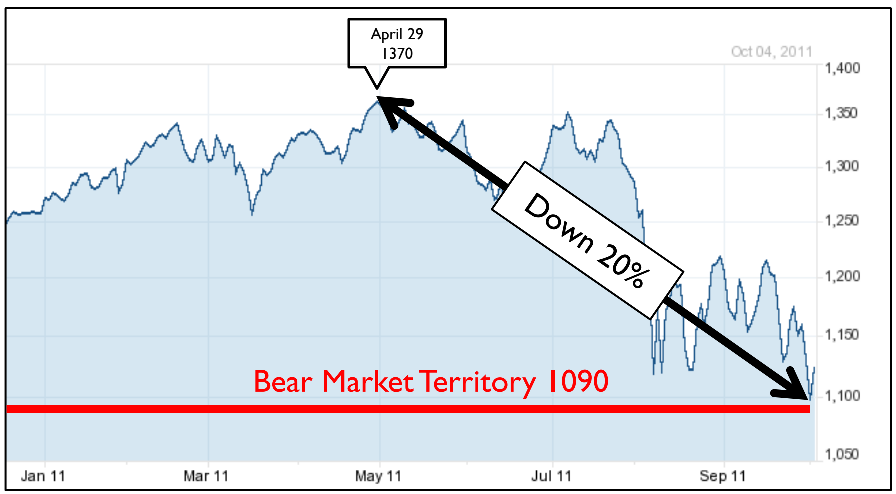
Market Recap

Dow Jones Third Quarter Highlights

Source: WSJ

The third quarter was especially challenging for the equity market and sent investors harkening back to the financial crisis of three years ago. The Dow Jones Industrial Average finished the third quarter down 12% at 10,913, its largest percentage decline since the first quarter of 2009. Over the three months, investors' sentiments shifted from hopes for a second-half rebound from the spring's "soft patch" to worries of a double dip recession. Further, emerging market economies slowed, and investors focused on China and its banking system. Of greatest concern is the prevailing view that the fate of the global financial markets is in the hands of government officials, particularly in Europe and the U.S., making it even harder than usual to predict the future.

S&P 500 Enters Bear Market Territory



Source: MSN Money

On Tuesday, the S&P 500 entered official 'bear market' territory, broadly considered a decline of 20% from a recent peak. The April peak for the S&P was 1370. The market did bounce off of the bear market threshold and staged a late-day surge that saw the index swing from a decline of 1.8% to a gain of 2.3% in the final hour. The market continued to rally the balance of the week, gaining an additional 5%. A report that European leaders may consider further help to the region's banks and better-than-expected employment data in the U.S. were cause for optimism this week. The recent swing was characteristic of the volatile trading that has whipsawed investors and driven many out of the stock market and into assets perceived to have greater safety.

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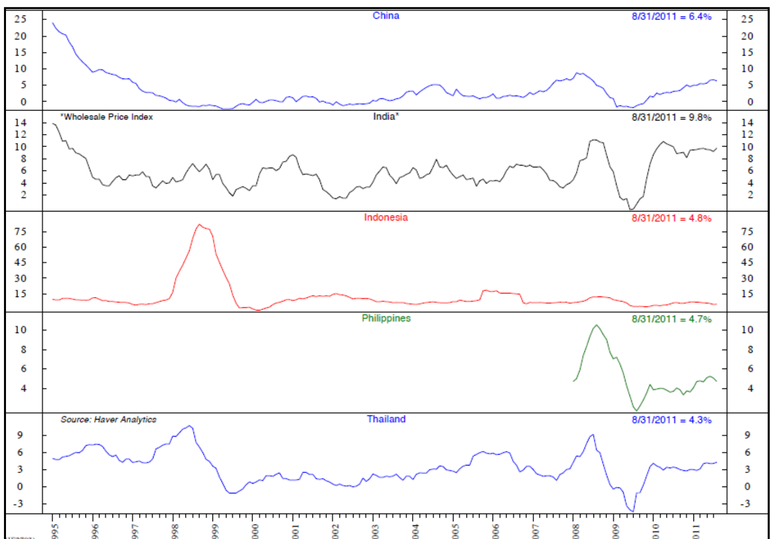
S&P 500 Earnings Yield vs. 10-year Treasury Yield

Source: Thompson Reuters

CPI for Select Asian Emerging Markets



Source: NDR

The Fed Model (a theory reflected in the adjacent chart) suggests that stocks are currently extremely under-valued. The model compares the earnings yield (company profits/price) for the S&P 500 Index versus the 10-year Treasury yield. Historically, the two have closely tracked one another with the spread moving within 2% in either direction. When the earnings yield for stocks is greater than the Treasury rate, stocks are considered to be undervalued. Currently, the forward earnings yield for stocks exceeds the Treasury rate by roughly 7.5% (levels not seen since late 2008 just prior to the market recovery). Even if corporate profits decline by 50%, the earnings yield would still be twice the current 10-year Treasury and stocks would still be significantly undervalued.

Despite the global slowdown, many emerging market inflation rates have been hitting new highs. Notably, Korea and Thailand recorded their highest CPI growth during the past three years. Recent market turmoil has pushed investors to the safety trade, causing emerging market currencies to fall, thereby increasing import costs. Also putting upward pressure on prices are tight labor markets where there continues to be a shortage of skilled workers. Food price growth (a large share of CPI in emerging markets) has started to slow but remains high in areas such as China. Slower global growth may cause central banks in emerging countries to keep rates steady (e.g. Peru and Korea). Conversely, rising inflation risks will likely limit the amount of additional stimulus these countries can provide to aid global growth.

Contact: If you have any questions or comments, please do not hesitate to contact us at 703.992.6164. For more information about Harbour Capital Advisors, please visit our website at www.harbourcapitaladvisors.com.

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