



# MCCABE CAPITAL MANAGERS, LTD.

2011 Renaissance Boulevard, Suite 210, King of Prussia, PA 19406  
Tel.: (610) 277-8890 Fax: (610) 277-6903

## **ECONOMIC AND MARKET COMMENTARY** *Fourth Quarter 2009*

On October 29<sup>th</sup> the Bureau of Economic Analysis released the third quarter GDP report which reflected the fact that quarter over quarter on an annualized basis the US economy grew by 3.5%, formally marking the end to the Great Recession. Based on the pattern of data releases we had received for several weeks prior to the GDP release, it had been widely anticipated that this would be the case. What is harder to predict is the nature and shape of the looming recovery and how capital markets will react.

Over the past six global recessions, the nature of the recovery was largely symmetric to the downturn. Although the recent recession was the deepest and longest since the 1930s, we do not see a V-shaped recovery (three straight quarters of 6% annualized GDP growth) occurring in any G-3 economy (Japan, Euroland<sup>1</sup>, US), although global GDP growth rate projections have been revised upward to about 4% next year. The global economy is likely to see increased differentiation between the G-3, where the growth outlook is positive but asymmetric to the downturn, and the emerging market economies where robust growth is expected.

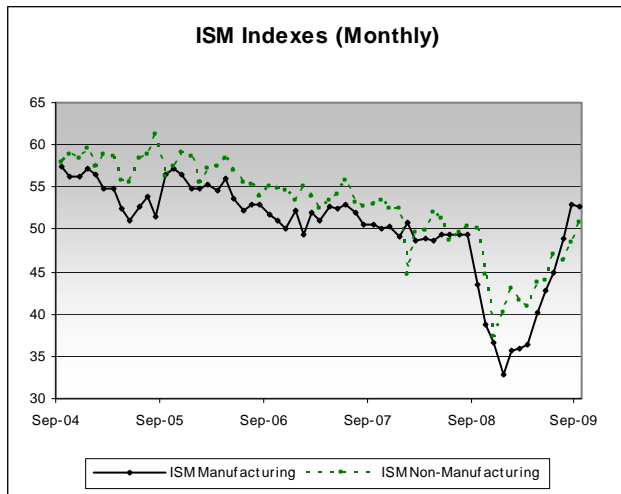
### **Economic Growth**

The growth picture, particularly in developed countries, will be driven largely by corporate inventory rebuild. This is one of the reasons that we expect the recovery to be somewhat muted, since the consumer makes up a much larger proportion of final demand. Corporations have responded to the crisis by cutting costs in proportion to revenue declines in a manner that looks very similar to the experience in late 2002. These cuts have put their balance sheets in reasonably good shape, especially with the re-opening of debt capital markets, and could lead to a major inventory rebound. One indicator of a possible boost to output growth as a result of a pending inventory build is a look at the unusual lengthening of manufacturing supplier delivery times. If we take Q2 as the last quarter of the recession and Q3 as the first quarter of the recovery, there has not been a business cycle since 1951 in which delivery times have lengthened comparably.<sup>2</sup> This figure has a good record of serving as a predictor of growth which is why it is a key component of the Conference Board's leading indicator series.

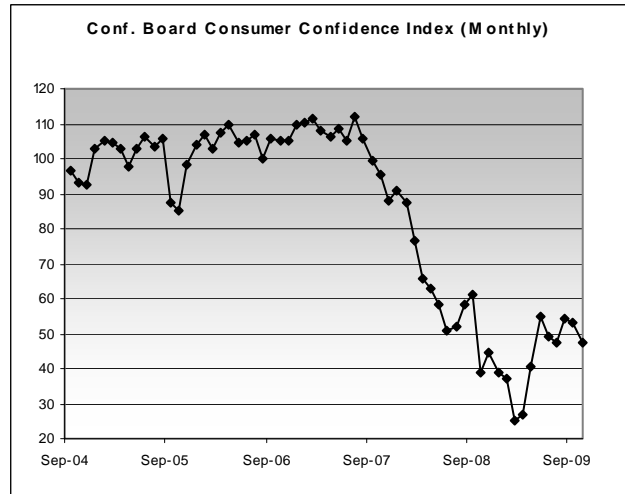
The consumer, on the other hand, is still dealing with a significant amount of uncertainty which is likely to shape behavior. The recent Labor Department report indicated that unemployment increased to 10.2% in October, the highest figure since 1983. Additionally, the under-employment rate, which includes part-time workers who would prefer full-time work and people who want work but have given up looking, reached 17.5% last month, the highest this figure, which records back to 1994, has ever reached. However, our outlook calls for a modest increase in employment, starting in 2010. After the increase in productivity like the one seen recently, companies do not normally

increase employment until they are more certain that the recovery is sustainable. Before they turn to hiring full-time workers, they take on temporary staff, as evidenced by the recent 30,000 increase in temporary hirings. The present lag is similar to that following the March 1991 and March 2001 recoveries when it took in excess of five quarters for a significant improvement in the labor market, as opposed to a month or two at the end of prior recessions. Although we are not anticipating that employment will rise anywhere near as fast as it did at the end of recessions prior to 1991, we are expecting the current recovery to create jobs with lags comparable to those of the last two recessions.

The recent state of the labor market provides a logical explanation for the state of consumer confidence. While a number of high-profile economic indicators have risen back above levels seen at the start of the recession in December 2007, consumer confidence is a notable exception. While off its lows, it remains below levels seen at the start of the recession, below long-term averages, and has recently started to head south again. In the US in particular, the size of the rebound in confidence is more modest than we are seeing elsewhere. Even in the UK, which tends to have consumer confidence figures that move closely with those in the US, the rebound in consumer confidence has been twice as strong over the last six months, which is particularly surprising since the UK economy has yet to officially exit recession.



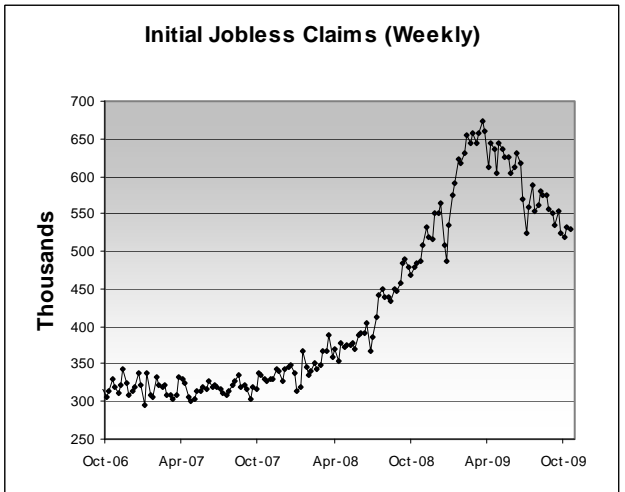
Source: Bloomberg



Source: Bloomberg



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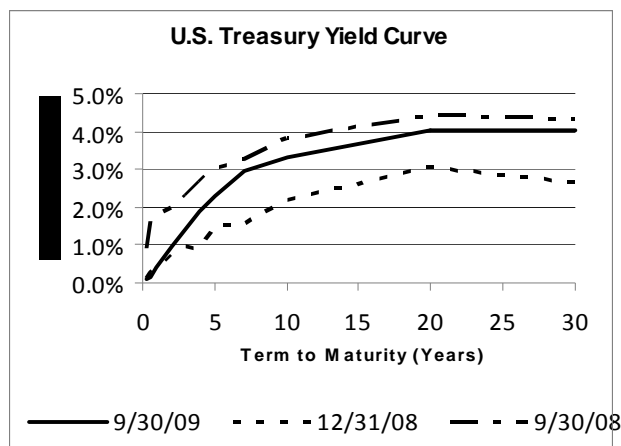
Source: Bloomberg

## **Implications of a Weaker Dollar and Inflation Expectations**

One of the factors that has propped up growth of the US economy has been an increase in the net export balance. If this continues, it may cycle back into employment gains despite the productivity variable discussed previously. The sustainability of this trade balance improvement may hinge on the weaker dollar. Since February, the dollar has fallen by 20% to 1.50 against the euro and by 10% against a broad basket of currencies. Seen in a cyclical context, the fall is a resumption of the downward trend in place since the dot.com crash and recession of 2001. This fall was interrupted by capital flow support in the wake of the Lehman failure and subsequent global crisis. The drop in safe haven demand was accompanied by some concerns that the dollar would lose its global reserve currency status and the fall of US interest rates to near-zero. A dollar collapse and a surge in the price of gold were predictable byproducts of these developments. The impact of the net export scenario was distinguishable in the stock price behavior of US companies as well. The Goldman Sachs International Sales basket of companies, consisting of companies in the S&P 500 that are highly levered to international growth,<sup>3</sup> was up 20.1% for the quarter relative to an S&P 500 return of 15.6%. A similar basket of companies levered to growth in the BRIC countries (Brazil, Russia, India, and China) was up an even more pronounced 23.7%.

If the inflection point in a bearish dollar trend is going to be driven by a rise in short-term interest rates, then the key may be to unlock the future path of inflation. Following its November 4<sup>th</sup> FOMC meeting, the Fed announced that “low rates of resource utilization, subdued inflation trends, and stable inflation expectations” would allow it to hold rates low for “an extended period.” The explicit nature of the Bernanke Fed proclamation will give the market an interest in tracking those variables. From our perspective, with capacity utilization at just over 70%, year over year CPI still registering negative, and breakeven expectation levels trending higher but still well below recent norms at 2.2%, we think that those rates are likely to remain low for the foreseeable future.

While we have seen longer-term government bond yields rise recently, we believe that, based upon our expectation of a genuinely deflationary world economy backdrop, US Treasuries are no longer expensive. Rather than any widespread fear that the adoption of unconventional monetary policy tools will contribute in the near future to incipient inflation, it may simply be seen as ultimately reducing fears of deflation. Indeed, concerns seem split between inflation hawks, who take it for granted that central banks will leave stimulus in place for too long, and doves, who believe they will make the opposite mistake of starting to withdraw stimulus prematurely. The answer may not be as coordinated as the initial policy responses from central banks. We are already seeing a geographic bifurcation, as Australia’s central bank has raised short-term rates, while the UK recently increased its quantitative easing program. Our impression is that while we may see headline inflation tick up in the coming months, based largely on sharp falls in commodity prices of a year ago dropping out of the annual comparison, we do not think it is going to be an issue that needs to be dealt with for a little while longer.



Source: Bloomberg

Latest Quarter End (9/30/09)	Latest Year End (12/31/08)	One Year Ago (09/30/08)	Three Years Ago (09/30/06)
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**CURRENCY**

U.S. Dollar Index Value	76.65	81.31	79.45	86.03
USD vs. Yen	89.70	90.64	106.11	118.18
Euro vs. USD	1.46	1.40	1.41	1.27
GBP vs. USD	1.60	1.46	1.78	1.87

**COMMODITIES**

Gold (\$ per troy ounce)	1007.70	882.05	870.95	598.30
Crude Oil (\$ per barrel)	70.61	44.60	100.64	62.91
CRB Metals Index	674.08	402.56	673.00	636.97
CRB Food Index	305.96	294.20	374.58	267.98

Source: Bloomberg

## **Fixed Income Markets**

We noted in our second quarter commentary that the easy money had been made in high yield fixed income, although we still believed the asset class would yield attractive returns. This was indeed the case as the Barclays Corporate High Yield Index was up over 14% in the third quarter. Spreads over Treasuries, which had come in from a mid-December high of over 2100 basis points to 1055 basis points to end the second quarter, continued to narrow to 760 basis points at the end of October. This movement appears to have been the byproduct of both a firming of the economic landscape for businesses, as well as continued investor flows, as high yield mutual funds reported an 11<sup>th</sup> consecutive monthly inflow of more than \$1 billion. We think inflows in this asset class may be unsustainable, and would again offer the opinion that while investors should tread cautiously here, there is still an opportunity on a relative basis. Where we are taking positions in high yield, we are doing so with an approach that focuses heavily on limiting both credit and interest rate risk.

Investment grade corporate bonds also performed well, returning over 8% for the quarter, as spreads for AA rated bonds narrowed from 185 basis points at the end of the second quarter to 138 basis points at the end of October. The outlook for these bonds remains positive, as companies continue to hoard cash, pay down debt, and generally shore up balance sheets, all of which are positive for bondholders.

Municipal bonds continued their strong performance through the third quarter, as the Barclays Municipal Bond Index was up 7.1%, bringing the year-to-date figure to 14.0%. Some of that was given back in October, as the Index was down over 2%. Third quarter strength continued to be driven by an investor desire for yield coupled with money market funds yielding nothing or next to nothing, along with a steep muni yield curve. The negative action in the space in October seemed to be influenced by two factors- heightened levels of supply along with continued deterioration of fundamentals at the state level.

On the supply side, nearly \$12 billion in new issuance hit the market during the course of October. Credit fundamentals for issuers continue to be negatively impacted by a decline in tax collections and other revenue sources. The level of stress that is catching up with the market is driven by the

fact that in the first half of the year, \$45.9 billion fewer tax dollars were collected by states compared to the first half of 2007. Forty-five states saw revenue declines with more than half of those down by double digits.<sup>4</sup> It is our belief that some states have a competitive advantage relative to others, as states like Texas have retained broad powers to tax with few limitations while other states like California have constitutionally imposed taxation limits. Texas also has a robust energy sector which has supported its economy. While we do not expect the Federal government to allow widespread defaults to take place, we do think bond prices can be materially impacted as states like California, Connecticut, Ohio, and Illinois have already been impacted by downgrades resulting from their failure to pass a fiscal 2010 budget in time.

## **Global Equities**

The US stock market is entering a transitional period where the cyclical bull market is shifting from a liquidity driven phase to a profit driven phase. Any bumps in this transition would place the equity markets at significant risk of major downside retracement. The postwar experience indicates that US equity markets have usually been successful in making such a transition, with the best equity market performance occurring in the 12 to 18 months after the end of a recession.

We expect improved corporate operating leverage as a result of major cost cutting to offset lower than normal revenue growth. This is consistent with survey data for the US and Euroland, which shows a clear V-shaped recovery in business sentiment rather than in consumer sentiment.

In the US market thus far, upside surprises in earnings reports (about 80% in the third quarter) have improved investor sentiment. It is estimated that S&P 500 operating earnings will increase 20% in the next 12 months as a result of higher incremental margins and a weak dollar in the non-financial sector and a steep yield curve in the financial sector, as well as improving overall economic conditions. If this were to occur it should lift the S&P 500 above recent levels..

US equities still look attractive when compared against competing assets, such as Treasury bonds, gold, commodities, real estate and corporate bonds. Based on the Goldman Sachs dividend discount model, if equity risk premia remain within the historic range, the implied earnings growth rate is only 2%, substantially below the long-term historic average.

Although a weak labor market, together with household deleveraging, will weigh heavily on US consumption growth, the picture on job losses in Euroland is far better and household leverage is a non-issue. For this reason, Euroland consumption growth is projected at a significantly higher rate than US consumption growth next year. Also alleviating the concern about sluggish demand recovery in major countries is the continued evidence of strong emerging market demand. Even though it is not strong enough to completely counteract the demand weakness in the G3, BRIC-led demand has driven the global recovery thus far. The high magnitude of the latest Chinese retail sales number is a case in point.

In sum, global equities have not yet fully discounted the likely economic recovery. Furthermore, equities are still undervalued in relation to many competing assets and the macroeconomic policy backdrop continues to be supportive of equity prices. Hence, the pro-reflation strategy still remains intact, although markets are likely to be more volatile over the next 12 months than they have been since early March.

## **Alternative Investment Strategies**<sup>5</sup>

Hedge funds as a group continue to deliver solid returns this year, as they picked up an additional 5.9% in the third quarter.<sup>6</sup> They held their ground in October, with flat returns in a market that saw equities begin to give back gains. Performance in the space has been fairly indiscriminating, as 8 of the 10 index sectors have posted positive returns, with the only two exceptions being the two sectors that outperformed last year given their negative correlation profiles – managed futures and dedicated short strategies.

We have discussed the fact that last year was a difficult one for hedge funds, as drawdowns (performance from peak to trough) approached 20%. It is important, however, to view that experience both relative to traditional asset classes, as well as in hindsight with respect to the subsequent recovery. The S&P 500 early this year reached a maximum drawdown figure of 48.5%, and even with the strong rebound we have seen this year, the recovery leaves them with a residual loss of 25%. The hedge fund drawdown was not only more shallow, but the index has now rebounded to the point that it is within 7% of its value as of the beginning of 2008.<sup>7</sup>

In private equity, we continue to see opportunities present themselves as a byproduct of the recent crisis, as distressed sellers still abound. These situations offer an investor with liquidity the option in select cases to acquire private equity interests at a discount to current valuations. In certain situations, we have had opportunities to buy secondary funds, which purchase institutional private equity interests at a discount, at an additional discount from the investor providing a healthy margin of safety by virtue of this “double discount”.

Elsewhere in the alternative investment arena, REITs continued their strong run during the quarter, picking up an additional 17.8% while commodities rallied another 9.1%. REITs are beginning to get expensive in our estimation, though they are still an attractive source of yield and a selective approach to investing can still yield positive results. Within the space we think REIT preferred securities are an area of particular interest.

In summary, our outlook for traditional asset classes, commodities and currencies is as follows:

Asset Class	Base Case Projection	Downside Risk
<b>Developed Corporate Bonds</b>	<ul style="list-style-type: none"> <li>No significant narrowing of spreads is expected. The space is unlikely to outperform Treasuries based on price appreciation.</li> </ul>	<ul style="list-style-type: none"> <li>If G-3 economies are extremely sluggish in 2010 spreads could start to expand again.</li> </ul>
<b>Developed Country Government Bonds</b>	<ul style="list-style-type: none"> <li>Inflation expectations remain below average and bonds are fairly valued.</li> </ul>	<ul style="list-style-type: none"> <li>An increase in headline inflation causes central banks to tighten monetary policy sooner than expected.</li> </ul>
<b>U.S. Large-Cap Equities</b>	<ul style="list-style-type: none"> <li>Stocks are fairly valued and total returns should be in the 7-9% range over the next 12 months.</li> </ul>	<ul style="list-style-type: none"> <li>Either a double-dip recession or multiple contraction present a negative environment for stocks.</li> </ul>
<b>Other Developed Market Equities</b>	<ul style="list-style-type: none"> <li>Export driven economies and a healthier consumer drive equity prices ahead of the US market.</li> </ul>	<ul style="list-style-type: none"> <li>A double-dip recession felt globally returns the dollar's status as a safe haven investment hurting the returns of foreign equities in dollar terms.</li> </ul>
<b>Emerging Market Equities</b>	<ul style="list-style-type: none"> <li>Overvalued equity markets lead to sluggish performance in the short-term but strong growth prospects drive performance over a longer horizon.</li> </ul>	<ul style="list-style-type: none"> <li>A stronger dollar and subsequent unwinding of the dollar carry trade leads to liquidation of emerging market equities.</li> </ul>
<b>Commodities/Hard Assets</b>	<ul style="list-style-type: none"> <li>World GDP growth in the 3-4% range leads to higher industrial metal, agriculture, and energy prices.</li> </ul>	<ul style="list-style-type: none"> <li>Dollar strength and lower than anticipated Chinese growth combine to drive down the price of dollar-denominated commodities.</li> </ul>
<b>Currencies</b>	<ul style="list-style-type: none"> <li>The dollar is technically oversold but likely to remain in a trading range based on the expectation that the Fed will leave its target fund rate unchanged.</li> </ul>	<ul style="list-style-type: none"> <li>A weaker than expected global recovery or a shock felt by global markets strengthens the US dollar in its return to safe haven status.</li> </ul>
<b>Municipals</b>	<ul style="list-style-type: none"> <li>As the effect of diminished supply continues to work through the system, the bid for municipals should strengthen, bringing the ratio of muni yields to Treasury yields below 90% and enhancing the value of current holdings.</li> </ul>	<ul style="list-style-type: none"> <li>If economic growth picks up faster than anticipated, then Treasury yields will rise, potentially diminishing the value of other fixed income securities like municipals that are in part valued at a spread to Treasury bonds. This may help issuing municipalities while simultaneously hurting the relative strength of the asset class.</li> </ul>

We are grateful to you for allowing us to manage your funds and for your continued confidence and support.

**James L. McCabe, Ph.D.**

**Adam B. Landau, CAIA**

*November 12, 2009*

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<sup>1</sup> Euroland (officially the euro area) is an economic and monetary union (EMU) of 16 European Union member states which have adopted the euro currency as their sole legal tender. It currently consists of Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

<sup>2</sup> Source: Barclays Capital

<sup>3</sup> Source: Goldman Sachs Global Economics- The median stock in the basket derives 68% of its revenues from sales outside the US compared with 25% for the median S&P 500 stock.

<sup>4</sup> Source: Belle Haven Investments

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<sup>6</sup> Return as represented by Credit Suisse/Tremont AllHedge Index.

<sup>7</sup> Source: Credit Suisse