

Gone are the days of a sure thing - nothing moves in a straight line anymore. This sentiment was reflected in the August and September consumer confidence numbers released by The Conference Board, which plummeted as pessimism about the economic environment re-emerged. According to a Gallup poll published in September, 80 percent of upper-income Americans are saying the economy is “getting worse,” up from 66 percent in July. This is a departure from the normal trend as upper-income Americans tend to be more optimistic about the future of the economy than those with lower incomes. On a brighter note, the Institute for Supply Management’s Report on Business indicates that economic activity in the manufacturing sector expanded in September for the 26th consecutive month. Manufacturing registered a score of 51.6 percent, an increase of one percentage point when compared to August’s reading of 50.6 percent. A reading above 50 percent indicates that the manufacturing economy is generally expanding.

Stock Market

The third quarter market recap in a nutshell: market goes down on fear that Congress will not reach deal on debt ceiling, market goes up after deal is reached, market goes down after U.S. government debt is downgraded, market stabilizes for a few weeks, market goes down after the “Operation Twist” announcement from the Federal Reserve, market goes up on hopes of Euro Zone bailout, market goes up when substantial decrease in unemployment claims is announced, market goes down on worries of a global double-dip recession. Déjà vu, anyone? Markets declined sharply following an announcement that the Federal Reserve would buy \$400 billion of long-term government bonds between now and June 2012, while simultaneously selling an equivalent amount of short-term debt as part of what’s being called “Operation Twist.” The Dow Jones Industrial Average (DJIA) closed the quarter down 12 percent, the largest percentage decline since the first quarter of 2009. The S&P 500 suffered an even larger 14 percent decline. Even gold collapsed in September, losing 12 percent of its value, after reaching a record high in August. Despite low yields and a credit downgrade, nervous investors flocked to government bonds. The following table highlights the average annual returns for various indices:

Index	3rd Qtr	1 Year	5 Year	10 Year
S&P 500 (Composite Total Return)	-13.86%	1.16%	-1.18%	2.81%
Russell 2000	-21.87%	-3.53%	-1.02%	6.12%
MSCI EAFE (Price)	-19.60%	-12.02%	-6.14%	2.42%
Barclays Aggregate Bond	4.08%	6.18%	6.61%	5.53%

The S&P 500 is a commonly used measure of common stock total return performance, the Russell 2000 is a commonly used measure of small capitalization stocks, the MSCI EAFE is a commonly used measure of common stock total return performance of international markets, and the Barclay’s Aggregate Bond Index is a commonly used measure of the bond market. All referenced indices are unmanaged and not available for direct investment.

Past performance is not a guarantee of future results.

Tug of War

The debt ceiling, which represents the cap on the amount of money the U.S. Treasury can borrow to pay the government’s creditors, dominated the headlines in the first part of the third quarter. Many Americans were taken aback by the lack of compromise exhibited on both sides of the fence. The major issues that held up the debt ceiling debate were Medicare, Medicaid, Social Security and tax revenues. Republicans strongly opposed including tax increases in the agreement, which was a major roadblock in the debt ceiling negotiations. Without tax increases, Congress had to determine which cuts were necessary to offset raising the debt ceiling. Just as all hope seemed lost, Congress was able to reach and draft an agreement at the 11th hour. The Budget Control Act of 2011 (BCA), signed into law by President Obama on August 2, authorized a \$900 billion increase of the debt ceiling by September 2011 (\$400 billion being immediately available upon passing the bill into law). It also requires over \$900 billion in cuts in discretionary spending over a ten-year period. Furthermore, a Joint Select Committee on Deficit Reduction has been established to designate another \$1.2 to \$1.5 trillion in deficit reduction over that same period. If the Committee cannot agree on a plan, or if Congress does not enact its recommendations by December 23, \$1.2 trillion in automatic spending cuts — called “trigger” cuts — would be applied in January 2013, most of which would come from Pentagon programs.

AAA no more

Congress' lengthy tug of war to resolve the debt crisis severely tarnished the perception of the government's policymaking ability. Only three days after President Obama signed the BCA, Standard & Poor's (S&P) rating firm downgraded the creditworthiness of the United States to AA+ from AAA, stating concerns about the effectiveness of the fiscal consolidation plan that Congress and the Administration agreed to. The downgrade triggered a selloff which stirred global markets. This was the first downgrade of long-term U.S. government debt since ratings firms were established in the early 1900s. The Treasury department was quick to point out that S&P's decision was based on flawed methodology that overstated U.S. debt by about \$2 trillion. According to the Wall Street Journal, the Securities and Exchange Commission (SEC) has opened an inquiry into the model used by S&P to downgrade U.S. debt following these accusations from the Treasury. They are also looking into potential insider trading and examining which S&P employees knew of the downgrade decision in advance. On July 13, in the midst of the debt ceiling negotiations, Moody's Investors Service also announced that it was putting the United States' triple-A rating on review for a downgrade; however, as soon as an agreement was reached on August 2, Moody's reaffirmed the United States' triple-A rating, stating that the risk of default had temporarily been eliminated. Moody's did change its rating outlook to negative, based upon uncertainty with the state of the economy.

Recession Proof?

Does news of the flailing economy have you down in the dumps? Join the rest of us, and grab a chocolate bar and a glass of wine on the way. For the so-called "sin industries," it is business as usual during a recession (aside from gambling, for obvious reasons). The confectionary and alcoholic beverages industries have been thriving in these hard economic times, as small luxuries are replacing large ticket items. Gourmet coffee and casual dining have been trickling back into American household budgets. Nail polish is even edging out lipstick as a "recession-proof" cosmetic product. Hershey's Foods, North America's largest chocolate producer, reported \$5.67 billion in revenue in 2010, a 7 percent increase from 2009. The following chart shows the steady increase of Hershey's stock price from January 2010 to current date:



Is smaller better?

A staple of the American Dream is shrinking – according to the National Association of Home Builders, the average square footage of new homes has declined and is expected to continue shrinking over the next few years. One of the many factors bolstering this new trend is that homeowners looking to move don't have enough equity in their current homes to roll over to a bigger home. Bigger homes come with bigger mortgages, and homebuyers are more skittish about parting with their hard earned dollars in uncertain economic times. Energy concerns could also explain the shrinking home trend – energy costs have been on the rise which in turn drives up the cost of homeownership, not to mention the cost of homebuilding. According to the National Association of Realtors' 2010 Profile of Home Buyers and Sellers:

- Median size of homes purchased from mid-2009 to mid-2010: 1,780 sq. ft.
- Median home size, first-time buyers: 1,540 sq. ft.
- Median home size, repeat buyers: 2,000 sq. ft.
- 19 percent of all buyers reported making compromises on home size.

Conclusion

The third quarter wrapped up on some encouraging news. The Department of Labor announced a sharp decline in jobless claims in the week ending September 24th. New claims dropped to 397,000 from the 428,000 announced the previous week. However, many economists feel that a sustained decline is needed to make a dent in the 9.1 percent unemployment rate. The GDP for the second quarter increased at an annual rate of 1.3 percent, still a little sluggish albeit better than first quarter results of 0.4 percent. The U.S. economy may be on the edge of a precipice, but it has not yet fallen off the cliff.

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