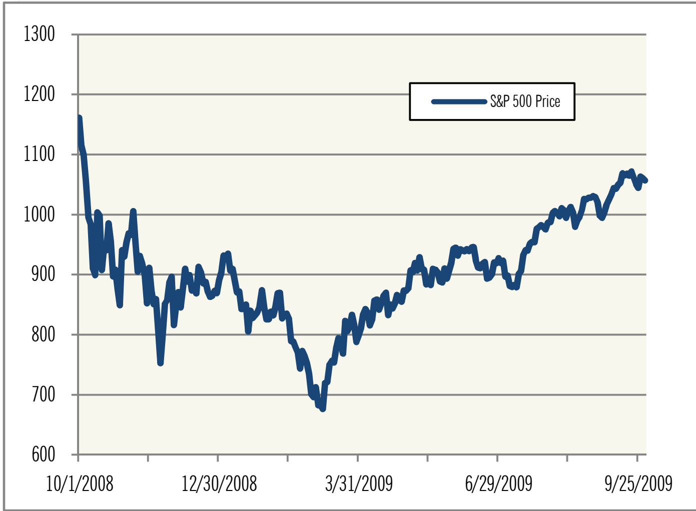
CONVERGENT | WEALTH ADVISORS

MARKET PULSE REPORT

SEPTEMBER 2009

S&P 500 PRICE



The S&P 500 continued to extend its gains, posting in September a seventh consecutive month of positive returns. Since hitting its March 9th closing low of 676, the index is up 56%, one of the most rapid short-term ascents on record. Still, not even nearly all losses have been recouped as the index remains some 33% off of its October 2007 high of 1565 (on a price basis).

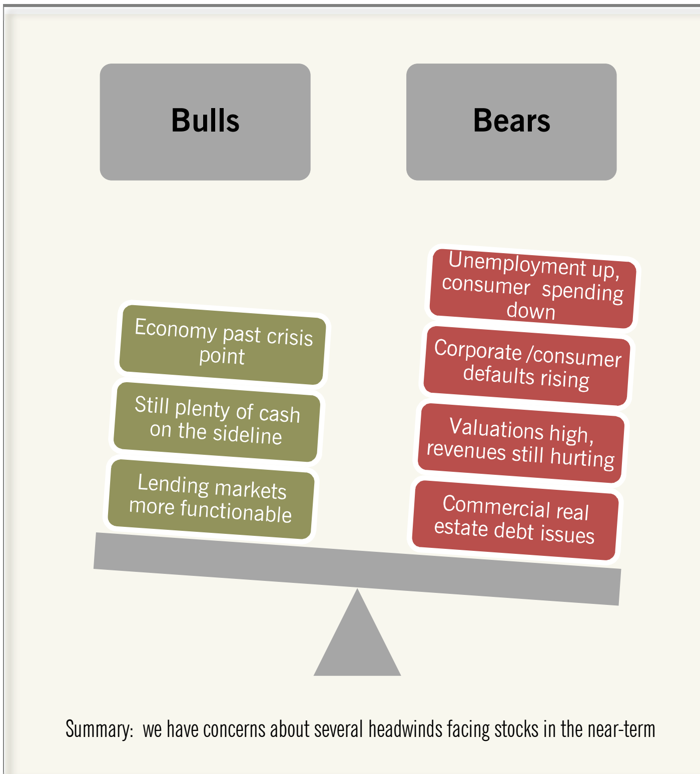
NOTES/COMMENTARY

Now that the Fed has begun peeling back some of the layers of stimulus (such as cash-for-clunkers, Treasury buying programs and first-time home buyer tax credits), we find ourselves asking what might continue to drive equity markets higher? Fundamentals do not seem very supportive. The bond market, with low Treasury yields, is simply not confirming the V-shaped economic recovery that the stock market has priced in. Valuations appear expensive, and continued high unemployment could hold back consumer spending and restrain corporate profit growth. Deflation worries are gaining traction, and the lurking wave of commercial real estate loan refinancings has not gone away. Finally, managers may be starting to move to protect profits on the year. The recession has receeded, for which we are glad, but we want to be prepared for any relapses. We would still like to see better indications of sustainable earnings growth (or more rationally-priced valuations) in order to be fully comfortable with equity prospects on a risk-adjusted basis. In fact, given the extent of the rally and our view that further upside might be limited, now could be a good time to take some gains off the table.

The Bullish Case
- the worst of the recession is behind us
- plenty of cash reserves on the sidelines

The Bearish Case
- employment is expected to deteriorate further, hindering consumer spending
- corporate earnings growth is uncertain; valuations have gotten rich
- bonds are pricing stagnant growth; commercial real estate loan problems loom

SUMMARY OF CURRENT EQUITY MARKET LEANINGS



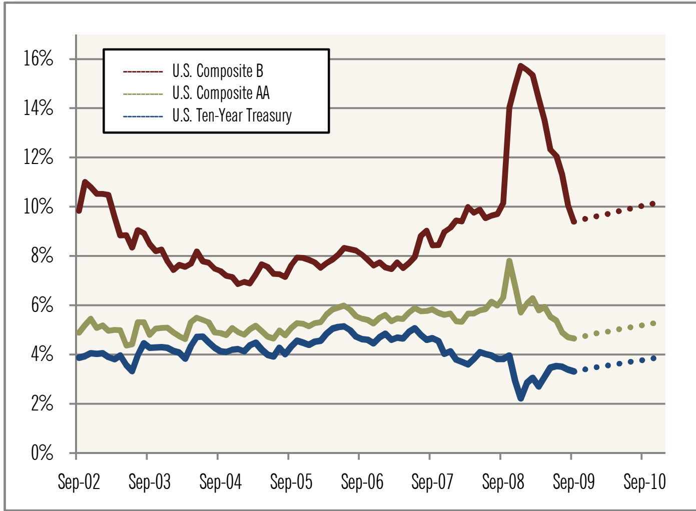
Summary: we have concerns about several headwinds facing stocks in the near-term

CONVERGENT TACTICAL POSITIONING

Asset Class	Positioning
Equity	
US Large Cap Equity	underweight
US Small/Mid Cap Eq.	slight underweight
Developed Non-U.S. Eq.	underweight
Emerging Markets Eq.	slight underweight
Private Equity	neutral
Directional Hedge Funds	underweight
Real Assets	
Real Estate	neutral
Commodities	overweight
Arbitrage/Credit	
Multi-Strategy Hedge	neutral
Opportunistic Credit	overweight
Fixed Income	
Core Fixed Income	slight overweight
Cash Equivalents	overweight

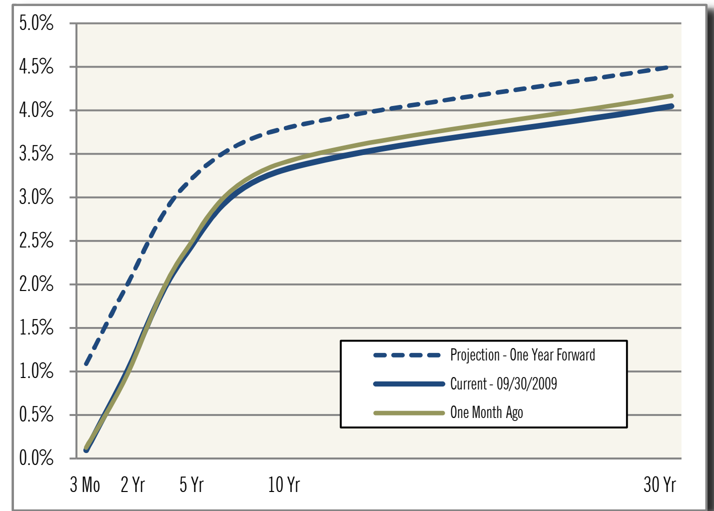
Given the extent of the stock market rally past where fundamentals seem supportive, we feel that some further reduction to equity exposure could be warranted. Rather than shift out of growth assets and forego any potential upside, however, we believe that an increase to commodities (esp. gold) makes sense to provide additional safe haven/weak dollar positioning. Also, given the run-up in bond prices, we suggest shifting a portion of the overweight fixed income allocation to cash.

CREDIT YIELD SPREADS



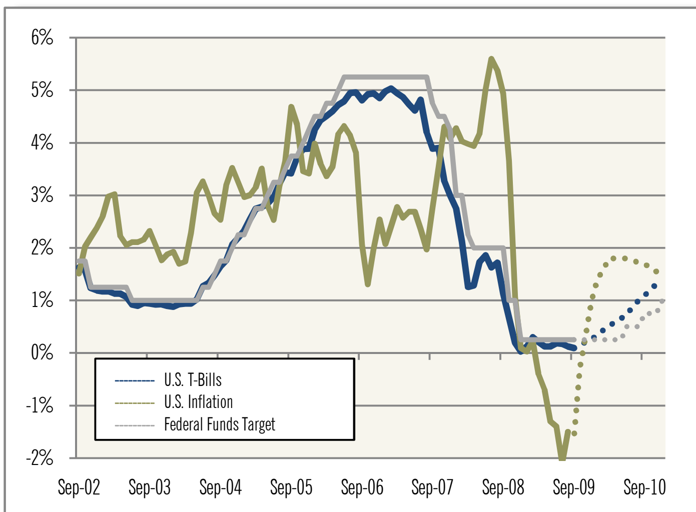
Credit spreads have narrowed significantly but remain wide on a historical basis as bond investors continue to price in a much less robust economic environment than do stocks. While much of the low-hanging fruit in the credit space may have been already picked, there still appear to be plenty of opportunities that look attractive on a risk-adjusted basis as compared to stocks. We have largely shifted out of the dedicated high yield and bank loan segments, which have run up tremendously this year, and into mortgage-backed securities and emerging market local debt. **Advantage: Bears**

U.S. TREASURY YIELD CURVE



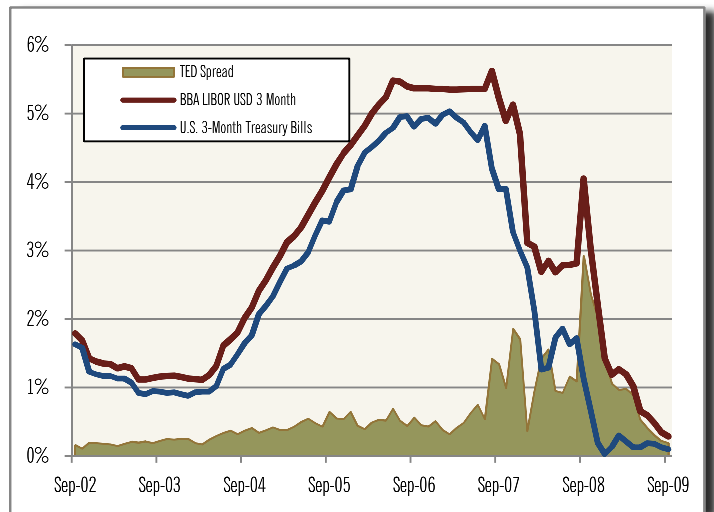
Treasury and equity markets are in disagreement as to the near-term direction of the economy; yields on longer-term Treasuries have been falling (signaling deflationary risks and outweighing concerns about future inflation) at the same time that equity markets have been rising (reflecting investor hope of some reflation). Many pundits feel that bonds, via a flattening yield curve, have generally proved to be more prescient than stocks in reflecting uncertain economic growth when there is such a divergence (1987, 1994, 2000, 2007). **Advantage: Neutral**

T-BILLS, FEDERAL FUNDS AND INFLATION



Inflation, which has remained subdued thanks to high unemployment, is expected to start to show some increase in part due to year-over-year comparison points, yet will likely remain below trend levels for a while. Inflation expectations seem to be a tale of two time-frames: deflation is a renewed concern in the short-term; longer-term (post-2010), inflation as a result of the huge monetary stimulus could cause problems. **Advantage: Neutral**

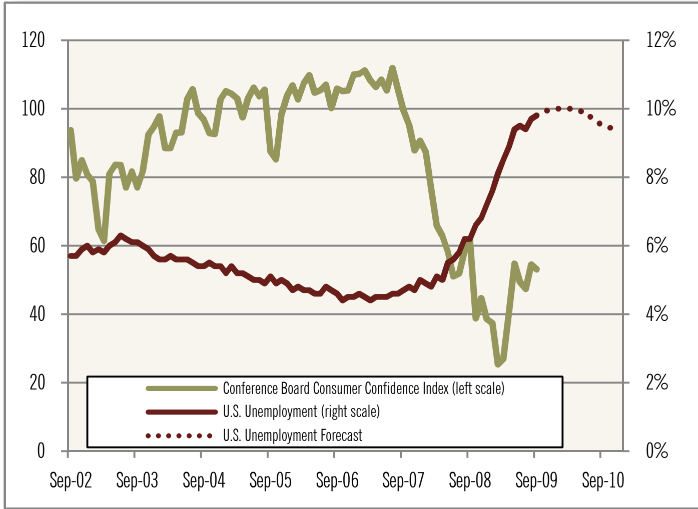
LIBOR/T-BILL RATES AND TED SPREAD



The TED spread is a measure of how tight the credit markets are as illustrated by the difference between T-Bill yields (a risk-free loan) and LIBOR yields (the rate at which banks lend to one another). During last year's credit crisis, extremely wide TED spreads indicated a high degree of anxiety and riskiness in the bank lending market as liquidity was being withdrawn. The recent decline (to lower levels than well before the crisis began) illustrates that the risk of bank defaults is considered to be dramatically decreased. **Advantage: Bulls**

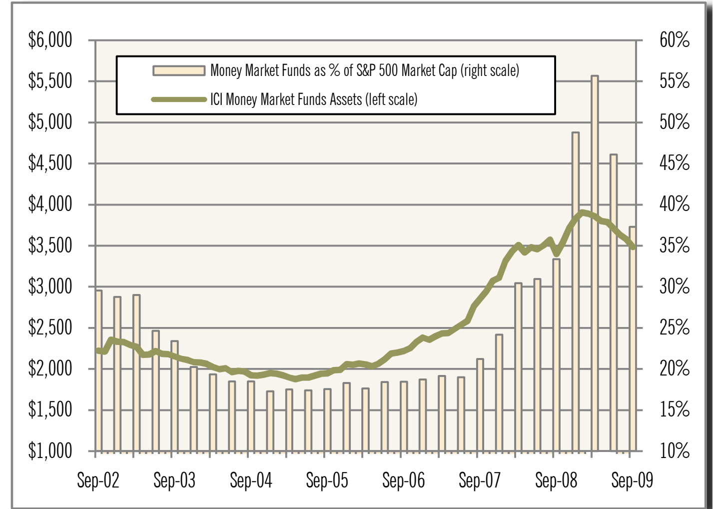
Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

CONSUMER CONFIDENCE & UNEMPLOYMENT



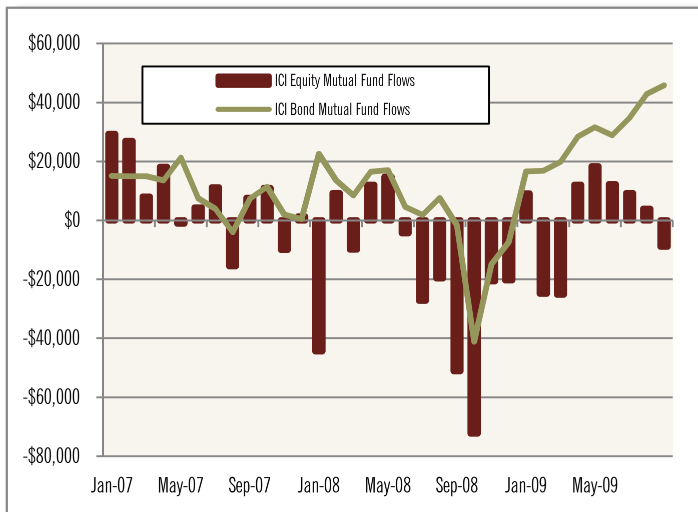
Consumer confidence readings have stabilized but, thanks to job concerns, remain well below levels that generally signal a solid economy. Employment figures are worsening, and are not expected to show reprieve until perhaps mid-2010. Worries about job losses will remain a headwind to consumer spending (which makes up more than 2/3 of U.S. economic activity) and impede a rapid economic recovery. **Advantage: Bears**

MONEY MARKET FUNDS ASSETS ($ BILLIONS)



Despite the stock market rally, there remains a huge amount of cash on the sidelines as retail investors have been slow to jump on the wagon. We have, however, seen many equity managers reduce their cash balances in an attempt to keep pace with the market. There is a concern that now many fund managers may choose to play it safe and lock in gains for the remainder of 2009, removing a leg of support for equities. Still, unless investors have decided to dramatically increase their savings rate, there remains plenty of powder available for stocks. **Advantage: Bulls**

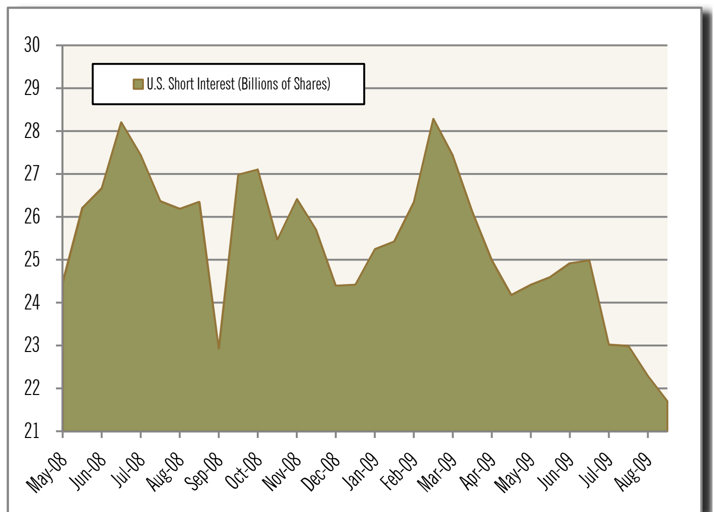
MUTUAL FUND CASH FLOWS ($ MILLIONS)



According to estimates for September, record dollars continue to flow into bond funds. Equity funds, however, recorded outflows during the month. Retail investors seem to have been relatively conservative with regards to where they are directing their money. As corporate insiders are not in buying mode either, a key leg of support for stocks appears to have come from portfolio managers reducing their cash balances. That prop may also be waning as managers lock in gains for the year.
Advantage: Bears

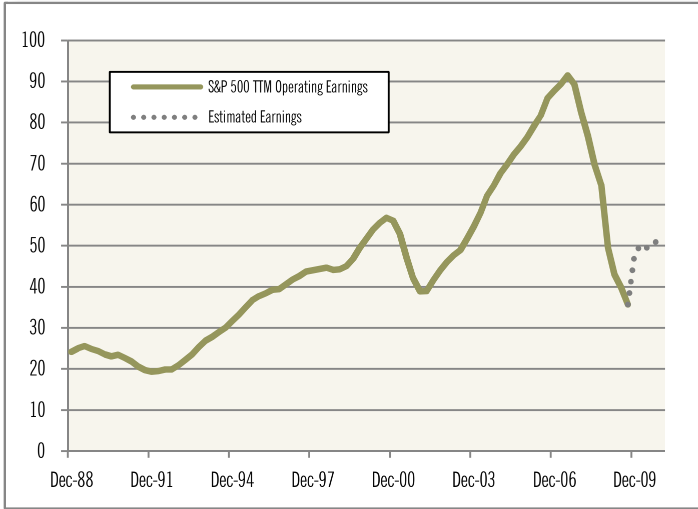
Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

U.S. SHORT INTEREST



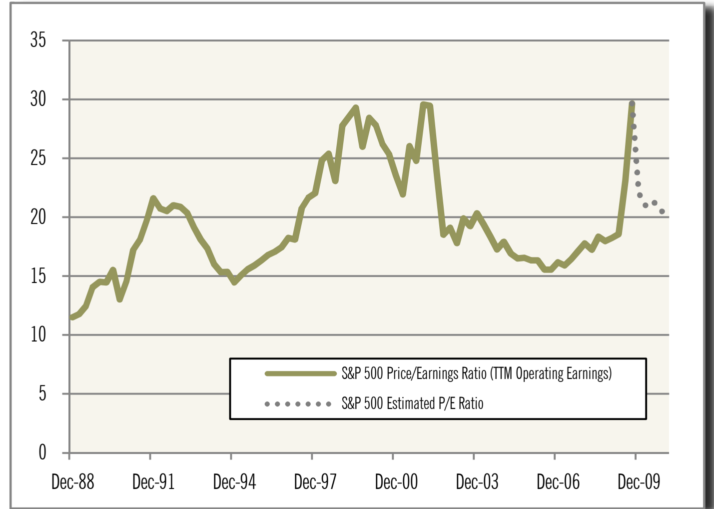
Short interest (the number of shares sold short but not yet covered) can be a telling indicator of investor sentiment, though it is often viewed as a contrary indicator since high levels of short positions are eventually covered, providing upward pressure on stock prices. Short covering appears to have been heavy since mid-March, and perhaps a significant contributer to recent stock gains. As short interest has declined, the benefits from any short squeeze are now largely behind us.
Advantage: Bears

CORPORATE EARNINGS



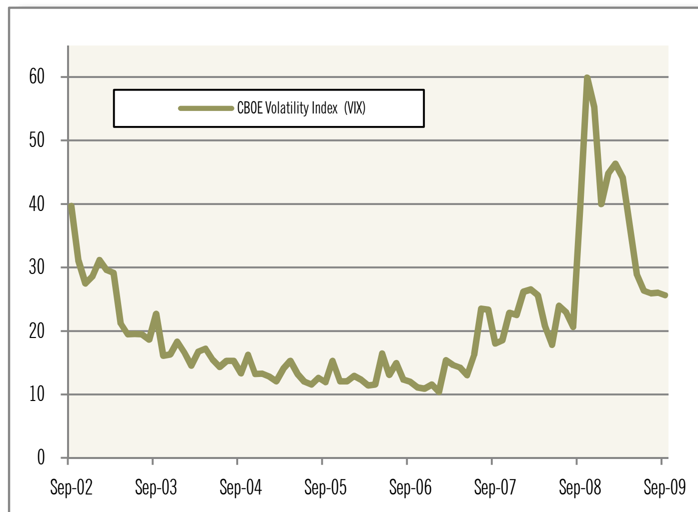
Through September, operating earnings for the S&P 500 are expected to be down about 45% from Q3 2008 on a year-over-year basis. Profits appear to be stabilizing, however, and once we get past Q3, the fact that late 2008 and early 2009 earnings were so bad should allow the year-over-year numbers to start trending upward. A step in the right direction, and Standard and Poor's projects that trailing 12-month operating earnings could rebound to $50-55 by the end of next year. The market seems to be pricing in much better than that, however. **Advantage: Bears**

STOCK MARKET VALUATIONS



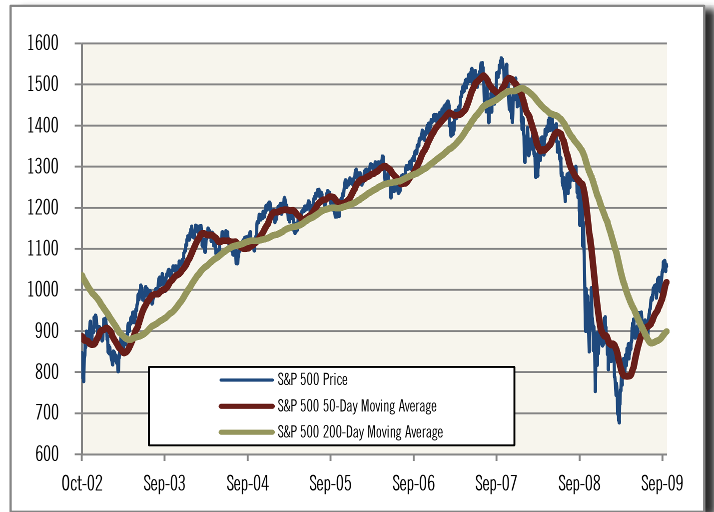
Valuations are not cheap, given the decline in trailing earnings in conjuction with the run-up in prices. The S&P 500 trades at about 30x operating earnings and a somewhat nonsensical 140x "as reported" earnings. Trailing twelve month statistics are somewhat misleading, however, due to low 2008 comparisons. It is clear, though, that in order for valuations to become more attractive (barring stock prices simply declining), revenue growth needs to continue to show improvement and catch up with hgh expectations, and not just through cost cutting. **Advantage: Bears**

STOCK MARKET VOLATILITY



Stock market volatility continues to drop and is well below peak observations, indicating that investors are percieving less downside risk. While the cost of hedging by using options becomes cheaper as the VIX declines, allowing investors to potentially be more comfortable maintaining long positions, bears may argue that it could also be a sign that complacency is back in the market. **Advantage: Neutral**

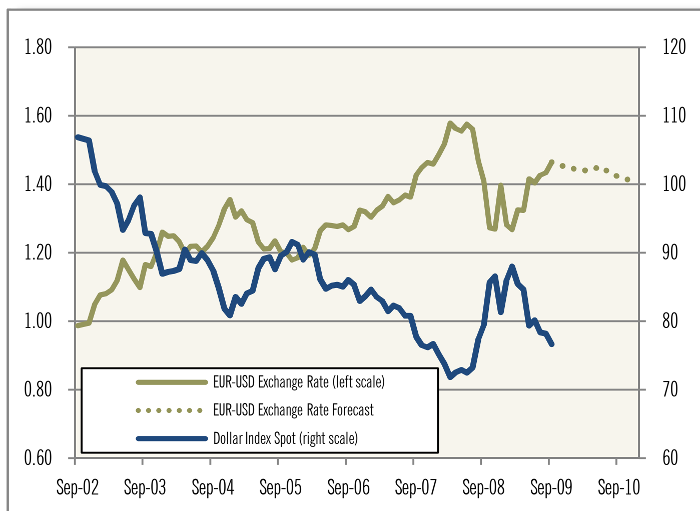
STOCK MARKET TECHNICALS



Some technical indicators have been very supportive of the recent equity market surge. The 50-day moving average of the S&P 500 is higher than the 200-day moving average, interpreted by many as a bullish signal. **Advantage: Bulls**

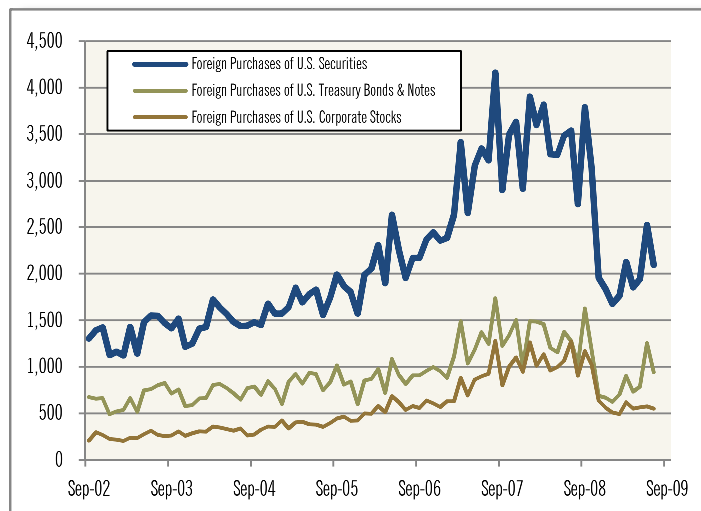
Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

U.S. DOLLAR



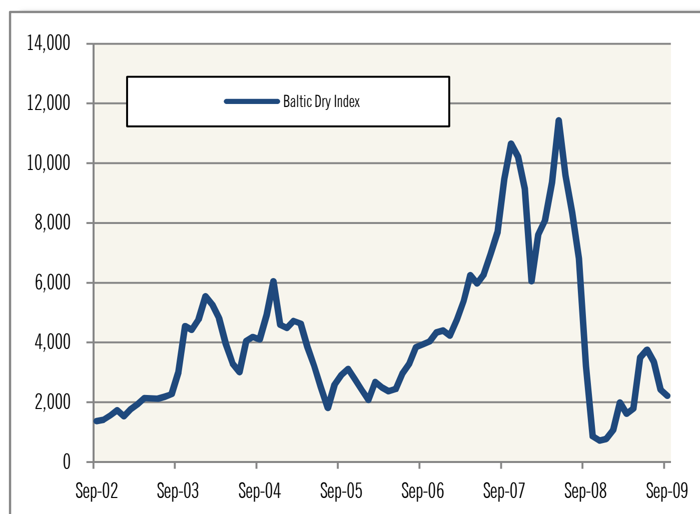
The U.S. dollar continues to fall, undermined in part by concerns over the size of the U.S. budget deficit and low domestic interest rates. Dollar weakness has also contributed to rising interest in commodities. While a short-term bounce is possible, there are fundamental reasons for continued secular dollar weakness and exposure to commodities as well as international equities and bonds could provide a hedge for U.S. investors. **Advantage: Neutral**

FOREIGN PURCHASES OF U.S. SECURITIES ($ BILLIONS)



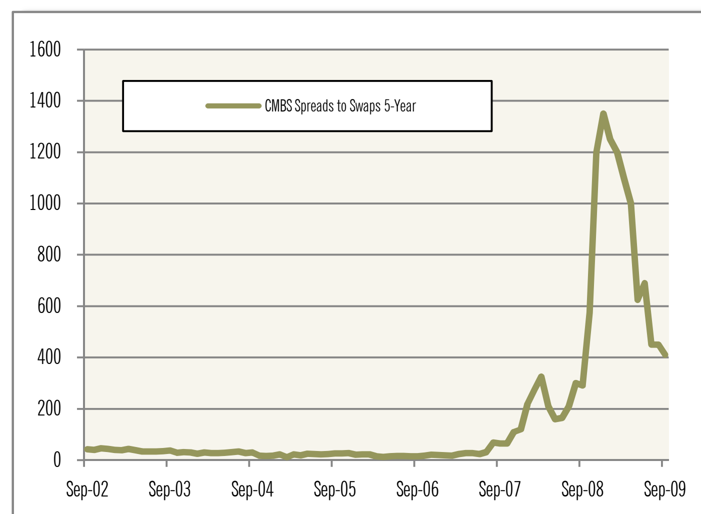
Foreign purchases of U.S. securities declined dramatically during the recent market crisis as investors pulled their capital back home. A pick-up in foreign purchases of stocks and Treasuries was seen heading into summer, but that might be reversing. Going forward, a concern is that dollar worries may keep some foreign investors away. In the long-run, a lack of demand for American investments is bad news for U.S. markets. **Advantage: Bears**

BALTIC DRY INDEX



The Baltic Dry Index (BDI), a measure of world trade, provides a barometer of the price of moving major raw materials by sea, taking into consideration the demand for shipping capacity versus the inelastic supply of dry bulk carriers. The BDI, in a troubling development for signs of improving health of the global economy, has slipped for three consecutive months, and was down 41% in the third quarter. **Advantage: Bears**

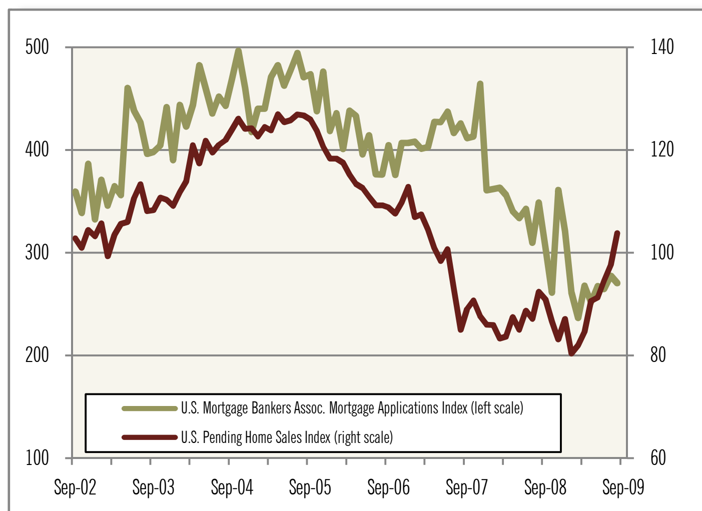
CMBS SPREADS



Despite a significant pullback in CMBS spreads since last fall, levels are still high in a historical context and concerns are rising about commercial real estate loans. Loss expectations remain high thanks in part to a large amount of loans that need to be refinanced in the next couple of years at the same time that vacancies are rising, rental rates are falling, and many commercial real estate owners are struggling to pay their mortgages. Commercial real estate loan delinquencies and defaults will likely continue to accelerate until job losses revert. **Advantage: Bears**

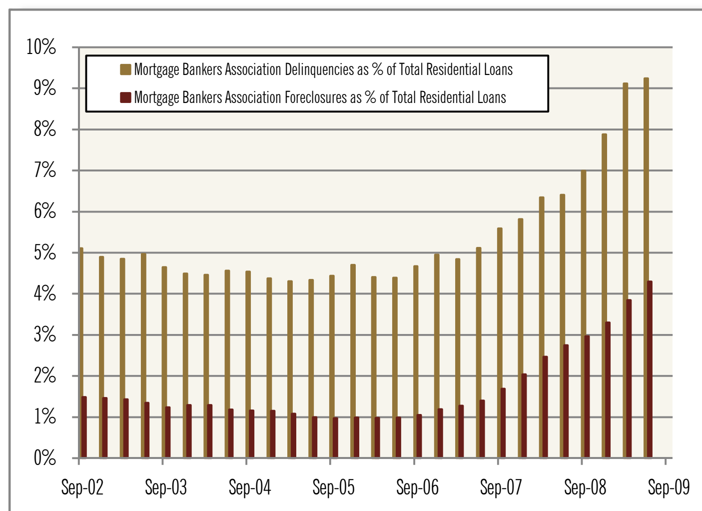
Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

MORTGAGE APPLICATIONS & PENDING HOME SALES



There continue to be some indications that the residential real estate market might be forming a bottom. Pending home sales (used to predict actual home sales activity) have risen for seven consecutive months, and home prices continue to show gains on a monthly basis (though they are still down significantly from their peak). Inventories remain high, however, mortgage applications still have not shown much increase, and foreclosures continue to hit the market. As such, housing will likely be a drag on the economy for some time. **Advantage: Bears**

RESIDENTIAL DELINQUENCIES & DEFAULTS



Home owners remain under pressure as mortgage delinquencies and foreclosures are surging. Huge amounts of outstanding consumer debt and rising unemployment are expected to be a headwind to the economy for some time. The wave of foreclosures is spreading to borrowers with good credit and is not expected to crest until sometime in 2010. **Advantage: Bears**

STOCK PERFORMANCE AFTER MARKET TROUGHS

S&P 500 Performance after Bear Market Troughs since 1970
(based on daily simple price appreciation)

Peak	Trough	Peak to Trough	Initial 3 Mo of Recovery	Months 4-6 of Recovery	Months 7-12 of Recovery
Jan-73	Oct-74	(48.2%)	13.5%	15.3%	5.4%
Nov-80	Aug-82	(27.1%)	36.2%	5.8%	9.8%
Aug-87	Dec-87	(33.5%)	19.4%	(0.1%)	1.8%
Mar-00	Oct-02	(49.1%)	19.4%	(6.6%)	19.9%
Oct-07	Mar-09	(56.8%)	39.3%	9.6%	--
Average		(42.9%)	25.6%	4.8%	9.3%

After market troughs, stocks tend to mover higher in rapid fashion (i.e. during the first three months) before slowing their pace of ascent or taking a breather altogether. That has been the case this time around as well, even as the recovery has been seemingly nonstop. **Advantage: Neutral**

Sources: Bloomberg, Standard & Poor's, Ibbotson, Investment Company Institute

Disclosure: Not FDIC insured - No Bank Guarantee - May Lose Value. *The information contained in this summary is for informational purposes only and contains confidential and proprietary information that is subject to change without notice. Any opinions expressed are current only as of the time made and are subject to change without notice. This report may include estimates, projections or other forward looking statements, however, due to numerous factors, actual events may differ substantially from those presented. The graphs and tables making up this report have been based on unaudited, third-party data and performance information provided to us by one or more commercial databases. While we believe this information to be reliable, Convergent bears no responsibility whatsoever for any errors or omissions. Additionally, please be aware that past performance is not a guide to the future performance of any manager or strategy, and that the performance results displayed herein may have been adversely or favorably impacted by events and economic conditions that will not prevail in the future. Therefore, caution must be used in inferring that these results are indicative of the future performance of any strategy. Index results assume the re-investment of all dividends and interest. Moreover, the information provided is not intended to be, and should not be construed as, investment, legal or tax advice. Nothing contained herein should be construed as a recommendation or advice to purchase or sell any security, investment, or portfolio allocation. Any investment advice provided by Convergent is client specific based on each clients' risk tolerance and investment objectives. Please consult your Convergent Advisor directly for investment advice related to your specific investment portfolio.*