

## Commentary

U.S. stocks ended the third quarter with a bang, as major indices posted their best September in 71 years. Economic news, while not great, was enough to dispel fears of a double-dip recession, especially as the Federal Reserve now appears ready to take additional stimulus measures.

While any improvement in the U.S. economy is welcome, the longer-term story for developed economies is not nearly as bright as that for emerging markets. In fact, the "decoupling" phrase is making its way back into Wall Street nomenclature after being burned in effigy during the 2008/2009 liquidity crisis. Back then, the idea of decoupling gave investors a misguided belief that emerging economies in Asia, Latin America and Europe would not depend on America as much for growth and that they and their capital markets would be partially insulated from future U.S. economic slowdowns or recessions. While all the rage, we didn't subscribe to the idea as a near-term phenomenon, and as the crisis grew and virtually all risk assets tumbled in tandem the theory was thrown out the window en masse. Now, however, decoupling is being viewed in the context that developed economies will continue to see slower growth over the next decade while emerging markets will continue to prosper. This is not a new phenomenon, as emerging economy GDP growth has outpaced developed economies by 5% per year since 1999. And we agree that, while global recessions will still affect all regions, risks skew towards deteriorating sovereign debt ratings and deflation in developed economies and towards stronger credit ratings and inflation pressures in emerging regions.

## CONVERGENT TACTICAL POSITIONING

While we continue to transition back to our strategic equity targets at a measured pace, we remain underweight to *developed* equity markets (though not emerging) in order to accommodate shifts to: (i) certain opportunistic credit segments (multi-sector, emerging market debt/currencies, and international bonds) to collect a current yield while addressing themes such as mitigating equity, deflation/inflation, and currency risk; and (ii) gold as a paper currency hedge and safe-haven asset. We have recently made a modest reduction to core fixed income allocations given low total return prospects in the space, shifting to a blend of cash and growth assets (equities and opportunistic credit) to approximate the risk of bonds with greater upside.

<b>EQUITY</b>		
U.S. Equity	underweight	
Developed Non-U.S.	underweight	
Emerging Markets	overweight	
Private Equity	neutral	
Directional Hedge	slight underweight	
<b>REAL ASSETS</b>		
Real Estate	underweight	
Commodities	overweight	
<b>ARBITRAGE/CREDIT</b>		
Multi-Strategy Hedge	neutral	
Opportunistic Credit	overweight	
<b>FIXED INCOME</b>		
Core Fixed Income	underweight	
Cash Equivalents	overweight	

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

## THE EQUITY AND FIXED INCOME MARKETS

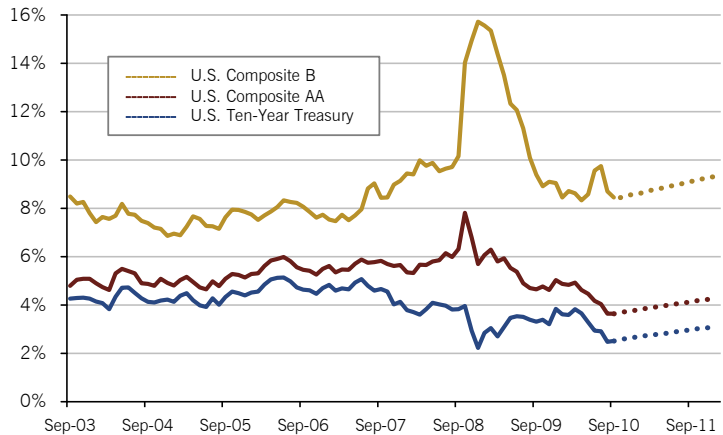
### S&P 500 PRICE

In what is typically a weak month, stocks chalked up their best September gain since 1939. Stocks surged throughout the month as worries the economy would fall back into recession were alleviated. The S&P 500's monthly total return of 8.9% was its fourth best month in the past twenty years, trailing only April 2009, March 2000, and December 1991. Year-to-date, the U.S. large cap index is back in the black, up about 3.9%.



### CREDIT YIELDS

The yield of the ten-year Treasury note continued to hover near all-time lows around the 2.5% level as investors poured dollars into bond funds despite the equity market rally. Some warn of a bubble in government bonds, especially if economic growth quickens, while others argue low yields are appropriate given prospects of little inflation and additional quantitative easing by the Federal Reserve.



### SUMMARY OF CURRENT EQUITY MARKET LEANINGS

While we are modestly below our target equity allocations, it is not due to an overly pessimistic outlook regarding stocks or to seeing outsized risks. Rather, our equity underweight is in order to accommodate desired shifts to gold, emerging market currencies/debt, and other opportunistic credit segments that play into global themes we want to address. In fact, we are not below target with regards to what we categorize as "growth assets" within the portfolio.

## BULLS

Valuations at reasonable levels

Strong corporate earnings growth

Large amount of cash on sideline

## BEARS

Weak job market = tepid spending

Deleveraging = moderate growth

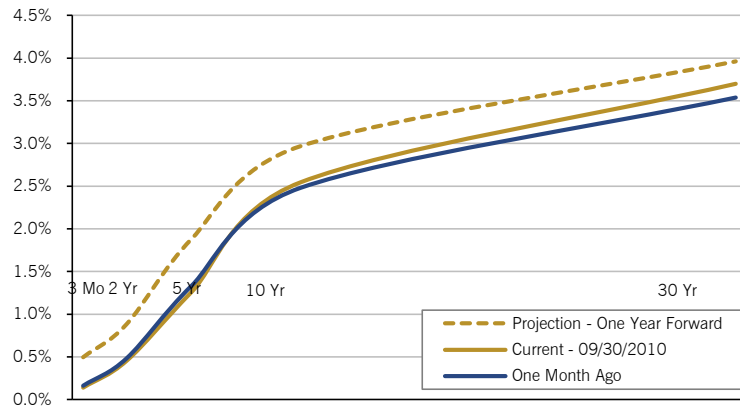
Commercial/residential real estate issues

## THE EQUITY AND FIXED INCOME MARKETS

### U.S. TREASURY YIELD CURVE

On one hand, a steep Treasury yield curve with short-term rates well below long-term yields possibly suggests a low likelihood of a double dip recession or severe economic difficulties. On the other hand, the absolute low level of yields indicates that neither robust economic growth nor inflation is expected by the bond market.

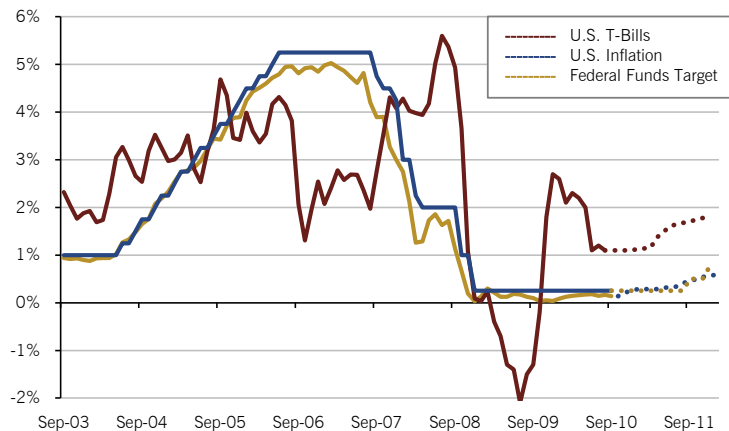
**Advantage: Neutral**



### T-BILLS, FEDERAL FUNDS, AND INFLATION

Continued high unemployment and constrained inflation has the Fed keeping short-term interest rates at record lows. In the near-term, deflationary pressures remain more of a concern than inflation. Longer-term, however, many fear some form of inflation (perhaps caused by currency devaluation) is inevitable and that rates will rise.

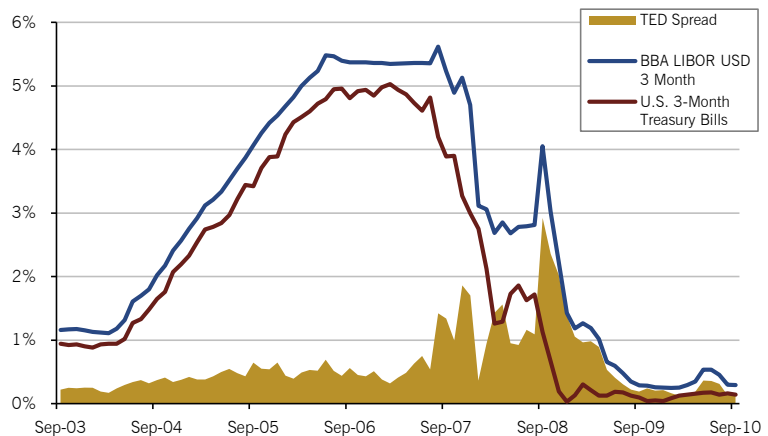
**Advantage: Neutral**



### 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). Low spreads illustrate credit markets are operating with little anxiety. A recent blip higher in the TED spread has reverted as the European crisis has played out.

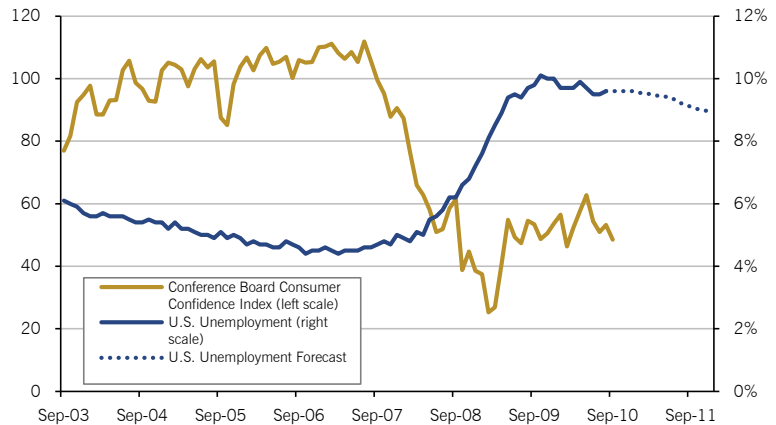
**Advantage: Bullish**



**CONSUMER CONFIDENCE AND UNEMPLOYMENT**

Consumer confidence, which measures how households feel about the current business environment, the job market, and future conditions (over the next six months), is at its lowest point since February and nowhere near levels that signal a healthy economy. Expectations that conditions will not improve have raised concerns about future consumer spending, the biggest driver of the economy.

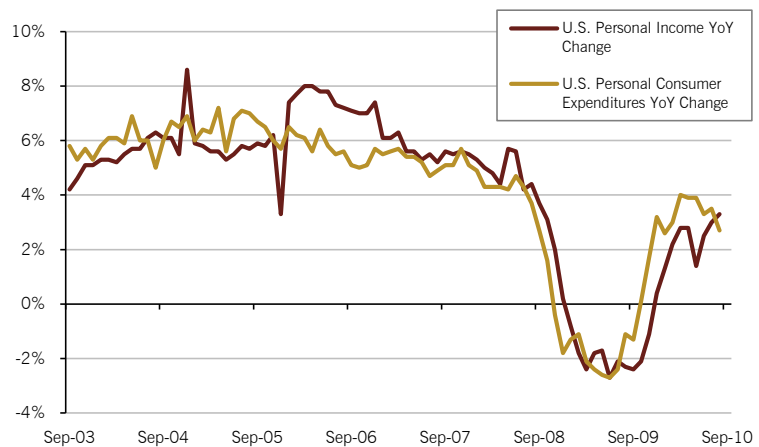
**Advantage: Bears**



**U.S. CONSUMER INCOME AND SPENDING**

Consumer incomes rose in August, but not to a high enough level to rejuvenate spending and the slowing economy. Income has recently been boosted by a resumption of extended unemployment benefits. Without signs of job growth, however, the gains are probably not sustainable.

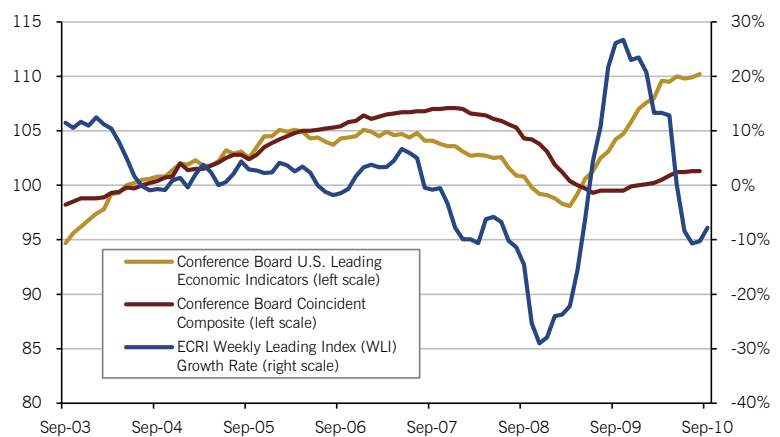
**Advantage: Neutral to Bearish**



**LEI AND ECRI**

The U.S. leading economic index remains at high levels, though the steady rise over the past year appears to be peaking. The Economic Cycle Research Institute (ECRI) weekly leading index, meanwhile, is rebounding off levels that historically have signified a slowdown in economic growth. This bounce may mean we simply experienced a mid-year slowdown, not the start of a double-dip recession.

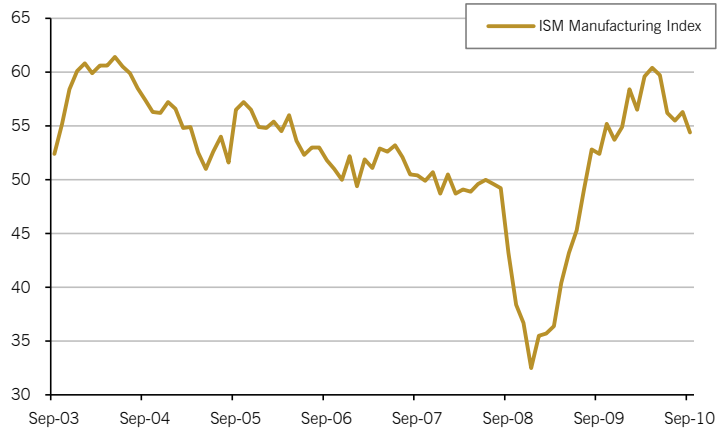
**Advantage: Neutral**



**ISM MANUFACTURING INDEX**

The ISM report is a national survey of purchasing managers covering such indicators as new orders, production, employment, inventories, delivery times, prices, export orders, and import orders. A reading over 50% indicates expansion relative to the prior month, while a reading under 50% indicates contraction.

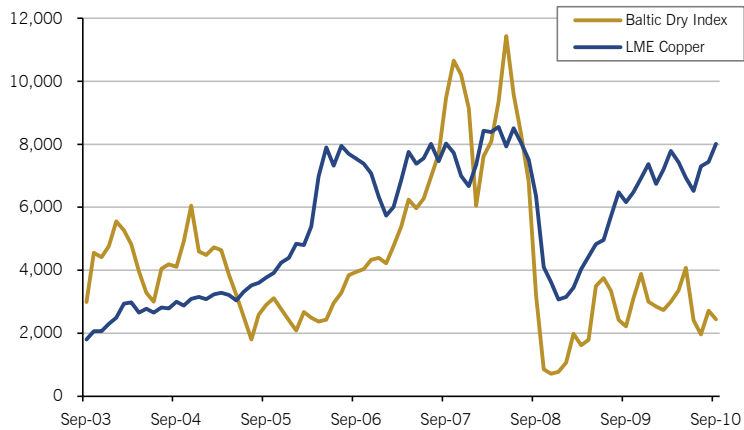
**Advantage: Bulls**



**BALTIC DRY INDEX**

The Baltic Dry Index (BDI), a measure of world trade, provides a barometer of the shipping costs for commodities. The BDI is off the lows seen a year ago, but has seen choppy trading for several months. Meanwhile, the demand for copper, as a plentiful and heavily-relied upon metal in construction and manufacturing activities, reflects a healthy trend in global economic growth.

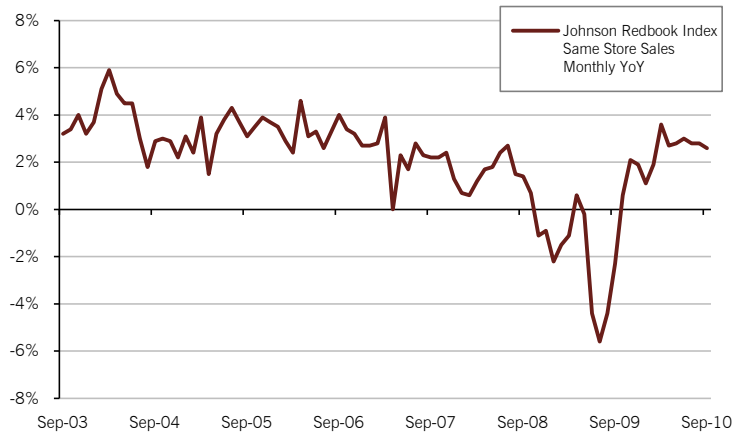
**Advantage: Neutral**



**RETAIL SALES**

Retail sales figures, which track the dollar value of merchandise sold to consumers, could be an indicator of economic recovery and ultimately inflationary pressures. Recent data has been moderately positive on back-to-school buying, reassuring some that a double dip recession is not likely despite high unemployment.

**Advantage: Neutral**

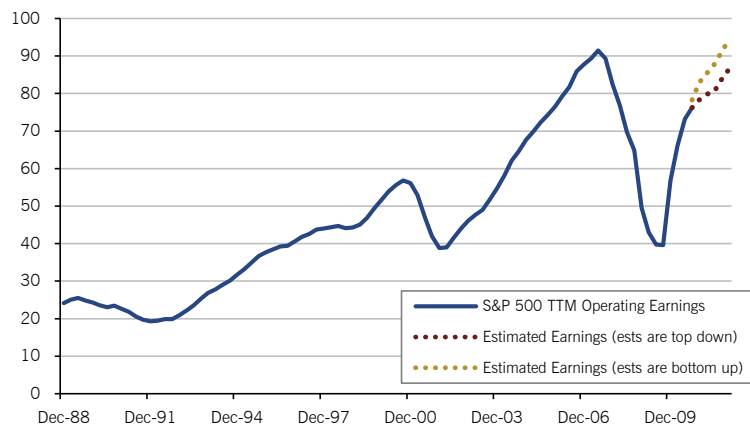


## U.S. CORPORATIONS

### CORPORATE EARNINGS

Bottom-up forecasts for S&P 500 2011 earnings, while still at a healthy \$94.1, have actually been cut by analysts for the first time in more than a year. Expectations are now for somewhat more muted future earnings growth, especially with GDP projected to be below trend next year.

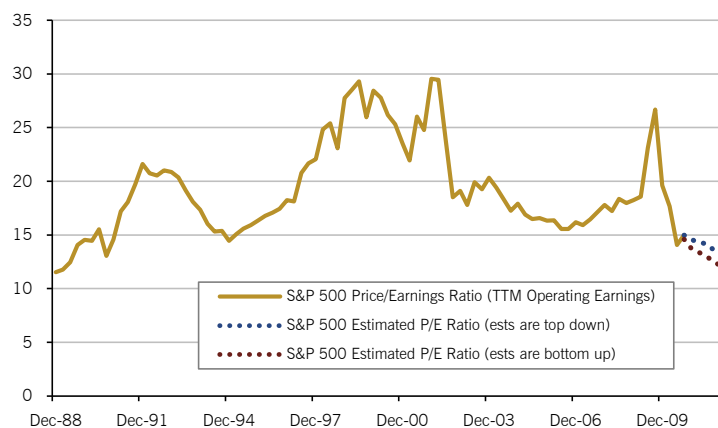
**Advantage: Neutral to Bullish**



### STOCK MARKET VALUATIONS

Sustained earnings growth over the past year has helped trailing 12-month and forward P/E valuations look more and more compelling (below historical average levels). Longer-term methods of measuring valuations, however, such as the ten-year real P/E pioneered by Yale economist Robert Shiller, remain a bit elevated (near 20).

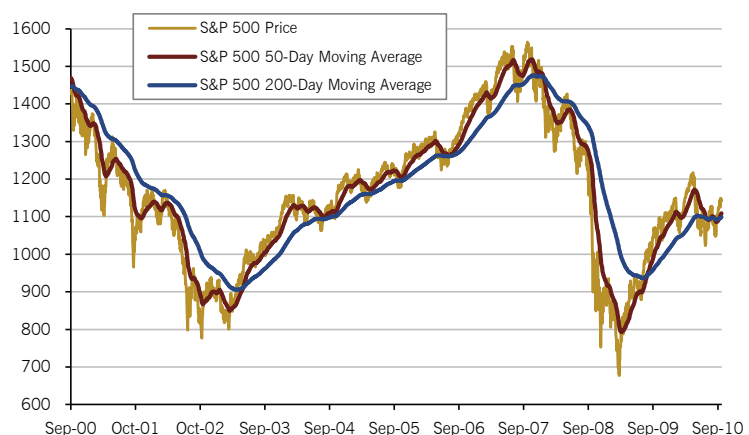
**Advantage: Neutral to Bullish**



### STOCK MARKET TECHNICALS

The S&P 500 50-day moving average, after falling below the 200-day moving average for a brief period of time this summer, has once again crossed into higher territory (the so-called "Golden Cross"), interpreted by many as a bullish signal.

**Advantage: Neutral to Bullish**

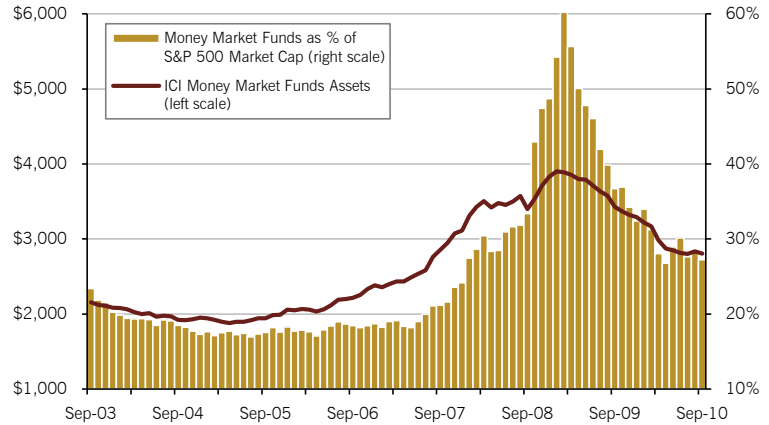


## INVESTOR FLOWS AND LIQUIDITY

### MONEY MARKET FUNDS ASSETS (\$ BILLIONS)

While much of the cash balance built up over the past few years has been put to work (to the tune of \$1.1 trillion since January 2009), there still remains a large amount on the sidelines in money market funds (approximately \$2.8 trillion) despite extremely low interest rates. Barring a secular shift towards increased cash and bond allocations, there remains plenty of dry powder available for stocks.

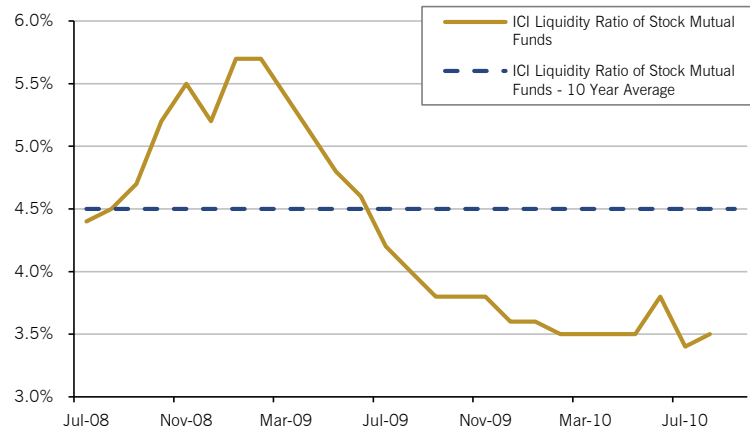
**Advantage: Bulls**



### MUTUAL FUND LIQUIDITY RATIO

The liquidity ratio compares the amount of cash relative to total assets held by stock mutual funds. As stocks tanked in 2009, mutual fund managers were bearish and sitting on a large amount of cash. Since then, managers have put most of that cash to work and are now holding unusually low levels of cash.

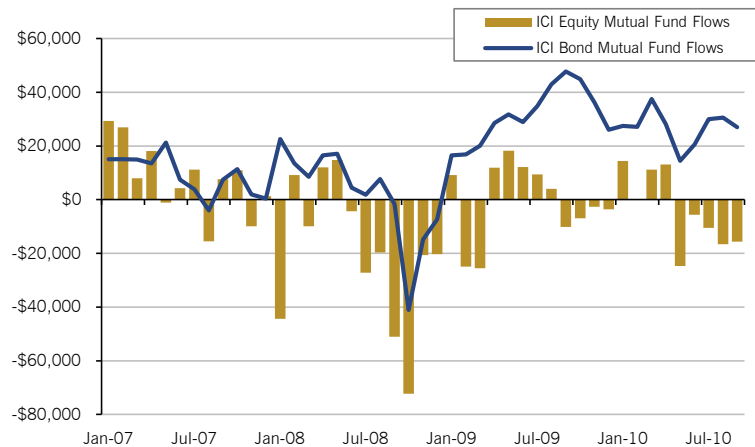
**Advantage: Bears**



### MUTUAL FUND CASH FLOWS (\$ MILLIONS)

Once again, investors have taken cash out of stock funds and entrusted it to bond managers. Since the stock market lows in early 2009, more than ten times as many dollars have flowed into bond funds as compared to equity mutual funds (this excludes ETFs). Shifting demographics and attitudes may be resulting in a secular shift towards income generating investments.

**Advantage: Neutral to Bearish**

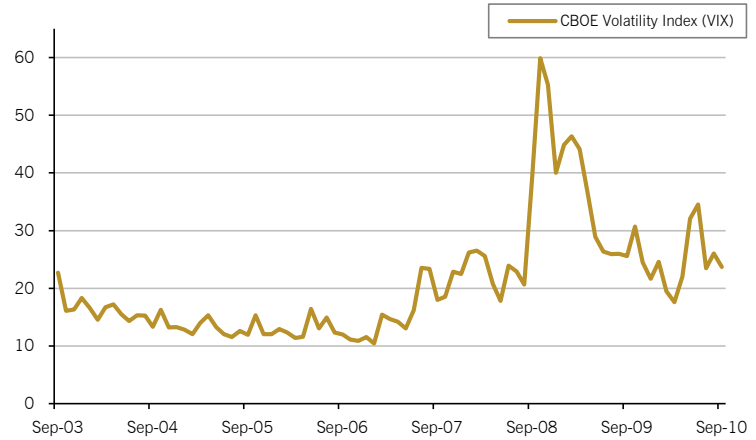


## FEAR MEASURES

### STOCK MARKET VOLATILITY

Volatility, as measured by the Chicago Board Options Exchange Volatility Index, fell slightly to end September at 23.7. Readings in excess of 30 generally correspond with times of investor fear or uncertainty, while values below 20 are typically associated with less stressful (or even complacent) times in the markets.

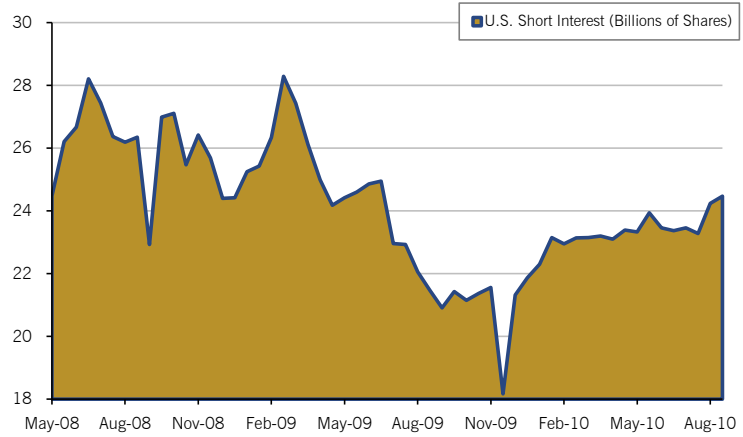
**Advantage: Neutral**



### U.S. SHORT INTEREST

Short interest can be a measure 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.

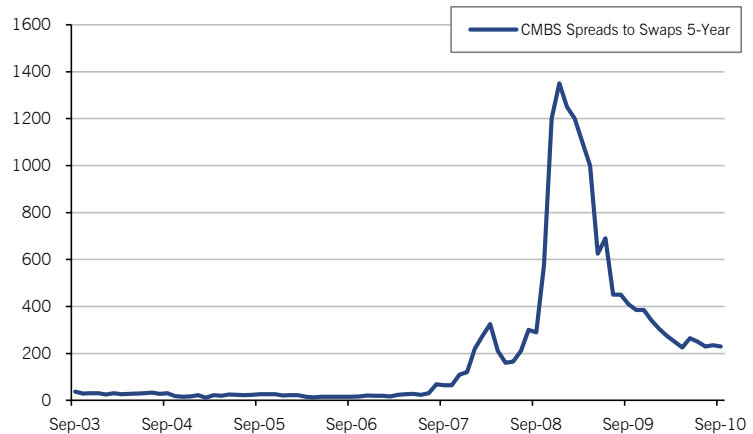
**Advantage: Neutral**



### CMBS SPREADS

Problems in the commercial real estate market are slowly working themselves out, as banks are systematically moving troubled loan assets through their books (or perhaps simply pushing distress into the future). Commercial mortgage-backed securities (CMBS) spreads have been in a narrow, though historically elevated, range for months.

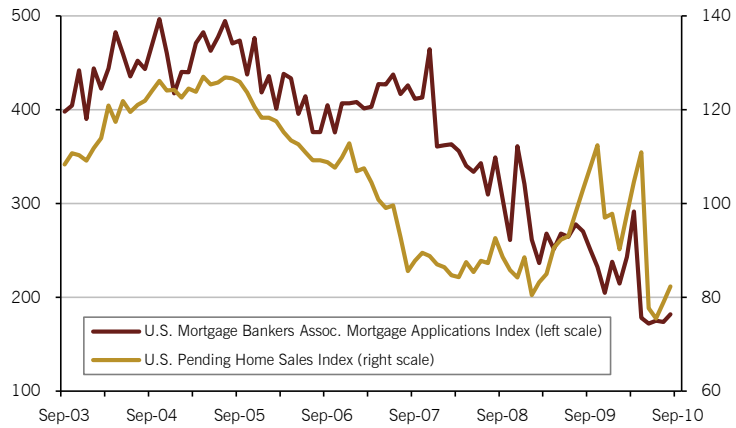
**Advantage: Neutral**



**MORTGAGE APPLICATIONS AND PENDING HOME SALES**

Even though mortgage rates are near all-time lows, high unemployment is keeping many home buyers at bay. Furthermore, sales are typically slower after the school year begins. As lending remains restrictive and inventories high, the housing market is not expected to see a meaningful recovery anytime soon.

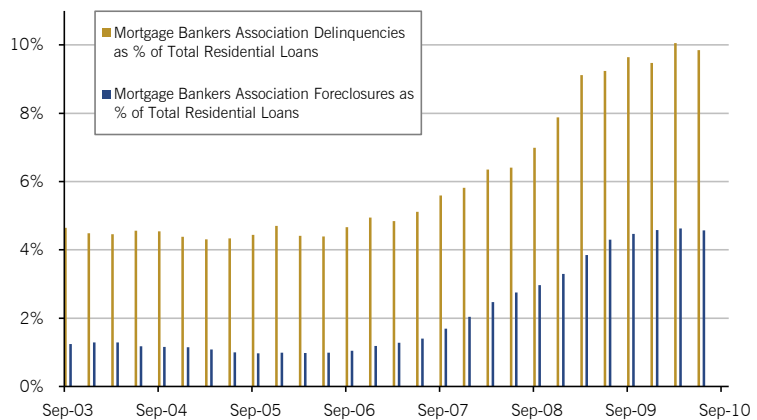
**Advantage: Bears**



**RESIDENTIAL DELINQUENCIES AND DEFAULTS**

Mortgage delinquencies and foreclosures have surged to record levels. With unemployment and unsold inventories remaining high, the wave of foreclosures is expected to be a headwind to the housing market and economy for some time.

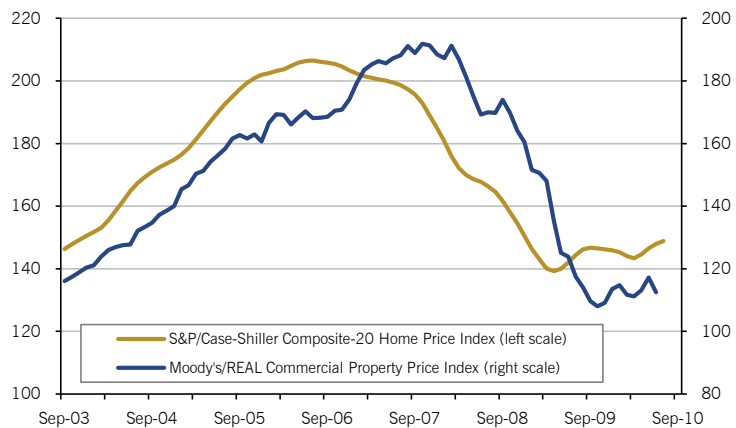
**Advantage: Bears**



**RESIDENTIAL/COMMERCIAL PROPERTY PRICE INDICES**

Real estate prices continue to bounce along the bottom, as market fundamentals offer few positive signs. Any renewed downturn in prices could put further pressure on the economic recovery, as falling home prices tend to accompany cutbacks in consumer spending.

**Advantage: Neutral to Bearish**

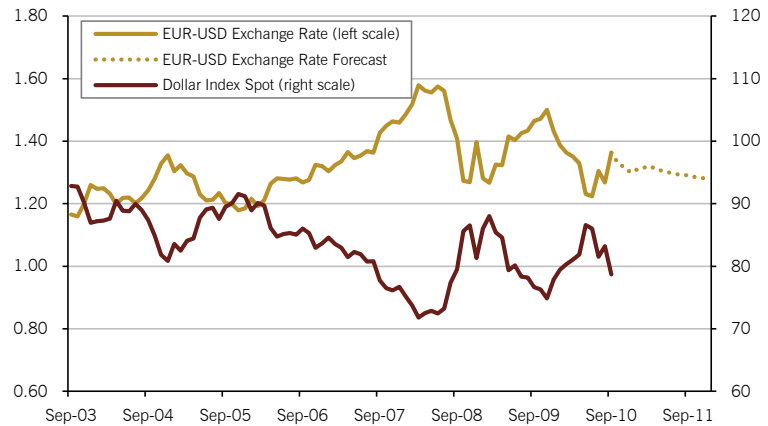


## CURRENCY

### U.S. DOLLAR

As the Federal Reserve looks to engage in another round of quantitative easing, the U.S. dollar has been faltering. The DXY dollar index ended September near its low for the year as the dollar is testing a 15-year low against the yen. Given longer-term issues such as the size of the U.S. budget deficit, most expect the dollar to struggle against many currencies for some time.

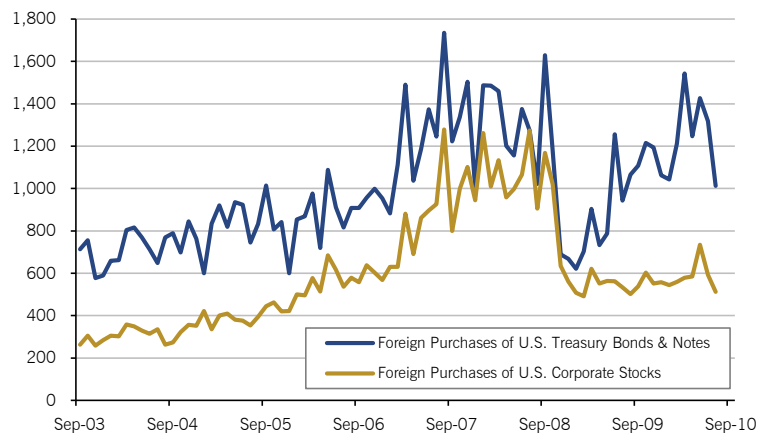
**Advantage: Neutral**



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

China, the biggest foreign investor in U.S. government bonds, has cut its holdings by about 10% over the past year while raising concerns about the mushrooming U.S. debt. There is concern that over the long run U.S. fiscal (and currency) uncertainties may keep some foreign investors away, at least from public securities.

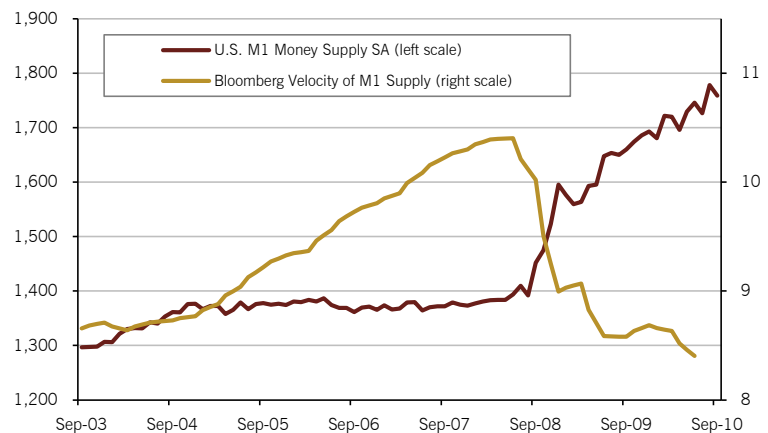
**Advantage: Neutral to Bearish**



### U.S. M1 MONEY SUPPLY AND VELOCITY

M1, the most narrowly defined measure of money in circulation, consists of the most liquid forms of money, namely currency and checkable deposits. With the recent stimulus, M1 has spiked to unprecedented levels, causing fears of eventual inflation and dollar weakness. Currently, however, velocity of money (the rate at which money changes hands) has actually been dropping as consumers and businesses are not spending or borrowing.

**Advantage: Neutral to Bearish**

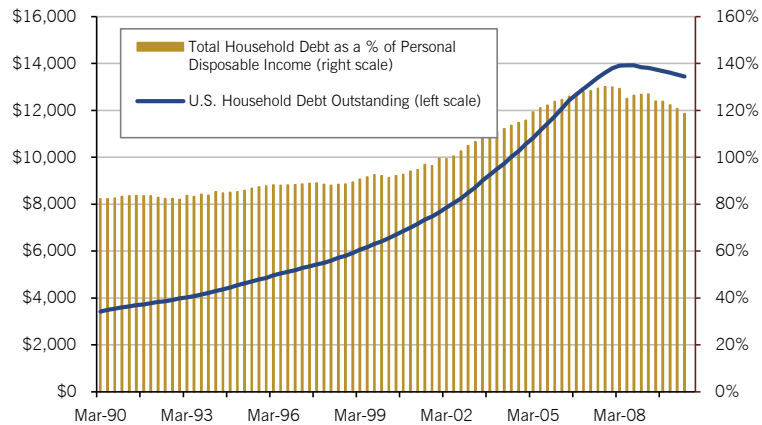


## BORROWING

### U.S. HOUSEHOLD DEBT AS A % OF DISPOSABLE INCOME

U.S. household debt (including mortgages and consumer credit debt), and its percentage of disposable personal income, have increased dramatically since the early 1990's, fueled in part by declining interest rates. Despite talk of a deleveraging cycle, consumers so far have been decreasing debt at a slow pace.

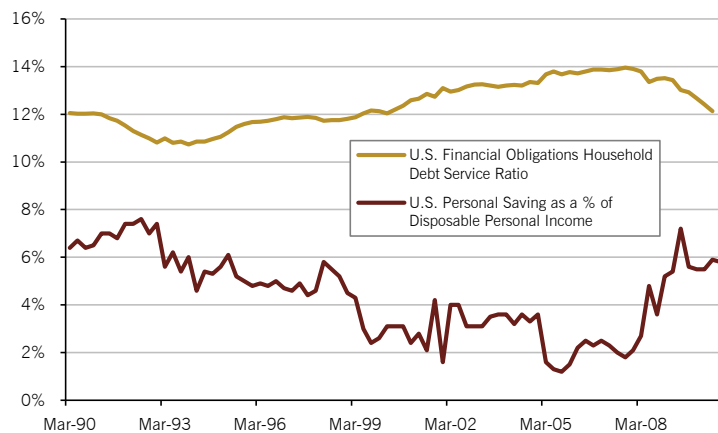
**Advantage: Neutral to Bearish**



### U.S. SAVINGS AND HOUSEHOLD DEBT SERVICE RATIO

The debt service ratio measures how much of their earnings households spend on debt payments. Despite the remarkable increase in total debt over the past few decades, the rise in service ratios has been more muted due to the decline in interest rates. If rates spike, however, so too could debt payments.

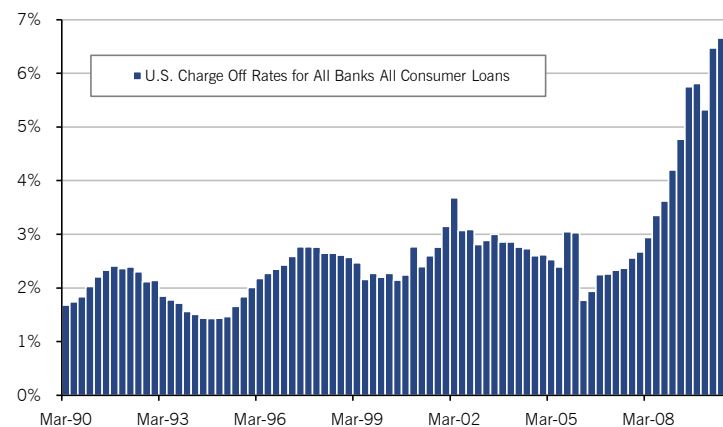
**Advantage: Neutral**



### U.S. CONSUMER LOAN CHARGE-OFF RATES

Even though interest rates remain low, U.S. consumer bank loans (including credit cards, but excluding real estate) written off as unrecoverable remain near the highest levels on record.

**Advantage: Neutral to Bearish**



## DISCLOSURE

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