CONSTELLATION
WEALTH ADVISORS LLC
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Third Quarter | October, *2009*
Constellation Quarterly

Out of the Storm … Or Into the Eye?

In Review

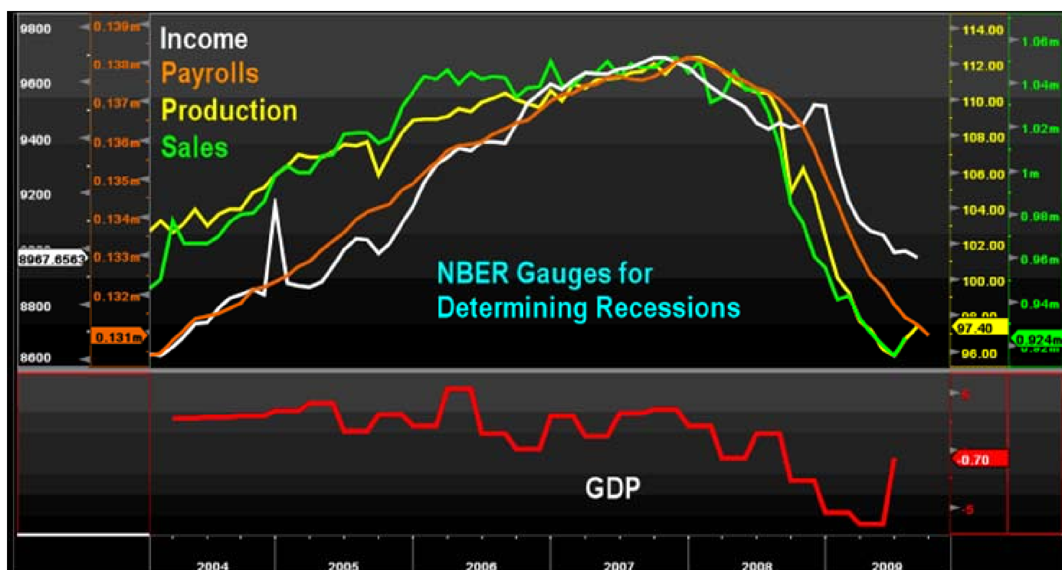
The world markets continued their rally through the third quarter with performance as detailed below:

Benchmark Performance
Data as of September 30, 2009

	QTR	YTD	1 Year	3 Year	5 Year	7 Year
Barclays 5 Year Muni	3.75%	6.82%	11.03%	6.13%	4.55%	4.23%
Barclays Aggregate	3.74%	5.72%	10.56%	6.41%	5.13%	4.96%
S&P 500	15.61%	19.26%	-6.91%	-5.43%	1.01%	5.86%
Russell 1000	16.07%	21.08%	-6.14%	-5.10%	1.49%	6.31%
Russell 2000	19.28%	22.43%	-9.55%	-4.57%	2.41%	8.99%
iShares MSCI EAFE	19.17%	28.51%	3.13%	-3.68%	5.91%	10.72%
iShares MSCI Emerging Markets	20.31%	58.49%	16.98%	8.29%	17.18%	n/a

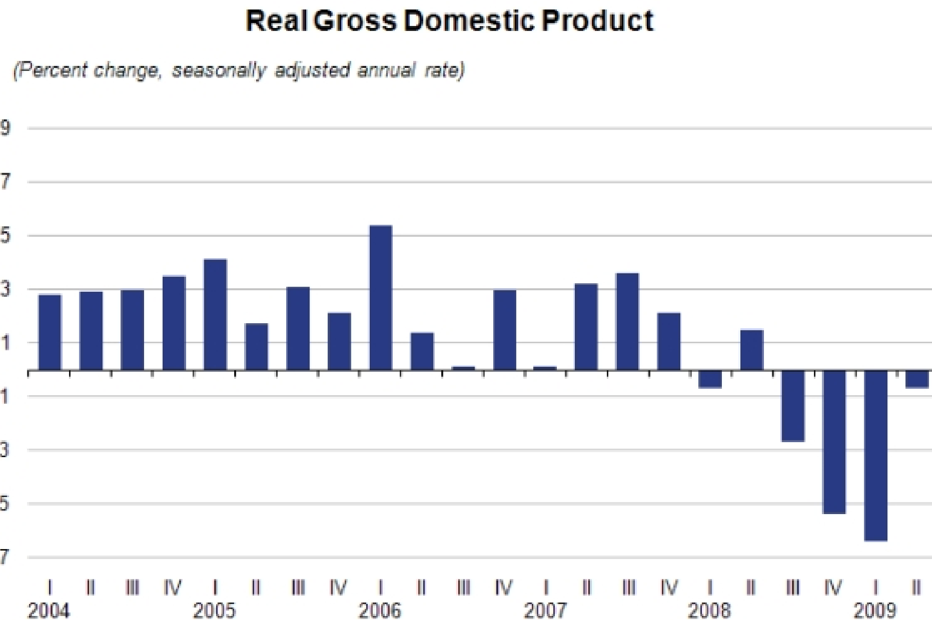
Source: PSN Informa

Equity and credit markets responded to the more favorable economic data that generally showed improvement throughout the quarter. Additionally, the unprecedented amount of liquidity being pumped into the system created an environment that was advantageous for financial assets. While we can't speak to the sustainability of the recovery, the economy is clearly showing signs of improvement, as inventory restocking and stimulus measures provide a lift. The following chart shows the four gauges of economic health followed by the National Bureau of Economic Research (NBER), the organization that defines the beginning and end of recessions in the U.S.:



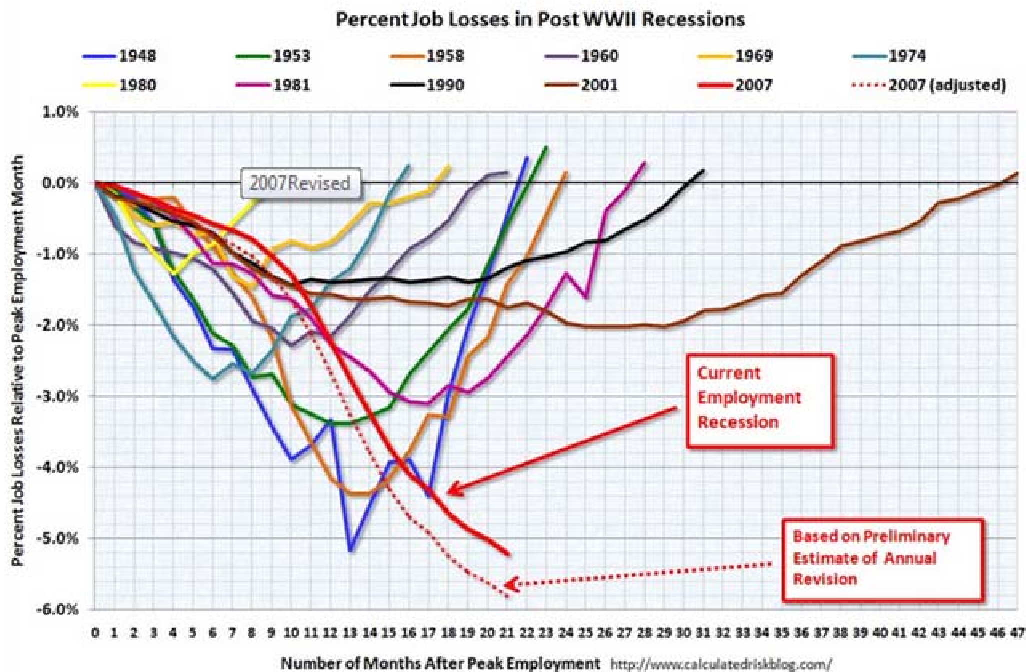
Source: Bloomberg

Two of the four gauges have turned up while payrolls and income are leveling off. As a result, third quarter GDP is anticipated to come in at 3.0%, its first positive number since the second quarter of 2008, and only the second positive quarter in the last two years as shown below:

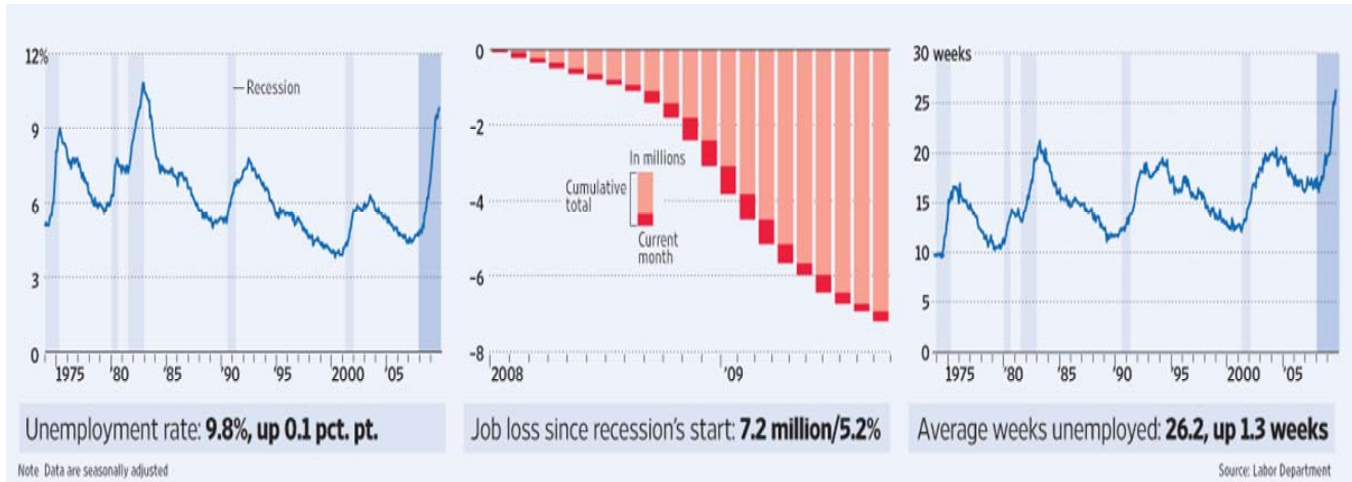


Source: Bureau of Economic Analysis

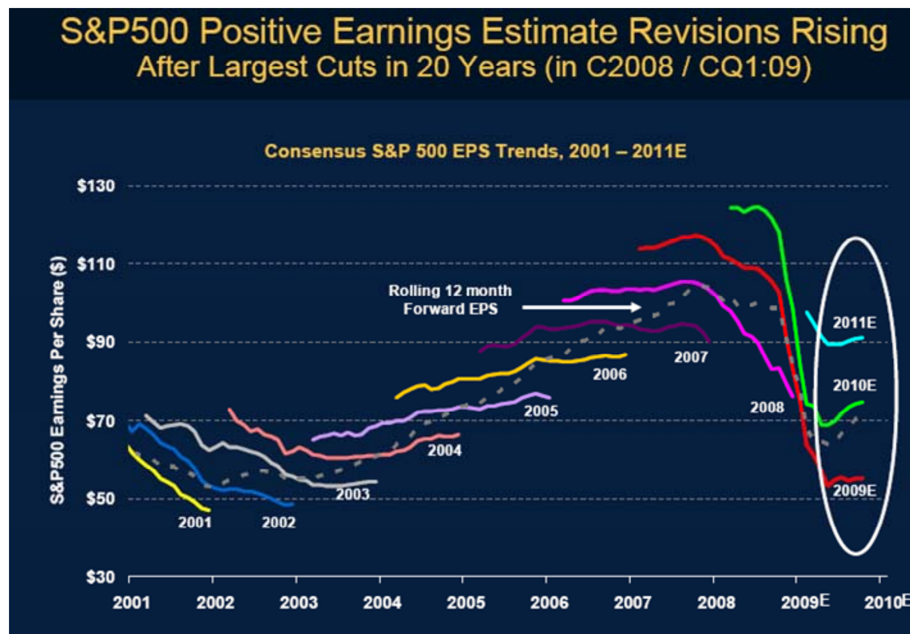
However, the employment situation continues to deteriorate, albeit at a slower pace as this data generally lag during an economic recovery. The chart below tracks the change in employment since the start of all the post WWII recessions, including the current one shown in red (with estimated revisions to the current data shown in dotted red):



The chart demonstrates the unparalleled depth of the job losses in the current downturn against the context of other recessions in the post WWII era. The numbers would be much worse if they included the millions who have given up seeking employment and those working part time because they cannot find full time work. Below are three additional depictions of this situation: the unemployment rate, the cumulative job losses and the average weeks someone who loses a job stays unemployed; all are at generationally low levels.

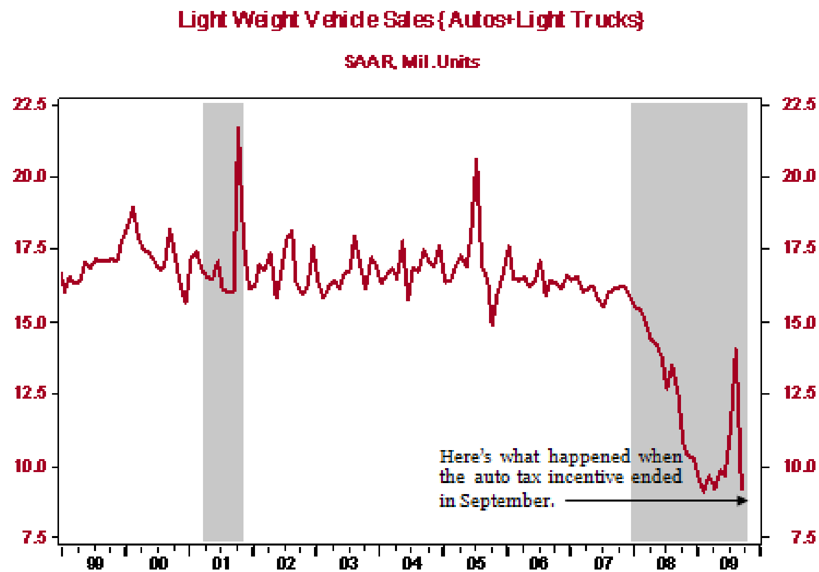


The jobs data exemplify the difference between Main Street and Wall Street. Corporate managements reacted swiftly and dramatically to the crisis and reduced cost structures by record levels. With the economy expected to grow in the latest quarter, companies are poised to show much improved earnings as a result of their now increased operating leverage. Weakness in the dollar is aiding as well, since foreign sales benefit from the favorable currency translation. Analysts have been raising their earnings estimates (although cautiously) in anticipation as shown below:



Source: Bloomberg

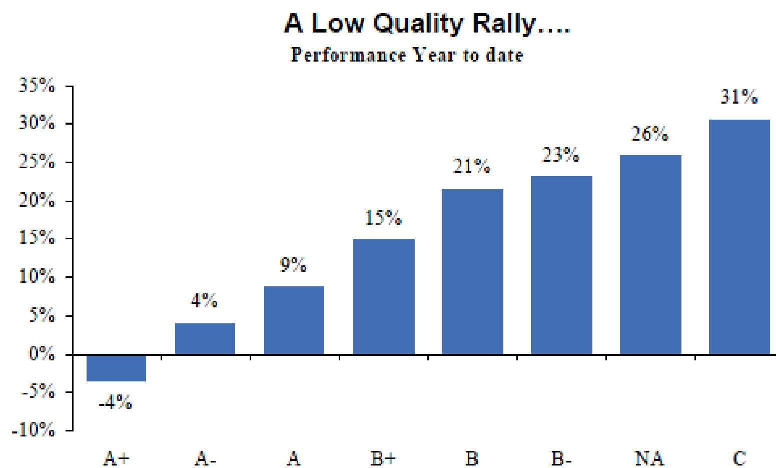
The question, of course, is whether there can be continued growth in earnings, or at least enough to justify the higher valuations, now that the cost cutting is largely complete. The experience of the cash for clunker program speaks to the potential lack of follow through once stimulus expires:



Source: Strategas

The fear is that the fall off in car sales after the rebates ended are representative of the fact that the economy is experiencing an artificially higher level of activity than might otherwise be the case. By continuing to incentivize spending, we are merely pulling forward future demand.

The recent stock advance has been met with some skepticism and disbelief; likely due to the severity of the decline and the prophecies of the death of capitalism as well as the financial system itself. During the crisis, equities as an attractive investment asset class began to be challenged, even for the long term investor. Given that, it is surprising that when you look beneath the surface, this recent rally has been led by the lowest quality stocks. Below is a chart ranking returns in the stock market through August 17 (when the S&P was up roughly 9% year-to-date) broken out by the quality of corporate balance sheets:



Source: Morgan Stanley

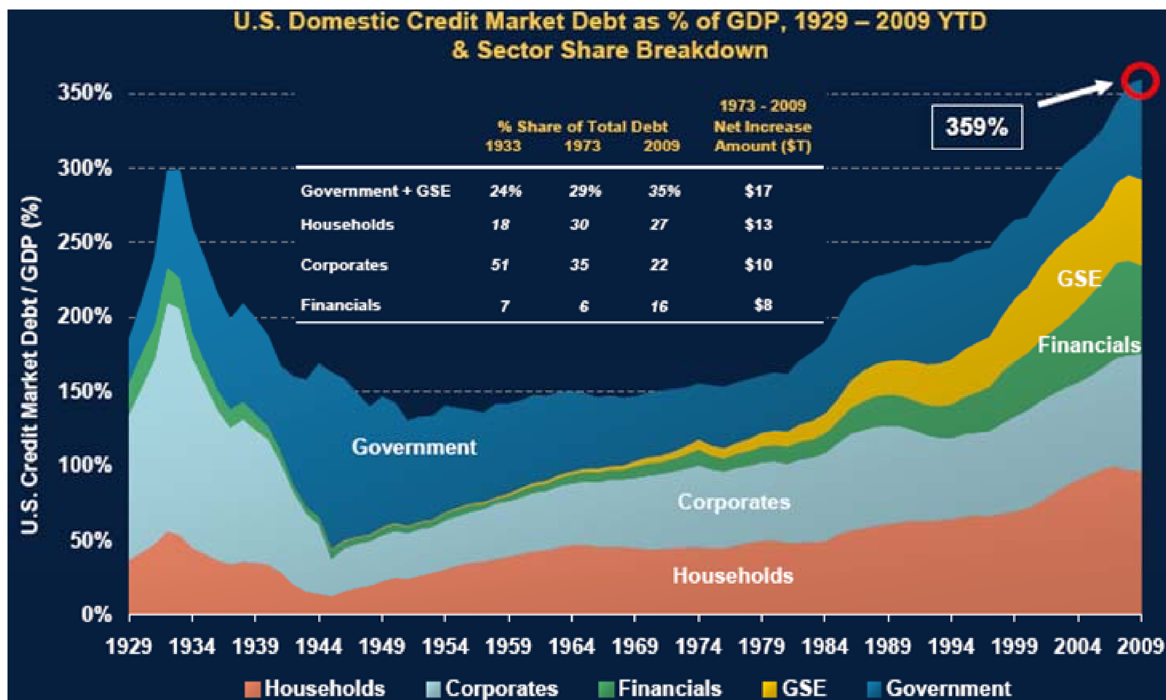
Normally, rallies develop from the highest quality first and end when the run up begins to include those companies that are most speculative in nature. We are not sure why investors gravitated to the riskiest stocks right after a bout of severe risk aversion. Fortunately, it has created a unique convergence of value providing the opportunity to buy the best companies with the highest quality financials at relatively attractive prices.

Outlook

"We're not going to make the same mistake many countries made in the past of putting the brakes on too early and creating the risk of a weaker recovery with even higher levels of unemployment." Timothy Geithner, Secretary of the Treasury

Last quarter, we discussed the tug of war between the deflationary forces of deleveraging, the output gap and unemployment versus the inflationary pressures caused by quantitative easing, massive fiscal stimulus, record budget deficits and a weak currency. A subset of that debate is the current balancing act between the need and political desire for fiscal stimulus and the potential market forces demanding fiscal responsibility.

One of the primary causes of the current economic malaise is the stubbornly high amount of debt in the system ("balance sheet recession"). The chart below breaks out the total debt by category. We have shown a different version of this in prior letters, and there are several insights to glean from this updated data. Most important is that the total debt in the economy has still not begun to decline, instead, the government, which now includes the Government Sponsored Enterprise (GSE) debt, has increased its share at the same time as household and financial sectors have begun to delever.



Source: Bloomberg

The data set of balance sheet recessions is shallow, and past experiences of this type have resulted in prolonged recovery periods. Most prominent are the past twenty years in Japan and the U.S. in the 1930's.

While many speak of the policy errors that resulted in those bad outcomes, the truth is that no one knows for sure if there is an easy way out of this type of malaise. It is likely there is not. For now, the U.S. is banking on having the government, through spending initiatives and easy monetary policy, fill the void of consumer demand and banks' reluctance to lend which is evidenced in their increased debt.

But the country's balance sheet is not infinite and the rumblings about the ability of our country to meet its obligations are louder than ever. To that point, Moody's recently announced that the AAA rating of our government debt may be in jeopardy if current trends continue, a once unimaginable occurrence. This, coupled with the demographic headache of rising healthcare costs and social security obligations, caps the confluence of financial hardships that need to be addressed in a credible fashion to comfort foreign creditors and prevent borrowing costs from rising. As a result, the dollar has been under pressure despite the apparent leveling off of the economy.

For now, the massive increase in the money supply effectuated through Federal Reserve purchases of Treasuries and mortgage-backed securities has not been inflationary as banks have kept their excess capital on deposit at the Fed. Banks are most likely preparing for future losses and availing themselves of the attractive spread between their near zero borrowing costs and intermediate dated Treasuries.

As long as banks continue to keep their excess reserves at the Fed, they will not be multiplied, keeping the velocity of money in the system low, and neutralizing the potential inflationary effects of Fed policy. This reluctance to lend has an impact on the real economy. While large corporations have been able to tap a more receptive public market for funding, smaller businesses, the greatest source of job creation, rely more heavily on bank financing and have not had the same luxury.

The Fed has put itself in a very difficult position. On the one hand, they are signaling to the markets that they will provide ample liquidity and keep short term interest rates low for a "considerable period of time." On the other hand, they are going out of their way to elaborate an exit strategy and to assure the bond markets they will act quickly and decisively when the time is right to avoid inflation. Monetary and/or fiscal policy error would therefore seem to be a major risk as it is unlikely the government will be able to orchestrate such a seamless handoff.

In the near term, deflationary forces should win out (with the possible exception of food and energy) as consumers pay down debt and the foundation for sustainable growth is built. The Fed is bound to err on the side of being late despite some rhetoric to the contrary, and the government is likely to continue to attempt to stimulate (see Secretary Geithner's quote above). Inflation should therefore be an eventuality that will need to be dealt with, but one whose timing is presently uncertain.

Given all of the above we make the following investment recommendations:

- Fixed income portfolios should continue to be constructed striking a balance between the possibility of renewed inflation while taking advantage of the steepness of the yield curve. As we have been stating, credit quality remains paramount in this environment. This is particularly so given the strong rally in weaker credits. To that end, the risk/reward in the high yield segment of the market is no longer compelling.

- Higher quality large cap stocks appear to offer the best value in the domestic market. Their prospects are enhanced due to their international revenue streams and the benefit derived from the weak dollar; many also pay attractive dividends especially relative to short term interest rates.

- We continue to believe that equities will be in a wide trading range, and recommend using some of the expected increase in economic volatility to opportunistically add exposure if so inclined. If the last two quarters have taught us anything, it is not to abandon equities as an asset class even when it looks most dire.

We continue to seek ways to generate alpha in our domestic and international equity exposure, as well as seeking uncorrelated investment opportunities. We welcome any questions you may have about your portfolio and what might be appropriate for your particular asset allocation in the context of your goals. As always, we are most appreciative and thank you for your trust and confidence.

A copy of Constellation's Form ADV Part II is available upon request by calling Philip Frank at (212) 697-2500 or e-mail philip@constellationwa.com.

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