

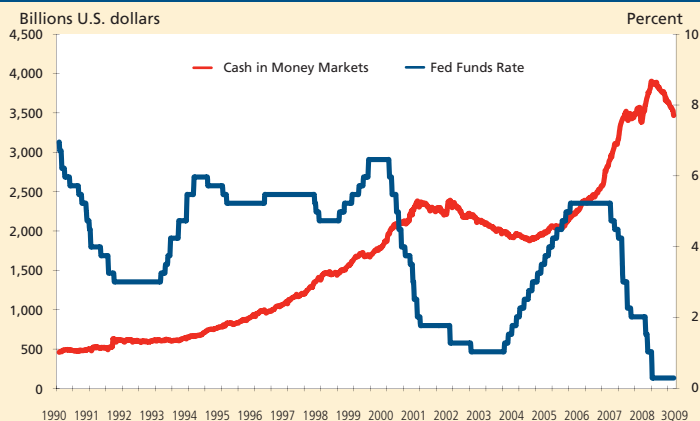
Where Is All the Money Going?

By Mark Luschini, Chief Investment Strategist



The veritable mountain of cash that has been accumulating in money market funds is showing some erosion. After peaking at a record level just north of \$3.9 trillion in January, money market fund assets began to descend in mid-March. From that point, more than \$400 billion has been shed from fund balances. (See Chart A)

Chart A: Cash on the Sidelines



(Source: Bloomberg and Parker/Hunter Asset Management)

Investors fled risk assets at an accelerating pace through the fall of 2008 and early 2009 as financial markets suffered under the threat that the credit calamity would ruin the entire financial system. The distortion that occurred in the capital markets was agnostic across asset classes. Equities of all denominations fell, government bond prices jumped, pushing yields to multi-generational lows while practically all other types of bonds suffered, and commodity prices collapsed. Seeking a port in the storm, money escaping these investments rushed to cash equivalents such as money market funds. When it became apparent that the most intense point of the crisis passed, spurred by the restoration of investor confidence resulting from the Treasury Department's "stress tests" of the major banks and Fed Chairman Ben Bernanke's sighting of economic "green shoots," risk assets responded. Stock values turned and have advanced sharply from the March lows and bonds of all varieties, with the exception of longer-term government securities (the opposite of last year) have moved substantially higher as well.

Investors have seized on the recovery in asset prices by placing money in investments that not only seem safer now that the recovery is well-entrenched, but also offer a return hurdle that requires almost no exercise to clear since the yield on cash-like instruments, such as money market funds, is near zero (the Fed Funds Rate is a proxy for Money Market Yields). What is interesting, however, is that the money flowing from money market funds is discriminate in its destination. The overwhelming majority is flooding into mutual funds that invest in bonds. Equity mutual funds have actually been experiencing net outflows—the money going out exceeds that which is coming in. Actually it is domestic equity funds that are taking the brunt of the redemptions because foreign equity funds have had respectable inflows. The money flowing into bond mutual funds, both taxable and tax-exempt, is at record levels. The implication is that investors being chased out of low yielding money market funds have crawled out on the risk spectrum rather than sprinting right through bonds to equities. Not that the returns generated by bond funds this year have been disappointing. Quite the opposite. As seen in Chart B, the rally in bond prices, particularly corporate bonds, has produced returns that rival, or in some cases exceed, that of the equity market.

Chart B: Bond Index Returns as of 9/30/09

Barclays Municipal Bond Index	14.0%
Barclays Corporate Bond Index	17.1%
Barclays High Yield Corporate Bond Index	49.0%
S&P 500 Stock Market Index	19.3%

(Source: Janney Montgomery Scott)

The buying power required to push prices higher has not been sourced exclusively from money market fund proceeds, but it certainly helped. The investment firm MF Global reported that flows to corporate bond mutual funds, the recipient of a record \$121 billion in inflows this year, accounted for an astounding 99% of the decline in corporate bond yields. The result is that returns will likely be more muted from this point forward since the yields on non-government securities have narrowed so sharply compared to Treasuries. Additionally, should the bond vigilantes step back to the fore, prices could retreat and bonds could lose some of their recent luster.

It is perhaps telling that the surge in equity prices has not drawn more assets to stock funds. Investors remain skeptical as the expense of the recent decline still burns in their memory. With factors including a soft labor market, distressed home values, and tight credit conditions contributing to their unease, it is no wonder that so much cash remains idled while the stock market has charged higher. The silver lining for stock prices is that the enormous amount of sidelined money means there is still plenty of cyclical liquidity support for the equity market. As such, there lies opportunity to mine for future growth where the money has not been going—toward quality American companies with great franchises. ■



Eight Would Be Great

By Gregory M. Drahuschak, Market Strategist

"The nearly constant mention of September's supposedly ominous history makes us wonder if once again the consensus will be wrong—all Septembers have not been bad especially when the month falls in the middle of a string of monthly gains."

The opening paragraph this month was near the end of our *Investment Perspectives* article in September. As it suggested was possible, the market cast aside seasonal biases. Instead of being the worst month of the year, September saw the S&P 500 post its seventh-consecutive monthly gain and become the 12th best September in the last 60 years. The first three weeks of the month, however, had a different character than the final seven trading sessions.

Market sentiment in early September focused on improved data reported for many economic measures. The S&P 500 set a closing peak on September 22. It reached an intraday peak in the following session before slipping into the end of the month. Weakness in the closing days of September came alongside some disappointing reports like the *Conference Board's Consumer Confidence Index* and the *Chicago Purchasing Managers' Index*.

The length and extent of the market's move up from the March low prompted rapidly increasing calls that the market was destined for a correction—calls that the market in its normally perverse style completely ignored. Undaunted by the market rise during what was supposed to be a poor month, bearishly biased traders merely shifted their attention to the potential for weakness in October.

Despite a few historic declines in October, gains in the month are about 50 percent more common than losses. During the last 59 years, October

has produced an average gain of 0.63 percent. October, however, is complicated by a 1986 change in the tax code which mandated that mutual funds were expected to make year-end distributions to balance gains and losses by the end of October, not the end of the calendar year. This effectively creates a second tax season that could impact the market. This activity often does not have significant impact on the direction of the major averages, but it can notably impact individual stocks.

October is also the time for third quarter earnings reports. Although each day features its share of reports early in the month, the barrage of releases does not begin until the week of October 12. As we have noted many times in our *Market View Daily*, we think upside surprises will be relatively common. As Chart C shows, positive second quarter earnings surprises dwarfed the number of negative surprises. The 72.5 percent of positive surprises was very high relative to the typical rate over many years. Beating the number of second quarter earnings surprises, however, will be difficult.

Chart C: Second Quarter 2009 Earnings Surprises

Sector	Percent Positive Surprise	Percent Negative Surprise	Percent Inline
S&P 500	72.5	19.0	8.5
Consumer Discretionary	77.5	17.5	5.0
Consumer Staples	84.6	10.3	5.1
Energy	72.5	22.5	5.0
Financials	62.3	31.2	6.5
Health Care	81.1	3.8	15.1
Industrials	76.4	12.7	10.9
Information Technology	73.7	17.1	9.2
Materials	73.3	16.7	10.0
Telecommunication Services	44.4	44.4	11.1
Utilities	54.3	34.3	11.4

(Source: Credit Suisse Quantitative Research)

Part of the reason the positive second quarter earnings surprise rate will be difficult to match is that expectations now are substantially more optimistic than they were heading into the second quarter reporting period. Third quarter year-over-year comparisons, however, largely will continue to be negative with only the consumer discretionary and financial sectors expected to produce positive year over year results. (See Chart D)

2009 Index Performance

2009 Market Data		Prior Close	Last	Change	% Daily	% Yearly	% Jan	% Feb	% Mar	% Apr	% May	% June	% July	% Aug	% Sep	1st Quarter	2nd Quarter	3rd Quarter
DJ Industries	.DJIA	9742.20	9712.28	(29.92)	(0.31)	10.66	(8.84)	(11.72)	7.73	7.35	4.07	(0.63)	8.58	3.54	2.27	(13.30)	11.01	14.98
S&P 500	SPX	1060.61	1057.08	(3.53)	(0.33)	17.03	(8.57)	(10.99)	8.54	9.39	5.31	0.02	7.41	3.36	3.57	(11.67)	15.22	14.98
NASDAQ Comp	COMP	2124.04	2122.42	(1.62)	(0.08)	34.59	(6.38)	(6.68)	10.94	12.34	3.32	3.42	7.82	1.54	5.64	(3.07)	20.05	15.66
SOX Index	SOX	323.00	325.75	2.75	0.85	53.53	(1.84)	(5.11)	13.89	9.63	7.86	(3.01)	14.66	1.47	6.39	8.14	14.69	23.79
Biotech Index	BTK	925.39	922.88	(2.51)	(0.27)	42.60	(1.95)	(6.01)	7.55	(0.69)	1.83	7.47	24.83	6.35	(0.29)	(0.88)	8.69	32.38
DJ Transports	.TRANS	3826.60	3799.84	(26.76)	(0.70)	7.43	(16.16)	(15.73)	7.40	17.14	1.85	1.00	10.68	2.43	3.62	(24.12)	20.51	17.48
DJ Utilities	.UTIL	380.27	377.23	(3.04)	(0.80)	1.75	(0.29)	(12.37)	1.67	1.47	2.03	4.93	3.26	1.05	1.04	(11.16)	8.63	5.43
Volatility Index	VIX	25.19	25.61	0.42	1.67	(35.98)	12.10	3.37	(4.77)	(17.31)	(20.77)	(8.89)	(1.63)	0.35	(1.54)	10.35	(40.30)	(2.81)
S&P Midcap 400	MID	695.04	691.02	(4.02)	(0.58)	28.38	(7.36)	(9.87)	9.75	13.76	2.56	0.46	8.63	4.22	5.57	(8.36)	17.21	19.52
S&P 100	.OEX	490.25	488.35	(1.90)	(0.39)	13.16	(9.33)	(11.01)	8.37	7.59	5.31	0.49	7.12	3.14	2.87	(12.56)	13.86	13.66
Gold ETF	GLD	97.43	98.85	1.42	1.46	14.25	5.54	1.45	(2.54)	(3.33)	10.23	(5.22)	2.38	0.05	5.84	4.35	1.00	8.41
Russell 1000 Index	.RUI	581.96	579.97	(1.99)	(0.34)	18.90	(8.29)	(10.67)	8.52	9.95	5.27	0.06	7.49	3.40	3.90	(11.09)	15.82	15.47
Russell 2000 Index	.RUT	610.45	604.28	(6.17)	(1.01)	20.99	(11.20)	(12.29)	8.67	15.33	2.88	1.34	9.53	2.76	5.63	(15.36)	20.23	18.89

(Source: Standard & Poor's)

Chart D: Third Quarter 2009 Year-Over-Year Growth Comparisons

Sector	Actual Growth (%)		Projected Growth Rate (%) Q3/2009
	Q1/2009	Q2/2009	
S&P 500	-34.3	-15.6	-16.8
S&P 500 Ex Financials	-33.9	-27.7	-27.5
Consumer Discretionary	-96.7	70.8	82.5
Consumer Staples	-1.5	-0.8	-4.1
Energy	-60.8	-67.1	-65.0
Financials	-29.6	773.6	169.4
Health Care	1.5	3.7	-2.4
Industrials	-38.3	-38.0	-47.3
Information Technology	-27.0	-21.9	-15.4
Materials	-77.5	-65.0	-66.4
Telecommunication Services	-17.5	-24.1	-19.1
Utilities	-1.8	-7.1	-3.2

(Source: Credit Suisse Quantitative Research)

Earnings are significant but they will not be the market's only consideration this month. (See Chart E)

Chart E: S&P 500 Sector Results (%)

Sector	MTD	QTD	YTD
S&P 500	3.57	14.98	17.03
Information Technology	4.47	16.70	44.80
Materials	4.74	21.00	35.86
Consumer Discretionary	5.16	18.85	27.78
Financials	1.93	25.14	19.19
Industrials	6.57	21.24	11.93
Health Care	0.90	8.91	7.87
Consumer Staples	3.26	10.50	6.70
Energy	4.60	9.49	5.94
Utilities	1.05	4.96	0.68
Telecommunication Services	2.81	3.94	-3.06

(Source: Standard & Poors)

The final estimate of second quarter Gross Domestic Product showed a 0.7 percent decline. This, however, was moderately better than the prior estimate and considerably better than the initial estimate. There is a growing consensus that third quarter GDP will be a positive number that could be at or above the long-term trendline rate. The consensus also is biased toward equally good fourth quarter GDP results. Anything that jars this thinking could rattle the equity markets. This, of course, means that paying attention to the major economic releases will continue to be important.

Traders in October will also face the fact that in the last 60 years, the S&P 500 has risen for eight-straight months only five times. On the positive side, October has been the stopping point for consecutive monthly gains of four months or more only once, which happened in 1974. In addition, October has produced abnormally large gains after the end of bear markets. In the 14 Octobers that came after bear market lows, the S&P 500 gained an average of 3.2 percent. Of these 14 Octobers, only four were down months.

We cannot rule out the chance the market may need to endure a correction. Action late in September in many individual stocks was similar to patterns seen when stocks reach an interim peak and settle back for a

Lessons From A Crisis

By Guy LeBas, Chief Fixed Income Strategist



In our last installment of *Investment Perspectives* we noted that Janney Fixed Income Strategy would be spending the month of September looking back over the past 12 months of crisis and trying to extract some wisdom from the near-collapse of the financial system, as well as what ensued. Over the course of the month, we published a special series of notes titled *One Year Later* that identified nine major lessons from the crisis in the fields of economics, the capital markets as a whole and the credit markets in specific.

Economics

Lesson #1: Financial sector problems can have major repercussions in the real economy. Traditional thinking suggests that the financial markets impact the real economy in only limited ways, primarily through interest rates and monetary policy. The fact that credit conditions and liquidity problems have triggered, or at the very least added to declines in consumer and corporate spending throughout late 2008 into 2009 is clear.

Lesson #2: Government expenditures can never replace consumer capital. Consumer spending accounts for around 70% of GDP, while federal government expenditures total just 7%. A total 2% decline in consumer activity would therefore require an 18% increase in the federal budget in order to fully compensate. While in the short-term, such an increase is tolerable, in the longer-term, that same increase becomes completely unsustainable.

(Continues on page 4, *Lessons From A Crisis*)

time. We are not overly concerned about the widely discussed overbought condition of the market. From an intermediate and longer-term viewpoint, an overbought market condition is a sign of strength, not weakness, but it can lead to interim pullbacks, which we think will be comparatively shallow.

Instead of thinking about the potential for a correction, we would counsel investors to look ahead toward a cyclical peak for the market that could be near 1200 for the S&P 500, and we would not rule out the possibility it could be higher than this. We would note that our view is not Pollyannaish. We are fully aware of the headwinds the economy faces long-term. As noted in previous reports, one of our key concerns is government policy shifts that, if not done carefully, could produce more harm than good. The biggest issue ahead is how the U.S. deals with the massive budget deficit that surely will go higher over the next year or two.

These and other concerns, however, will probably not impact the market in a timeframe that most investors need to consider right now. ■

(Lessons From A Crisis, Continued from page 3.)

Lesson #3: Producers can't raise prices when nobody's buying. When economic conditions weaken as the result of anemic consumer demand, this short-term source of producer-push inflation simply cannot materialize. Said another way, when nobody's purchasing a producer's products, that producer cannot realistically raise prices. (See Chart F: Inflation: Actual Results and Market Expectations)

Capital Markets

Lesson #1: In a crisis, all correlations go to one. This phrase refers to the trend of unrelated assets to suddenly become related in times of trouble. There's a notable history of this coupling phenomenon that accompanied a range of financial and economic crisis, but rarely has the problem been as severe as it was in late 2008.

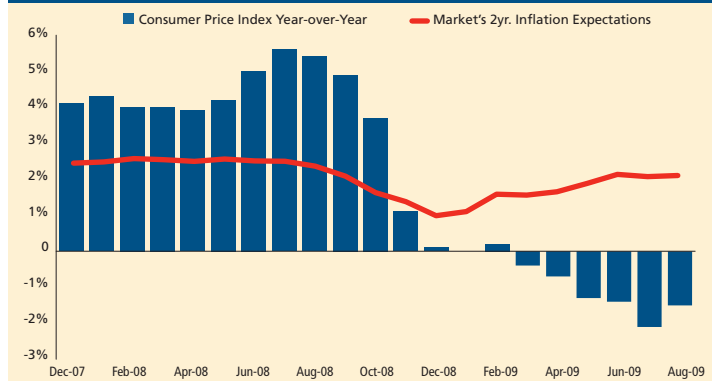
Lesson #2: Until basics of government support are written into law, they can and will change. After that, the details can and will change. The most basic lesson we can glean from the changing nature of government support is that it's unfair to rely solely on government support as a justification for investing in a given sector, industry or corporation. While government support can be credited with the assist, from our perspective, it was an improvement in investor sentiment that generated the capital markets rebound in evidence from March through the middle of September this year.

Lesson #3: Treasuries and the U.S. Dollar remain the quintessential safe haven assets. Despite talk to the contrary, there's been no evidence of investors abandoning either Treasuries or the USD as safe haven assets—quite the opposite, in fact. While it's unfair to dismiss this talk out of hand, stability and strength in Treasuries and the USD in times of economic and financial troubles is a concept unlikely prove errant in the foreseeable future.

Credit Markets

Lesson #1: Falling revenues smart, weak balance sheets maim, but poor liquidity kills. While a decline in income negatively impacts creditworthiness, and too high of a debt to equity ratio increases the cost of credit, it's ultimately the ability to pay off a given debt maturity that determines whether a distressed corporation can sink or swim. Any uncertainty about near-term liquidity is a big red flag, as it raises the risks of a solvency event or, at the very least, a coercive restructuring.

Chart F: Inflation: Actual Results & Market Expectations



(Source: Janney Fixed Income Strategy; Labor Dept.)

Lesson #2: Credit investing can rapidly deteriorate into game theory as restructuring events approach. While default risk is traditionally estimated through reasoned analysis of an issuer's prospects, as a firm, sector, or even whole economy approaches the point of distress, this traditional method of analysis begins to break down. Instead, credit performance tends to be determined by creditors' power relationships with other classes of creditors and with management/equity holders.

Lesson #3: The leveraged bid for credit is a fickle one. If we were to pick one demand feature that characterized the greatest trend in the first half of this decade, it'd easily be the emergence of the leveraged hedge funds and other similar investor structures. These investors tend to have a short-term and arbitrage focus, based on following or playing contrarian to popular trends that depend on supply and demand. The net result for real money investors is a credit market that's far more volatile today than in past credit cycles, regardless of credit fundamentals.

Even though the financial markets are looking like an increasingly positive place right now, the memory of the last year of crisis will stay with investors likely for decades. We believe this set of nine lessons—three economic, three capital markets and three credit markets—represent some of the key takeaways that will prove useful in navigating the markets for the months and years to come. ■

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