



## Summary

The economy grew at a 2.5% annual rate in the third quarter, a relatively strong improvement in growth over the first two quarters as consumers and businesses boosted spending. In fact, real final sales (gross domestic product less changes in private inventories) grew 3.6% compared to a 1.6% rise in the second quarter.

Consumers were apparently able to put aside the talk of another recession and the financial problems in Europe. As a result, there was a higher rate of spending in September, though incomes rose less than expected. Concerns remain centered on the job market and a lack of strong employment growth even though the size of the U.S. economy has now passed its pre-recession level. While the labor market has exhibited more stability, it has yet to add jobs fast enough to lower the unemployment rate very quickly.

Corporate America's financial health is good, with companies holding an ever-increasing amount of cash on their balance sheets. However, these same companies do not appear to be in any hurry to hire a large number of new workers any time soon. There still are a number of concerns related to taxes, health care and global economic growth that lead corporations to a cautious approach in their hiring decisions. The Fed remains committed to keeping interest rates low in an effort to avoid another downturn. The Institute of Supply Management manufacturing and non-manufacturing indexes remain above 50, which indicates continued, but sluggish growth. We continue to believe the U.S. economy will stay in positive growth territory, even though the growth will most likely remain slow and unexciting.

### POSITIVES

- ❑ ISM manufacturing and non-manufacturing indexes remain above 50 level
- ❑ More stability and slight improvement in the job market
- ❑ Spending by the consumer remains a positive for growth
- ❑ Consumer inflation continues to be under control and may be moderating

### NEGATIVES

- ❑ Decline in Conference Board's Consumer Confidence Index
- ❑ Drop in personal savings rate reflects income growth trailing spending growth
- ❑ Wholesale prices rose more than expected in September

### UNKNOWNNS

- ❑ Health of the holiday selling season and impact on U.S. economy of continued problems overseas



## Summary

After suffering a dismal third quarter, the U.S. equity market rallied sharply in October, driven in part by a glimmer of a resolution to the seemingly intractable European debt crisis. In contrast, fears this summer of a “double dip” recession in the U.S. appear to have been overblown as many measures of economic health, while not robust, do not point to recession.

The S&P 500 Index gained 10.9% in October, with the more volatile materials and energy sectors leading the charge with gains of 17.7% and 17.0% respectively. As expected, the more defensive utilities and telecommunications sectors lagged the market, adding just 3.0% and 3.6%.

It was telling to observe the explosion of pent up demand for equities in the last week of October as European politicians appeared to have hammered out a framework to move forward with debt resolution.

As a measure of the global nature of the stampede into risky assets, the Emerging Market Index gained 13.3% and even European bourses participated, adding 9.6% as measured by the MSCI EAFE Index.

Our outlook for U.S.-based equities remains positive from a fundamental valuation basis. Other metrics, including absolute price-earnings ratios, discounted cash flow metrics and earnings yield comparisons versus interest rates, all point to a much undervalued U.S. stock market.

### POSITIVES

- ❑ Economy not pointing to recession
- ❑ Dividend yields attractive
- ❑ Historically positive time of year for equities

### NEGATIVES

- ❑ Unresolved European debt crisis
- ❑ U.S. economy lacking robust job growth
- ❑ U.S. political gridlock

### UNKNOWNNS

- ❑ Euro contagion spreading to Italy



THE SOURCE

**FCI**

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# FIXED INCOME OUTLOOK

## Summary

Two or three years from now, Greece and Italy won't be dominating the financial news headlines. The only context in which these countries will then be making news is when the tabloids exploit surreptitiously taken photos of celebrities frolicking on their pristine beaches or yachts in their harbors. But for now, little else matters to financial markets.

Last month we thought there was a real plan for bailing out Greece (with a 50% haircut on their debt), recapitalizing the European banking system and limiting the fallout on other debtor nations (e.g. Italy) while they get their deficits under control. In reaction to the news, investors sold the world's largest safe-haven market, U.S. Treasury securities, and flocked into riskier asset classes like equities and corporate bonds.

There are many reasons to be optimistic. When the tabulations are complete later this month, it is likely that S&P 500 companies earned a record amount last quarter. Employment gains are increasingly steady, although moderate. Consumer spending, which drives approximately two-thirds of the economy, has been surprisingly resilient. Corporations are flush with cash that can be used for innovation and expansion. On its own accord, the U.S. economy is unlikely to slip back into a recession. But none of this matters.

The future of the bond market will be determined by the ability of European leaders to craft a real solution to stabilize the markets for their debt and provide support for their banking system. If they are successful, investors can once again focus on our own reasons for optimism and risk assets will rise at the expense of Treasury bonds. If unsuccessful, it's back to the bunker: risk assets will decline and rates will drop steadily from these already-historic low levels. We are cautiously optimistic and therefore recommend maintaining a somewhat shorter duration policy.

### POSITIVES

- ❑ Inflation at the core level is likely to remain moderate; outlook is benign
- ❑ Uncertainty in European financial crisis

### NEGATIVES

- ❑ Rates already reflect slow growth and uncertainty; historic lows
- ❑ Most Treasury yields lower than the 12-month trailing rate of inflation

### UNKNOWNNS

- ❑ Investors continued flight from riskier asset classes
- ❑ Ability to attract international investors; China trade skirmishes
- ❑ Further Fed actions to stimulate the economy