

An Anniversary for the Ages

By Mark Luschini, Chief Investment Strategist



The month of September is noteworthy because it marks, among other things, the end of summer, the point beyond which wearing white in anything other than a shirt is considered a fashion faux pas and the start of football season. This year, however, September brings with it the dates of several particularly notable events. On the lighter side, one of the most celebrated golfers of all time turns 80-years-young on September 10th; Arnold Palmer—appropriately nicknamed “The King.” Many tributes will be forthcoming that will regale his professional accomplishments as well as his singular style, which helped to ignite public interest in the game of golf on a global scale. On the darker side, turning one-year-old on the 15th of this month, and earning the public’s ire rather than celebration, is the collapse of Lehman Brothers. While many others struggled and/or failed, Lehman’s demise was a watershed event as it represented a Wall Street institution that fell victim to the credit crisis at a time when it seemed the entire financial system was teetering on collapse.

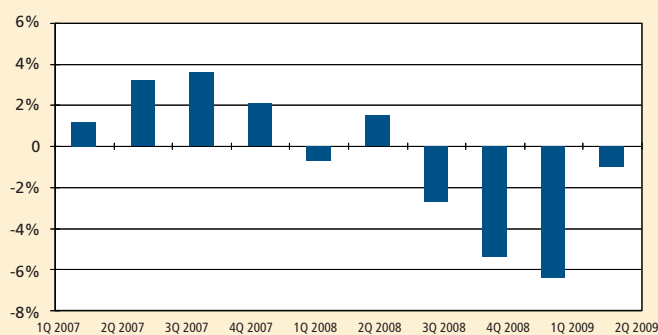
Chronicling the last 12 months would take volumes of detail, but it may be useful to compare where things stood then, at the precipice of disaster, and now after so much effort has been exercised to stabilize the economy. After the bankruptcy of Lehman Brothers, lending to banks and businesses practically came to a halt, or at a minimum the terms were exceedingly expensive. Once funding began to loosen, promoted by policymakers’ interventions to make credit available, business slowly

began to recover. Chart A helps to illustrate the improvement in Gross Domestic Product (GDP) since the point in the fourth quarter of last year when the world went in to cardiac arrest.

Clearly the pace of contraction has ebbed to the point where sequential improvement from the first to second quarter of this year was sizeable and then again to now, when most expect the economy to show actual growth as soon as statistics representing business activity in this year’s third quarter are released. News across multiple aspects of the economy has moved beyond “less bad” to absolutely better. Reports from the beleaguered manufacturing sector show resumption in order activity. Figures on the housing market, a variable we have noted many times as critical to the recovery, have turned to show increased sales of new and existing homes, as well as improving price trends in many regions. Employment conditions remain weak, but the pace of layoffs has deteriorated and programs such as “Cash for Clunkers” have actually aided in bringing idled employees back to work to meet production demand. While economic prosperity is still a way off, the aggressive actions of monetary and fiscal authorities have helped to engineer a recovery that is building momentum from almost desperate levels of activity a year ago.

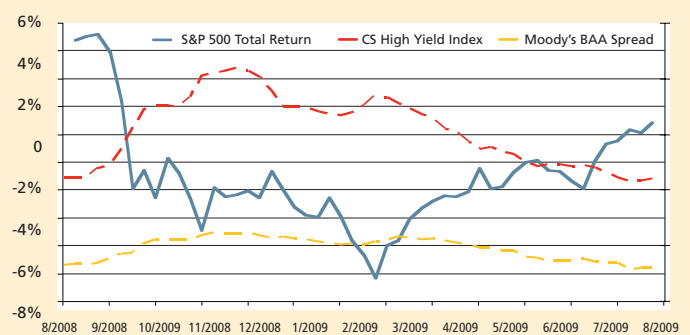
The financial markets have healed considerably as well. While the stock market has not yet fully recovered to its pre-Lehman levels, the credit

Chart A: GDP Quarter on Quarter, Annualized



(Source: Parker/Hunter Asset Management)

Chart B: S&P 500 Return and Bond Spreads



(Source: Parker/Hunter Asset Management)

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market has and then some. In Chart B, the left axis represents the percentage change in value of the S&P 500 index using the level of a year ago as ground zero.

Clearly, the recent rally in the stock market has been impressive, recapturing a substantial portion of the loss in market value year-over-year. While the S&P 500 has not necessarily breached that high water mark, the fundamental environment in which businesses can profit has improved. Many economies around the world are growing again, albeit at a more tepid pace than desired. Companies have right-sized to expectations of a soft and unpredictable business climate and will benefit from rebounding activity. In addition, confidence is picking up, an all-important ingredient to a sustained increase in consumption. Also in Chart B, the right axis plots the difference in yield or "spread" between Treasury bonds (not shown) and bonds issued by corporations of varying credit quality. Obviously, the spread has contracted viciously. At one point the yields on corporate bonds reached unprecedented heights relative to their government issued counterparts. The narrowing in yields that has occurred indicates an increased appetite for risk coming as a result of improving confidence that market conditions are healing, systemic risk has abated and the economy is moving out of intensive care. Spreads remain somewhat higher than historic levels though, intimating there is more that needs to be done to calm the markets. That will remain complicated for some time given the massive policy response to the crisis that has, at least in the form of the fiscal stimulus program, not even been fully implemented. The bond market typically holds above-average predictive powers, often telegraphing what the future holds with more clarity than economists or stock investors might bring. So while bonds might be signaling further caution, the threat of financial Armageddon that was clear and present a year ago has faded.

Now with the recovery underway we try to anticipate what the contour will look like in the coming quarters and years. At least at this juncture, we expect the path to be lumpy where there may be a quarter or two of growth that is quite strong followed by a period of weak statistical data. The overarching prognosis for the journey, not of the next month but rather several years, is for growth that is less robust than is typical post-recession. That is at least until such time the deleveraging effect from years of excesses has more fully unwound. Progress on that front over the coming 12 months will define the context of next year's anniversary card. ■



A September to Remember

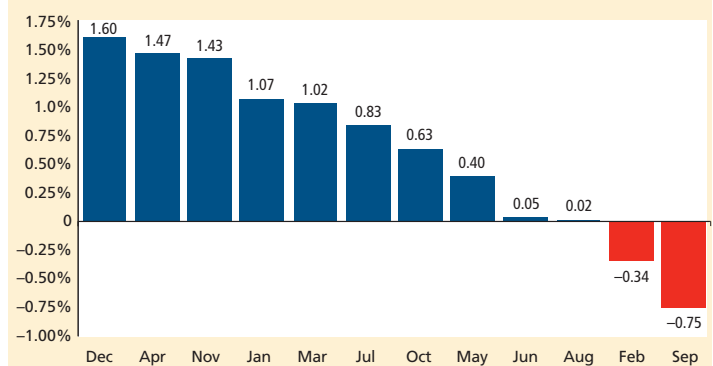
By Gregory M. Drahuschak, Market Strategist

August closed as the 15th best in the last 60 and it was the sixth straight monthly gain for the S&P 500. The market's apparent loss of upward momentum in late August, however, might have been due to the approach of September, as investors took note of the month's reputation as the worst month of most years. (See Chart C)

September's reputation is well earned. In addition to producing an average 0.75 percent loss over the previous 59 years, the month has produced some of the biggest drops for any month. Losses in 1974, 2002, 2008, 1986 and 2001 of 11.93, 11.00, 9.08, 8.54 and 8.17 percent respectively, top the list of the worst Septembers among the 34 during which the market has fallen.

However, there have been times when September has failed to live up to its reputation. Since 1950, there have been 10 times when the S&P 500 posted a gain in seven or more consecutive months—the most recent falling in the period of June 2006 through January 2007. On five separate occasions, September has been part of these periods of seven or more straight gains. September was a streak killer only once in 2003 when it stopped a six-month long winning streak.

Chart C: Average Monthly Results, S&P 500



(Source: Standard & Poor's and Janney Montgomery Scott)

After a trough to peak move in the S&P 500 of 55.89 percent, expecting a pullback is not unreasonable. The vigor of the advance produced overbought conditions in many individual stocks and the major market indexes, which further reinforced the potential for an interim correction.

An old cliché says that a trend in force remains in force until broken. It would take a significant drop to break the recent trend of higher equity prices. However, there are some disconcerting factors. Chief among these is the level of insider selling, which reached its highest level since May 2008.

Employment has been cited by many as a major negative, but we do not find this to be the problem others perceive it to be. There has been notable improvement in initial and continuing unemployment claims. Both, however, are far from desired levels. At the same time, many recessions have ended with unemployment being one of the last economic factors to turn positive. It would not be surprising to see employment not expand until well after a formal declaration that the current recession has ended.

Improvement in the economy and corporate earnings for the second quarter, which largely beat expectations, prompted many investors to question what the “fair value” of the market is or could be. We wonder, however, if anyone really knows what fair value is or if it ever exists. The classic definition of fair value is, “A valuation, in accordance with standard methodology, that is reasonable to all parties involved in a transaction in light of all pre-existing conditions and circumstances.” In relation to the stock market, however, a condition consistent with the definition is both incomplete and impossible to apply on a realistic basis.

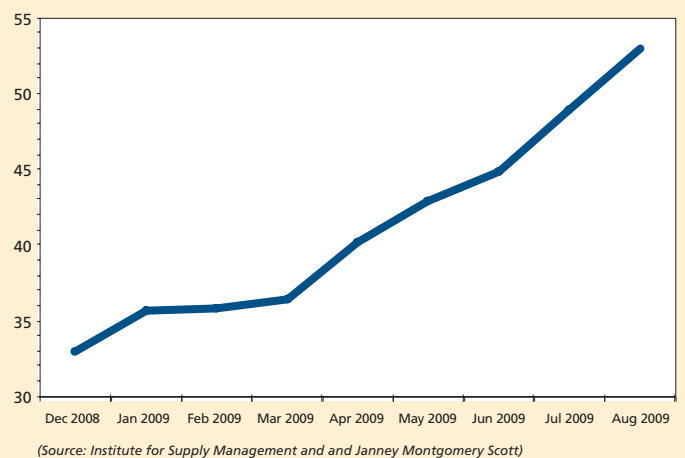
Investors like absolutes, but the market is devoid of absolutes or any certainties for that matter. Knowing “all pre-existing conditions and circumstances” theoretically might be possible, but in a market reference fair value requires making huge assumptions as to what earnings and interest rates will be, not what they were. And even if you have in hand everything needed to arrive at a fair value, it would be valid for only a split second as stocks move on to a new set of conditions.

If, for example, you knew with certainty what the total earnings for the S&P 500 will be next year and also where interest rates will be, you might assume you could determine what the fair value will be for the index. But what happens when you get into 2010? You may know what earnings will be by December 31 next year but long before then the market already will be assuming a new set of data.

Fair value, if there is such a thing, is a moving target; often a target that moves rapidly enough as to be useless. The reason to bring up fair value now is prompted by the number of estimates we are seeing for 2010 earnings. As soon as the estimates appear there are corresponding attempts to assign a multiple and therefore a “fair value” to the market. The key variable in the P/E, of course is the “E” portion. The range of estimates is so wide now that applying any specific multiple is meaningless.

We would prefer to evaluate data on a trend basis. This applies both to economic and stock market data. The trend of economic data is on an upswing. Nothing has surfaced yet to assume that the trend is broken. One of our favorite measures is the ISM Index, which the September 1 report showed was back above 50 to its highest level since June of 2007. (See Chart D)

Chart D: ISM Index, Dec. 2008 through Aug. 2009



The market likewise is in a positive trend. Weakness late in August and early this month did not change the trend. In terms of the S&P 500, the uptrend would remain in force even if the S&P fell slightly more than 10 percent from its most recent high.

The nearly constant mention of September’s supposedly ominous history makes us wonder if once again the consensus will be wrong. As noted earlier, all Septembers have not been bad, especially when the month falls in the middle of a string of monthly gains. Regardless, however, we are more focused on the intermediate-term potential for the market to set new recovery highs. Whether that will represent fair value or not we don’t have any way of knowing, but it is important, in our view, to remember that the trend is your friend—a trend we think will not be broken for many months. ■

One Year Later

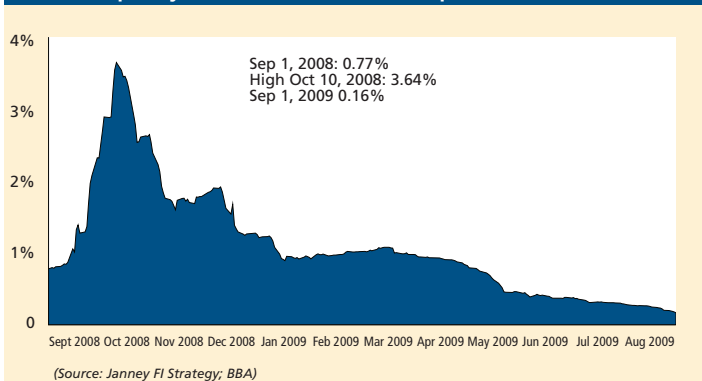
By Guy LeBas, Chief Fixed Income Strategist



September marks the one year anniversary of the month that changed the capital markets. Twelve months later, and with many investors' nerves still on edge, it's instructive to take another look at the events of September 2008 with an eye towards reviewing what went wrong, what mechanisms are in place today that make a relapse unlikely and what all the capital markets portend for the future. As such, Janney Fixed Income Strategy will be spending time this month in publications reflecting on the past year. Bygones can be bygones, but so long as we can learn from events of the past, they're absolutely worth revisiting. This brief note will focus on two major factors which point towards the changing health of the capital markets: liquidity conditions and credit spreads. In both cases, conditions appear significantly stronger today than they were one year ago, before the crisis broke.

Liquidity: Liquidity can be a catch-all term thrown around to describe a range of characteristics about individual securities, corporations or the market as a whole. In this context, liquidity refers to ability of a profitable and otherwise healthy entity to obtain cash as needed via borrowing from banks or issuing debt in the public markets. Arguably the best measure of liquidity is something called the LIBOR-OIS spread, which compares a lending rate ("LIBOR") and a derivatives market rate (the "OIS"), with the idea being that the difference points out banks' willingness to lend, regardless of the level of interest rates. On September 1, 2008, the LIBOR-OIS spread reached 0.77 percent, which was at the time the highest level ever recorded, indicating very tight liquidity conditions. While that spread worsened to 3.64 percent in October, today, that same metric measures under 0.16 percent, which is only slightly above the average level reached between 2001 and 2007. (See Chart E)

Chart E: Liquidity Conditions: LIBOR—OIS Spread



Credit spreads: Credit spreads provide an all-in estimate of the additional yield you receive for investing in a credit-sensitive security or market versus some credit risk-free benchmark. While traditionally credit spreads use corporate bonds as the credit-sensitive instrument, the same concept can apply to munis or even other asset classes. Credit spreads evaluate the risk inherent in investing in a credit-sensitive asset class under the theory that investors demand higher returns (i.e., wider spreads) for investing in riskier instruments. On September 1, 2008, the Barclays US Credit Index traded at a spread of 2.71 percent, the widest spread recorded in the 20-year history of the index. Subsequently, that same spread more than doubled to 5.45 percent, but today measures 2.10 percent, which remains elevated, but is significantly below last year's level. On a taxable-equivalent basis, highly rated 10-year municipal bonds, meanwhile, were trading with spreads of 2.02 percent on September 1, 2008 and are now trading with spreads of just 1.27 percent, also a significant improvement.

What do these two numbers tell us? First of all, liquidity conditions are now mostly normal, meaning that fundamentally "good" firms and municipalities can borrow as they need to. That ability removes a significant overhang to investing in the debt markets and has helped investors that have remained involved realize very nice returns thus far in 2009. Second, investor perceptions of credit risk are now lower than they were one year ago. Together, these two numbers suggest that, despite all of the fear that's been generated by the last year's events, investing in credit-sensitive securities, whether they be taxables or munis, is actually a lower risk activity today than it was one year ago—at least according to investors slinging around billions of dollars, anyway. While this concept seems counterintuitive given all that's unfolded in the last year, since the debt markets are more concerned about prospective than retrospective events; we see a great deal of value in using these metrics to inform our expectations about risk in the capital markets. Keep this fact—the idea that markets perceive credit-sensitive debt as less risky today than one year ago—in mind as you consider long-term philosophical changes in the post-financial crisis environment. ■

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