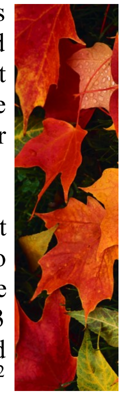
Larry Lars Knudsen & Dan Stober

2012: A Third Quarter Review

A quick summary of economies & markets for you.



While fundamentals may not have supported a powerful rally in Q3 2012, the policy decisions of central banks certainly did. The Federal Reserve launched its third round of easing in the past four years during the quarter and the European Central Bank also embarked on a new stimulus effort. Wall Street seemed to put concerns about Europe and China and job growth on the back burner – the Dow gained 4.32% in three months. The real estate market – already looking better – got a shot in the arm from the Fed. Commodity markets heated up. Our economy still appeared lethargic, but bulls ran freely during a pleasantly surprising quarter for investors.[1]

Domestic economic health. In mid-September, the Fed made the pivotal economic move of the quarter. It announced a third round of bond buying, the long-awaited QE3. Echoing QE1 back in 2008, the Fed decided to buy mortgages - $40 billion of mortgages per month for the foreseeable future. QE3 would be open-ended: the Fed would simply keep at it until home buying, the job market and consumer spending sufficiently improved. QE3 certainly had the potential to accelerate the real estate recovery, but would it also accelerate inflation? The Fed chose to take that risk. It also pledged to keep interest rates at 0%-0.25% into mid-2015, and perhaps even longer.[2]

Unemployment remained at troublingly high levels. The jobless rate did dip to 8.1% in August from 8.3% in July, but it had not been below 8% since January 2009. By August, 40% of the unemployed had been out of work for 27 weeks or more. Job creation was slower than hoped: 96,000 new hires in August, 141,000 in July and an average of 139,000 in the first eight months of 2012 compared to 153,000 in the first eight months of 2011.[3,4]

Consumer spending rose 0.4% in July and 0.5% in August, but it was basically because households were spending more money on gasoline. Spending was outdistancing income growth: when adjusted for inflation, personal incomes fell 0.3% in August after a meager 0.1% gain in July. Q2 2012 GDP was revised down to 1.3%, and there were no great hopes that it would return to the 2.0% pace of Q1. The Commerce Department did report retail sales increases for July (0.6%) and August (0.9%).[5,6]

Annualized consumer inflation remained within the Fed's target – but it rose from 1.4% in July to 1.7% in August. A 1.7% spike in wholesale inflation in August (mostly on fuel costs) took the annualized PPI gain to 2.0%.[6,7]

Consumer confidence improved during the quarter. The Conference Board's barometer went from 65.4 (July) to 61.3 (August) to 70.3 (September), and the University of Michigan's consumer sentiment survey went from 72.3 (July) to 74.3 (August) to 78.3 (September). The September levels were respectively 7-month and 4-month peaks.[8,9]

The quarter saw a contraction in manufacturing, then a surprising turnaround: the Institute for Supply Management's manufacturing PMI fell to 49.8 for July and 49.6 for August yet rose to 51.5 in September. ISM's non-manufacturing index rose to 53.7 in August after a 52.6 reading in July.[10,11]

Global economic health. The European Central Bank also went in for more easing during the quarter. In July, ECB chief Mario Draghi vowed do to "whatever it takes" to save the euro and prevent a "Grexit" or a default by Spain or Italy. The ECB followed that with a big move in September, with Draghi stating that the central bank would make "unlimited" sovereign bond purchases to try and relieve the debt woes of Spain, Italy and other financially beleaguered EU nations through the new Outright Monetary Transactions program. Two conditions had to be met: these countries had to implement austerity measures, and Germany had to give its approval to the newly expanded EU bailout fund. A week later, Germany's high court ruled that the country could continue to participate in EU debt relief efforts. European shares rose and so did the euro, and investors worldwide grew a bit more confident about the prospects for eurozone longevity. At quarter's end, the latest available data showed euro area inflation at 2.7% and the euro area jobless rate at 11.4%.[12,13]

China's growth seemed to be moderating. After a pair of interest rate cuts, $150 billion in infrastructure spending and relaxed capital ratios for its private lenders, its manufacturing sector contracted in both August and September (as measured by the PRC's official purchasing managers index). The problem of declining factory activity was hardly confined to China and the United States. Manufacturing in Brazil declined in both July and August; manufacturing in Mexico and Canada declined in each month of the quarter. As of September, the eurozone manufacturing sector had contracted for 14 straight months.[14]

World markets. According to the *Wall Street Journal,* the following indices saw the following Q3 gains: DAX (Germany), 12.5%; KSE 100 (Pakistan), 11.9%; RTSI (Russia), 9.3%; TSX Composite (Canada), 6.2%; CAC 40 (France), 4.9%; Sensex (India), 7.6%; Jakarta Composite (Indonesia), 7.8%; TAIEX (Taiwan), 5.7%; FTSE 100 (United Kingdom), 3.1%. The Shanghai Composite (China) fell 6.3% and the Nikkei 225 (Japan) slipped 1.5%. Among regional and global indices, the Dow Jones STOXX 600 rose 6.9% in the quarter, and the Dow Jones Global Titans 50 advanced 7.2%; the MSCI World Index rose 6.1% on the quarter while the MSCI Emerging Markets index gained 7.0%.[15,16]

Commodities markets. Key metals saw impressive gains in the quarter. Silver soared 25.2% in three months. Gold had its best quarter since 2002, advancing 10.6%. Platinum and palladium futures respectively gained 14.9% and 9.6%. Copper futures gained 7.5%. As for energy and crop futures, oil rose 8.5%, natural gas climbed 18%, wheat and corn rose 19% and soybean futures gained 12%. Hog futures plunged 22% while cattle futures advanced 3.5%. The U.S. Dollar Index lost 2.1% last quarter.[17,18,19,20]

Real estate. July's Case-Shiller Home Price Index (the most recent to date) showed an overall 1.6% monthly gain in home values across 20 metro markets, and a 1.2% annual gain – the largest recorded since August 2010. By August, the median sale price for residential resales had risen to $187,400 - a 9.5% gain from a year earlier – and the National Association of Realtors also noted existing home sales increases of 2.3% for July and 7.8% in August, with the sales pace in the latter month the hottest in more than two years. In yet another positive sign, the median new home price hit a 5-year peak of $256,900 in August (a 17.0% 12-month increase), with Census Bureau data also indicating a 27.7% annual jump in sales from August 2011. The Commerce Department reported 750,000 housing starts in August, compare that to less than 600,000 as recently as September 2011. Pending home sales dipped 2.6% in August after hitting a 2-year high in July.[21,22,23,24]

Mortgages were certainly cheap, with QE3 helping to hold average interest rates on assorted products at rock-bottom levels. Between June 28 and September 27, Freddie Mac reported the following interest rate movements: 30-year FRM, 3.66% to 3.40%; 15-year FRM, 2.94% to 2.73%; 5/1-year ARM, 2.79% to 2.71%; 1-year ARM, 2.74% to 2.60%.[25]

Looking back … looking forward. This past quarter was the best third quarter for stocks since Q3 2010 - and if you count June as well as July-September, the S&P 500's 4-month gain at the end of the ninth month of the year works out to 9.95%.

% CHANGE	Y-T-D	1Q CHG	1-YR CHG	10-YR AVG
DJIA	+9.98	+4.32	+22.03	+7.45
NASDAQ	+19.62	+6.17	+25.07	+15.99
S&P 500	+14.56	+5.76	+25.16	+7.41
REAL YIELD	3/30 RATE	1 YR AGO	5 YRS AGO	10 YRS AGO
10 YR TIPS	-0.77%	0.16%	2.27%	3.10%

Sources: cnbc.com, bigcharts.com, treasury.gov, treasurydirect.gov - 9/28/12[1,27,28,29]
Indices are unmanaged, do not incur fees or expenses, and cannot be invested into directly.
These returns do not include dividends.

Will stocks continue their YTD advance in the fourth quarter? Some analysts are skeptical, citing anxiety over the scheduled end to the Bush-era tax cuts, the real possibility of weak Q3 earnings, the yet-unresolved debt burden facing the EU and uncertainty on Wall Street until the presidential election is wrapped up. Volatility – oddly sporadic during stretches of the third quarter – may be much more common in the fourth. We are on pace for a very good year, and hopefully the market can ride through any prolonged negotiation in Congress or any sudden shocks from overseas. We will have to see how the drama in Washington unfolds – it may impact Wall Street more than anything else in the fourth quarter.

At the start of 2013, we'll send you a review of the economic developments from the final quarter of 2012. Should you have any pressing financial questions or concerns in the meantime, feel free to contact us.

Sincerely yours,
Larry (Lars) Knudsen & Dan Stober

Citations.

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