Third Quarter 2012 Reflections: Economy and Capital Markets

Prepared: October 19, 2012

OVERVIEW

Capital markets generated mostly positive returns for investors during the third quarter. This occurred even as challenges to the global economic environment led two major central banks to engage in further quantitative easing. Most major economies slowed, some even to the point of slipping into a recession.

Manufacturers scaled back their capital spending programs in response to concerns about:

- Economic slowdown and ongoing debt crisis in Europe
- Signs of slowing economic growth in China
- Fears about the impending U.S. fiscal cliff (a combination of scheduled spending reductions and expiring tax cuts)

Even with significant central bank initiatives to ease monetary policy, inflation pressures ebbed around the world. A welcome bright spot for the U.S. was improvement in the housing market. Homebuilder confidence rose as activity began to increase from steeply depressed levels.

Securities markets were decidedly more upbeat as risk assets surged in the third quarter. Investors who were not sitting on the sidelines were rewarded in a variety of sectors:

- Commodities surged 11.5%, as measured by the S&P GSCI. Performance was buoyed by gains in energy, precious metals and grain prices.
- Stocks were strong across the globe. The MSCI All-Country World Index gained 7%, emerging market stocks increased 8%, and U.S. stocks, as measured by the Dow Jones Total Stock Market Index, rose 5.6%. Even with Europe’s ongoing problems, the MSCI Europe Index returned 9% for the quarter.
- Foreign real estate gained 9.5%, although U.S. Real Estate Investment Trusts (REITs) experienced a difficult quarter as the Dow Jones U.S. Select REIT Index dropped 0.4%.
- Bonds generally performed well. Key benchmarks such as the Barclays U.S. Aggregate and the Barclays Municipal Bond Index rose 1.6% and 2.3% respectively. Credit risk was rewarded as high yield corporate debt and emerging market debt outpaced the broader indices.

GLOBAL ECONOMY AND POLICY

As data showed a slowing of the U.S. economic recovery in the third quarter, the U.S. Federal Reserve (Fed) and European Central Bank (ECB) both committed to further quantitative easing (QE) measures. In September, the Fed announced additional monetary accommodation, following its
initial QE1 and QE2 programs. This was dubbed by some as “QE Eternity.” The Fed indicated it would purchase $40 billion of mortgage-backed securities each month until the outlook for labor markets improves materially. This policy appeared to enjoy initial success in driving down mortgage rates and helping spur a housing recovery.

Global Purchasing Managers’ Index declined or slowed for most major economies, including the U.S. and China. Inflation remained low, even moderating some in the U.S., China and Europe. The U.S. unemployment rate managed to fall below the 8% mark, while Europe’s employment market deteriorated.

Positive news was limited, but one of the most encouraging signs came from the U.S. housing market. The market remains well below its peak levels, but home prices, as reported by the Federal Housing Administration and the S&P/Case-Shiller Index, moved into positive territory in year-over-year measures. Housing starts and building permits stretched to post-recession highs and new and existing home sales continued to recover from their lowest levels. Housing represents just a small part of the overall U.S. economy, but improvement in this sector is important to confidence and a sign of recovery from the financial crisis that was driven by excessive mortgage debt.

Worldwide economic growth appeared muted in the third quarter. In the U.S., Gross Domestic Product (GDP) grew at an annualized rate of just 1.3% in the second quarter. GDP in the eurozone declined 0.7% over the quarter, its second decline in three quarters. Underlying data was also modestly negative. The

Sources: Strategas Research Partners, Bloomberg.
MARKETS: RISK ON

Even though economic data was generally disappointing in the quarter, investor appetite for risk appeared to blossom. Markets climbed the proverbial “wall of worry” as stocks across a broad spectrum of the globe gained momentum. After a relatively flat July, investors appeared to see hope in expectations for an easing of monetary policy. Europe and emerging market nations were the strongest performers.

**Markets May Have Overly Discounted the European Debt Crisis**

![Graph showing MSCI Europe Index Price Level from Oct 15 2012 to Oct 15 2010](image)

Source: FactSet

**Equities:** The valuation of markets, as evidenced by price-to-earnings (P/E) multiples, has increased and is supported by global central bank activity, despite a decline in earnings expectations for 2012. At best, this pace of improvement may remain operative for another year, but not indefinitely. We believe earnings estimates may still be too high looking out into 2013. Even in this challenging environment, dividends for the S&P 500 reached an all-time high in the third quarter. The list of companies paying dividends to shareholders for the first time is growing and now includes the market behemoth, Apple. Others are raising payouts, such as an 8% increase from General Mills. Yet the payout ratio for the S&P 500 as a whole (dividends per share divided by earnings per share) is 29% below its ten-year average, so there may be room for future dividend growth. Still, dividend yields on stocks of the S&P 500 average 2.05%, outpacing the yield on both the benchmark U.S. Treasury note and the diversified Barclays U.S. Aggregate Bond Index.

**Fixed Income:** Bonds also performed well as central bank easing compressed yields, especially for risky debt. Investors hungry for higher yields than what were available from government-issued debt increased their exposure to credit risk. Yields on ten-year U.S. Treasury securities remained almost unchanged from the beginning to the end of the quarter, at 1.62%, but there was significant volatility in between. The Barclays U.S. Aggregate Bond Index gained 1.6% over the quarter and high yield credits rose another 3%. In the current interest rate environment, bonds are likely to continue to generate modest returns.

**Commodities:** Commodities were strong during the quarter due in large part to a drought in the U.S. which pushed food prices higher and increased fears of a Middle East conflict leading to higher oil prices. The grains index jumped 17%, but gave back larger gains by late in the quarter as damage to crop yields was lower than expected. Energy prices moderated in September as investor focus turned to concerns of a global economic slowdown that could temper demand. Going forward, the outlook for commodities is more modest, but as is often the case, volatile. Slow economic growth may limit price gains. The Middle East remains unpredictable. The struggle over Iran’s desire to expand its nuclear capabilities could result in a conflict, which would likely lead to a spike in oil prices. That appears to be the biggest wild card in the commodity markets today.
OUTLOOK

In the closing months of 2012, more policy risks are on the horizon as the U.S. deals with its fiscal cliff and the eurozone struggles with its debt crisis and the economic fallout from it. On the positive side, most corporations are healthy, maintaining low inventory levels and high cash reserves. China and other emerging market nations appear serious about providing more economic stimulus. China announced at the end of the third quarter that it would add 0.5% to GDP per year for the next four years through increased infrastructure spending. Another plus is that the U.S. consumer appears to be in reasonable condition. Household debt has been reduced, the employment environment is slowly improving and personal incomes are rising again.

Markets will be affected by ongoing uncertainty in the fourth quarter. Europe’s struggles remain unresolved, with debt issues in Greece, Spain and Italy taking center stage. Key benchmarks for resolution of the crisis, including fiscal union and a single banking authority, seem far off in the future. In the U.S., uncertainty surrounding the presidential election and fiscal and tax policies that could change dramatically in early 2013 are issues for investors that could affect performance in the coming months.

Source: Strategas Research Partners
This commentary was prepared on October 19, 2012 and the views are subject to change at any time based on market or other conditions. This information represents the opinion of U.S. Bank Wealth Management. Since economic and market conditions change frequently, there can be no assurance that the trends described here will continue or the forecasts will come to pass. It is not intended to provide specific advice or to be construed as an offering of securities or recommendation to invest. Not for use as a primary basis of investment decisions. Not to be construed to meet the needs of any particular investor. Not a representation or solicitation or an offer to sell/buy any security. Not to consult with their investment professional for advice concerning their particular situation. The factual information provided has been obtained from sources believed to be reliable, but is not guaranteed as to accuracy or completeness. U.S. Bank is not responsible for and does not guarantee the products, services or performance of third party providers.

Past performance is no guarantee of future results. All performance data, while deemed obtained from reliable sources, are not guaranteed for accuracy. Indexes shown are unmanaged and are not available for investment. The S&P 500 Index is an unmanaged, capitalization-weighted index of 500 widely traded stocks that are considered to represent the performance of the stock market in general. The Dow Jones U.S. Total Stock Market Index represents the top 95% of the U.S. stock market based on market capitalization. The MSCI All Country World Index is designed to measure the equity market performance of developed and emerging markets. The MSCI Emerging Markets Index is designed to measure equity market performance in global emerging markets. The MSCI Europe Index is designed to measure the equity market performance of the developed markets in Europe. Barclays Capital Aggregate Bond Index measures the investment grade, U.S. dollar-denominated, fixed rate taxable bond market, including Treasuries, government-related and corporate securities, mortgage-backed securities, asset-backed securities, and commercial mortgage-backed securities. Barclays Capital Municipal Bond Index is comprised of fixed rate, investment grade, tax-exempt bonds with maturities of one year or more. The S&P GSCI is a composite index of commodity sector returns that is broadly diversified cross the spectrum of commodities. The Dow Jones U.S. Select REIT Index measures the performance of publicly traded REITs and REIT-like securities.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments. International investing involves special risks, including foreign taxation, currency risks, risks associated with possible difference in financial standards and other risks associated with future political and economic developments. Investing in emerging markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Investing in fixed income securities is subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications, and other factors. Investment in debt securities typically decrease in value when interest rates rise. The risk is usually greater for longer term debt securities. Investments in lower rated and non rated securities present a greater risk than higher rated securities. Investments in high-yield bonds offer the potential for high current income and attractive total return, but involve certain risks. Changes in economic conditions or other circumstances may adversely affect a bond issuer’s ability to make principal and interest payments. The municipal bond market is volatile and can be significantly affected by adverse tax, legislative or political changes and the financial condition of the issuers of municipal securities. Interest rate increases can cause the price of a bond to decrease. Income on municipal bonds is free from federal taxes, but may be subject to the federal alternative minimum tax (AMT), state and local taxes. There are special risks associated with an investment in commodities, including market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes, and the impact of adverse political or financial factors. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates, and risks related to renting properties (such as rental defaults).

©2012 U.S. Bancorp (10/12)