices moved down in the quarter, but not smoothly. Day-to-day moves were very volatile. The S&P 500 Index gained or lost 2.5% or more in 23% of the trading days through September 28th. During one third of those days, the S&P 500 *gained* 2.5% or more. If the movements of stock prices seemed dizzying during the quarter, they were! In contrast, during the same period one year ago, the S&P 500 moved 2.5% or more in only 6% of the trading days.

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I believe this extreme volatility is a reflection of a significant level of investor uncertainty. While there are many issues that worry investors, there are some areas of good news. Price/Earnings ratios are low. As stock prices declined, corporate earnings climbed. During the third quarter, the median Price/Earnings ratio of the Value Line universe of 1300 stocks dropped to 13.4. Forecasts for future earnings growth are being trimmed, but forecasts are still for positive growth. September's manufacturing index was above consensus forecast, and construction spending in August rose. I believe this type of positive data helps to explain the very steep price gains experienced on any day in which there seemed to be hope for a positive outcome in the Greek mess, or good news on the employment front, or some other news item that provided a boost of confidence for investors.

It is unlikely that the economy will experience a speedy recovery. Any improvements in employment, housing, or the GDP will likely be slow. Yet, in the absence of a collapse in Europe, slow growth may still be the most likely scenario. However, it is very difficult to translate this into a short term forecast of the stock market, except that volatility will likely remain high.

In this environment it is critical that portfolios be structured to match the goals and constraints of the investor. We do not believe the case for equity investment has fundamentally changed. However, we do believe that investors will be subject to more short-term volatility in their portfolios than would have been the norm some years ago, because stocks themselves will be more volatile, and because traditional strategies offering protection from the impact of this volatility on portfolio values is less effective.

One traditional strategy to reduce volatility has been to hold high-quality bonds in addition to stocks. Falling interest rates in difficult economic times resulted in rising bond prices, which helped to offset falling stock prices. With interest rates at rock bottom, bond prices have little room to rise. Stock selection criteria emphasizing less volatile characteristics, as well as some basic hedging strategies, may help to substitute for some of what bonds provided in the past.

It is important that investors recognize that while the long term growth case for stocks may not have changed, the volatility environment may have changed. This should impel investors to review their portfolio structure with respect to their short and long term goals.

Michael F. Ryan
President

October 3, 2011