

CHARTWELL REVIEW

October 2009

THIRD QUARTER 2009

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Summer's Over



Summertime, an' the living was easy. Fish were jumping, and the cotton was high! (apologies to Cole Porter).

Last quarter we asked whether it was safe to increase our investment in equities, noting there had been a paradigm shift in market sentiment. The affirmative answer can be observed at right. Riskier assets continued to scramble up a wall of worry during the third quarter. Following the unprecedented sell-off early this year, high beta investments have moved sharply higher. The quarter saw the rally's pace accelerate.

With the further appreciation we've experienced in October, the S&P 500 stock index is now up over 60% from its 12-year bottom. Since WWII, nine of the other fifteen bull market rallies were ultimately greater in overall magnitude before they played out. But, *none* of those rallies ever rose this far, this fast. Further, non-US markets are up at least as much. On this basis it's very tempting to conclude the world's stock markets are due (even overdue) for a 10+% correction.

And perhaps they will. It's a real possibility. All markets function like voting machines in the short term, and most investors have had plenty of time by now to get as fully weighted to stocks as they care to be. As we move through the next six months, the mix of net sellers versus net buyers is very likely to favor the former.

With that in mind, we don't recommend adding much more to equity allocations, except on weakness. However, be careful before dismissing stocks altogether. This sharp rally follows the deepest bear market in 60 years (-57% in seventeen months). The relative value of stocks is still pretty darn attractive, **IF** corporate earnings can rise from current levels. That's going to be the key issue. Summer is certainly over, but a long cold winter is not guaranteed to set in just yet.

Table 1: Index Benchmarks

<i>Market Index</i>	<u>Trailing Returns *</u>				
	<u>Q3 09</u>	<u>1 Yr</u>	<u>3 Yr</u>	<u>5 Yr</u>	<u>10 Yr</u>
S&P 500	15.6	(6.9)	(5.4)	1.0	(0.2)
U.S. Large-cap Stocks	14.4	(7.1)	(5.5)	0.6	(1.4)
U.S. Mid-cap Stocks	20.6	(3.5)	(4.1)	3.9	6.0
U.S. Small-cap Stocks	19.3	(9.5)	(4.6)	2.4	4.9
Foreign Stocks (devel)	19.5	3.8	(3.1)	6.6	3.0
Foreign Stocks (emerg)	21.0	19.4	8.3	17.7	11.7
T-bills (3 month)	0.0	0.2	2.5	3.0	3.0
U.S. Aggregate Bonds	3.7	10.6	6.4	5.1	6.3
High Yield Bonds	14.8	22.4	5.2	6.0	6.0
Global Bonds, unhedged	6.2	13.8	9.4	6.6	6.7
CPI, annualized	2.5	(1.3)	2.1	2.6	2.6
Dow UBS Commodity	4.2	(23.7)	(4.9)	(0.7)	6.3
Chartwell Global 65/35	13.3	7.8	2.4	6.6	5.6

Table 2: Average Mutual Fund Returns

<i>Fund Category</i>	<u>Trailing Returns *</u>				
	<u>Q3 09</u>	<u>1 Yr</u>	<u>3 Yr</u>	<u>5 Yr</u>	<u>10 Yr</u>
U.S. Large-cap	15.8	(4.4)	(4.5)	1.7	1.3
U.S. Mid-cap	18.7	(2.4)	(2.7)	3.7	5.5
U.S. Small-cap	18.8	(5.3)	(3.6)	2.9	6.3
International Lg. Cap	19.1	1.7	(3.3)	6.3	3.9
International Sm. Cap	21.5	11.2	(2.6)	8.5	7.4
Emerg. Mkt. Equity	20.7	13.7	6.4	16.3	11.9
Balanced/Hybrid	11.5	2.9	(0.4)	3.2	3.7
General Bonds	6.6	12.6	5.1	4.5	5.9
Government Bonds	3.2	8.5	6.5	5.1	6.0
High Yield Bonds	12.4	13.7	3.1	4.5	4.7

* Annualized trailing returns for periods ending 9/30/09.

Curb Your Enthusiasm

Real GDP declined at an annualized rate of 0.7% in the second quarter. Per Figure 1, our country has endured four straight quarters of declining real GDP, during which time the overall economy contracted by 4%. This was our deepest recession since World War II. GDP is widely expected to increase in the 3rd quarter, bringing the recession to at least a technical end.

Per Table 3, reduced business investment has been the primary factor in this recession's depth. It has contracted by 20% (\$381bn) in the past year alone, while inventory levels have been cut by a cumulative \$340bn. On the other side of the ledger, unprecedented growth in deficit government spending at the Federal level and a favorable net export experience (imports have declined faster than exports have declined) have been consistent contributors to GDP growth. For the fiscal year ended in September, the federal budget deficit is estimated to have hit \$1.4Trn, more than three times last year's.

Prompted by continued fiscal stimulus and a long-awaited rebuilding of inventories, the economy is expected to bounce off its depressed production levels and show solid growth of 3-5% in the second half of 2009. Thus, it was disappointing to observe that inventories declined 1.1% in July and 1.5% in August.

The employment picture remained grim in the quarter. **Non-farm payrolls** declined by 770,000, after dropping 1.3mm in the 2nd quarter and 2.1mm in the first. According to the government's household survey, total employment dropped even more sharply in the quarter, by 1.33mm persons. Total employment has declined by nearly 4.5mm persons this year, after dropping by 3mm in 2008. Per Figure 2, more than 15mm persons in the labor force aren't working, even as the labor force itself has shrunk. Nearly 600,000 persons are estimated to have left the labor market in September.

Directly related to the employment picture, growth in real average weekly earnings continued to decline during the 3rd quarter (see Figure 3). They are down nearly 2% this year, after getting a pop in last year's 4th quarter (entirely due to a calculated decline in the CPI). More broadly, disposable personal income declined 1% in real terms during the latest quarter. It is up 0.7% this year, entirely as a result of increased government transfer payments and reduced personal taxes. It is hard to envision how consumer spending can grow in a sustainable fashion unless consumer pre-tax earnings grow in both nominal and real terms.

What's the good news? Consumer prices and producer prices are currently not rising very much. The CPI index rose at a 2.5% annual rate during the 3rd quarter, but has decreased 1.3% over the last year. Core CPI (ex-food and energy) is up just 1.5% for the same period. Producer prices for finished goods rose just 0.2% in the quarter, and have declined 4.8% during the past year.

Figure 1. Real GDP, quarter-by-quarter

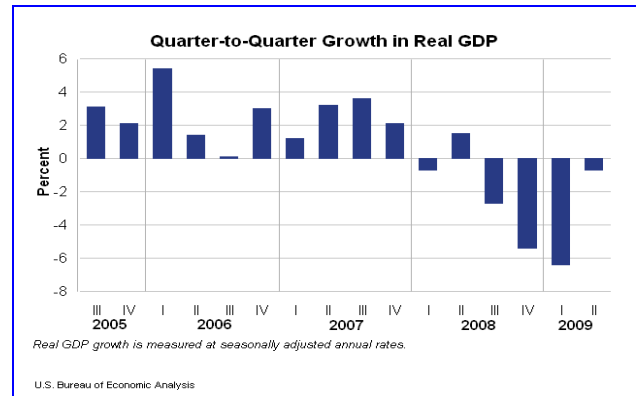


Table 3: Contributions to Real GDP

(seasonally adjusted at annual rates)

Factor	3Q '08	4Q '08	1Q '09	2Q '09
Real GDP Growth	(2.7)	(5.4)	(6.4)	(0.7)
Personal Consumption	(2.5)	(2.1)	0.4	(0.6)
Investment – Businesses	(0.7)	(2.5)	(5.3)	(1.0)
Chg. in Inventories	0.3	(0.6)	(2.4)	(1.4)
Investment – Consumers	(0.6)	(0.8)	(1.3)	(0.7)
Net Exports	(0.1)	0.5	2.6	1.7
Government Spending	1.0	0.2	(0.5)	1.3

Figure 2. Employment continues to shrink

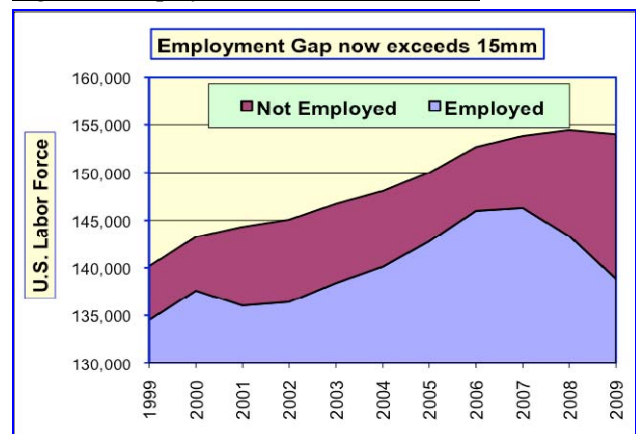
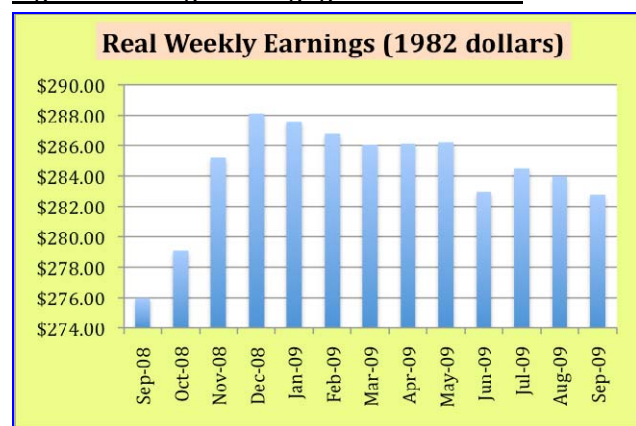


Figure 3. Average earnings growth has stalled



After the Credit Crisis: Bonds Rock

The broad-based risk rally in U.S. bonds progressed another quarter, led by the credit sectors. Near-zero interest rates on risk-free assets fueled the search for yield, after patterns of improving economic and liquidity indicators gave investors the all clear sign. As was the case in the 2nd quarter, individual sectors also benefited from government purchase and guarantee programs. The Barclays Aggregate Index advanced a strong 3.7%.

Government yields fell amidst signs that considerable slackness in the economy would keep inflation at bay. The Treasury index was up 2.10%. Issuance of debt by the Treasury was generally met with strong demand, despite concerns that foreign investors would be dissuaded from buying by weakness in the US\$. Prices for medium and long term Treasury bonds were pushed up, and the Long Treasury sector returned 4.53%. Price appreciation caused the 10-year Treasury bond yield to dip back to 3.40% at quarter's end. The front end of the yield curve remained anchored by the Fed at 0%.

The structure finance area is dominated by agency-backed residential mortgage securities. At 2.4%, that sector's return again exceeded Treasuries, despite lower duration. Option-adjusted spreads continued to fall in the quarter, and are now below those seen in late 2006. Prices in this sector have been sharply impacted by the Federal Reserve's \$1.25Trn purchase program.

The most successful structured finance sectors in the quarter were non-agency residential mortgages (RMBS) and Commercial Mortgage-backed bonds (CMBS). The latter continued to be the best-performing investment grade sector in 2009, after being the worst in 2008 (see Table 5). Demand has been boosted by very attractive excess yields, created by last year's sharp price declines, continued government support programs (TALF and PPIP), and investor optimism in the macroeconomic environment – despite weakening fundamentals to date.

Amid much-improved liquidity and what appears to be improving economic conditions, corporate credit continued to stage a major rally in the third quarter. Record excess yields versus Treasuries at year end 2008 have sharply given way since March (see Figure 4), leading to a 7.5% return for investment grade credit bonds in the 3rd quarter, and 14.9% for the year-to-date. Financial sector corporates led the way this quarter.

Asset allocation flows into fixed income have been significant throughout 2009. This has largely been from money funds now paying virtually no interest. It is estimated US\$334bn has left money funds this year, most of it headed for bond funds. Additionally, net demand from insurance companies rose to a US\$135bn annualized pace in the quarter, compared to negative \$59bn in 2008. This has all helped to fund 2009's record pace of corporate bond issuance, which is expected to hit US\$686bn. The previous record was US\$508bn, set in 2007.

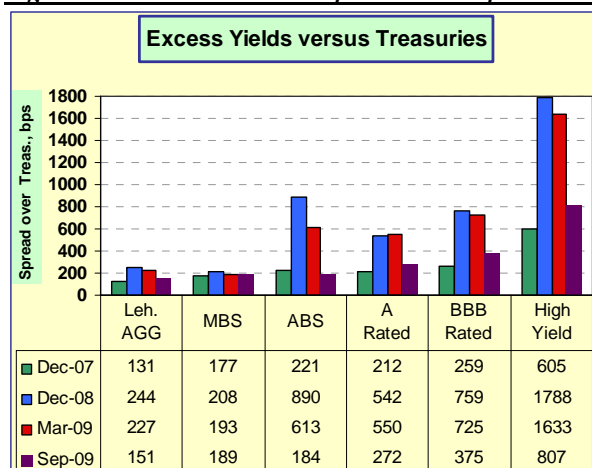
Table 4: Primary Bond Sector Returns

<i>Bond Index</i>	3Q '09	1 year	3 years
Aggregate Bonds	3.7%	10.6%	6.4%
3-mo. T-bills	0.0	0.2	2.5
US Treasury, long	4.5	9.1	8.0
U.S. TIPS, 1-10 yrs	3.0	4.0	5.7
Agency MBS	2.4	9.7	7.4
CMBS	12.3	5.5	0.5
ABS	6.3	14.7	3.5
Inv. Grade Credit	7.5	19.5	5.8
High Yield Credit	14.8	22.4	5.2
Non-US Global, Hedged	2.0	7.6	5.2
Non-US Global, Unhedged	7.3	16.8	10.3

Table 5: Spread Bonds continue to outperform

<i>Excess Returns versus Treasuries, duration-adjusted (%)</i>			
<i>Bond Sector</i>	3Q '09	YTD '09	2008
Aggregate Bonds	2.0	6.4	(7.1)
US Agencies	0.6	2.5	(1.5)
Agency MBS	1.1	4.2	(2.3)
Comm'l MBS	10.9	25.1	(32.7)
Asset-Backed bonds	5.0	23.0	(22.2)
Invest. Grade Credit	5.0	17.1	(17.9)
High Yield Credit	12.3	49.6	(38.3)
Primary Non-U.S.	(0.5)	5.4	(6.4)
Emerging Markets	8.8	33.2	(28.4)
AAA MBS (subprime)	24.6	25.0	(40.1)

Figure 4 as Credit Spreads have plummeted



Domestic Equities – the Rally Continues

The third quarter saw the global stock market rally accelerate, with domestic markets fully participating. US equities rose sharply higher amid speculation that growth had returned to the economy. Most major indices posted mid-teens or higher returns. The broad S&P index rose 15.6%, nearly matching the second quarter's 15.9% gain. After a 42% slide from September 2008 through February 2009, the market has posted seven consecutive positive months, advancing 46%.

Per Table 6, the value effect (*Value* > *Growth*) was observable across the entire capitalization spectrum during the quarter, for the first time in a long time. Growth has now sharply outperformed value in the 2009 rally to date, and since the market's peak in early October 2007. Value outperformed during the worst of the market breakdown last year. Nonetheless, cumulative returns over the past two and three years clearly favor growth stocks over value stocks.

The size effect (*Small* > *Large*) was also evident during the quarter, as investors continued to seek out higher beta mid-cap, small-cap and micro-cap stocks that had been oversold during the credit crisis. High beta stocks outperformed by over 6% in the quarter and have done so in surprisingly large proportions (+30% excess return) year-to-date.

Large-cap stocks in every sector produced positive returns for the quarter (see Table 7), with financial services firms once again leading the advance. We saw the same pattern in the 2nd quarter. The "bet" on an economic recovery was clearly evident, as the pro-cyclical industrials, materials, consumer discretionary, and technology sectors also outperformed. For the year-to-date, the high beta technology sector is up over 45%. In contrast, low beta and less economically sensitive utilities, telecom, consumer staples and health care shares were underperformers, as they have been all year.

Among small-cap stocks, materials and energy led the 3rd quarter parade, as five of ten sectors advanced more than 20%. Laggards were the same as in the large-cap space. Some interesting sector differences between large and small stocks have developed this year. Small cap financial stocks (which represent a large 20% of the total) have sharply underperformed large cap financials. The former are apparently not regarded as "too big to fail." Conversely, small cap energy stocks have sharply outperformed large cap energy, with the former comprised primarily of "upstream" producers.

The dominating domestic investment theme this year, and one which continued in the 3rd quarter, has been that of lower "quality" companies thoroughly outperforming higher quality firms (see Figure 4). We define quality here according to the long-lived S&P Quality Ranking System, which rates companies in terms of the long-term growth and stability of their earnings and dividends. It's been very good to be risky.

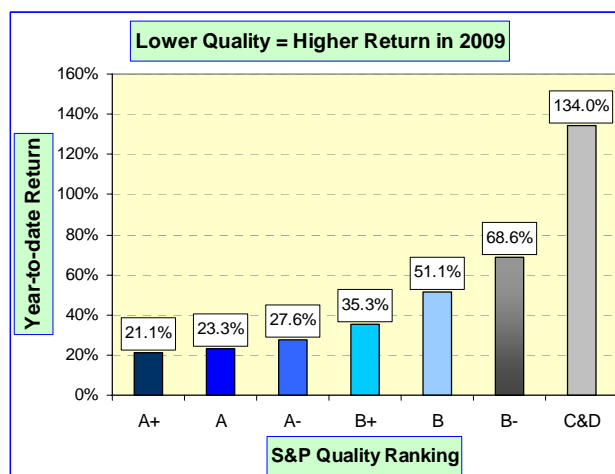
Table 6: U.S. Equity Market Size/Style Returns

	3Q '09	YTD '09	Trailing Periods	
			1-Year	3-Years
Growth				
Large Cap	12.7	23.6	(7.1)	(5.5)
Mid Cap	17.6	37.1	(0.4)	(3.1)
Small Cap	16.0	29.1	(6.3)	(2.6)
Micro Cap	18.4	40.3	(0.7)	(5.9)
Value				
Large Cap	16.2	10.4	(11.9)	(8.6)
Mid Cap	23.6	27.6	(7.1)	(5.7)
Small Cap	22.7	16.4	(12.6)	(6.6)
Micro Cap	23.1	17.8	(14.2)	(9.8)

Table 7: U.S. Sector Returns in the 3rd Quarter

Sector	Large-cap Returns (%)		Small-cap Returns (%)	
	3Q '09	YTD	3Q '09	YTD
Financials	24.5	20.5	22.3	3.6
Industrials	21.5	16.4	18.4	16.5
Materials	21.5	39.8	28.3	45.6
Cons. Disc.	20.0	32.4	23.4	49.2
Info Tech	16.6	45.4	22.2	55.3
Cons. Staples	11.3	9.3	12.9	24.9
Energy	10.9	10.2	28.0	42.8
Health Care	9.4	10.5	14.3	26.8
Telecom Svcs	8.7	7.9	9.7	17.8
Utilities	6.3	5.5	8.7	4.9

Figure 5. Better quality stocks have underperformed



International Equities – Anything but Normal

International stocks continued their remarkable recovery run the quarter, despite worries over poor real estate markets, high debt levels, low profitability, rising unemployment and the eventual retraction of government stimulus packages. Developed market stocks, measured by the EAFE+Canada index, gained 19.5% in US\$ terms, with the Dollar's weakness adding 5% to local market returns. That ranked as the *seventh best* quarter in the past 40 years, and followed the *third best* period the prior quarter. Year to date, the EAFE+Canada index is up 30.5%, with the currency exposure adding 9% for US investors. During the six months ending February 2009, the index fell 56%. During the seven-month rally, it has advanced 60%.

All developed nation stock markets posted positive returns for the quarter (see Table 8). As a region, Europe gained 23% in US\$ terms, and 20% in local terms. The Pacific *ex-Japan* index rose 27% in US\$ terms, and 20% in local terms. It contained the best performing developed market country, Australia (+33%), which benefited from a relatively strong banking sector and investor enthusiasm for commodity-related stocks. Japan, which represents just over 30% of the non-US developed market's capitalization, has been a decidedly weak link for investors, with the strong Yen the only positive. Its markets were held back by continued weak domestic consumption and uncertainty regarding policies of the new DPJ government.

Non-US value stocks outperformed growth stocks. In marked contrast to the US, however, value has outperformed growth by nearly 10% for the year to date. Small cap stocks continued to outperform large caps.

Stocks of every global economic sector posted double-digit gains during the quarter. Financial services firms jumped nearly 27% (see Table 9). Returns for the remaining nine sectors were more closely aligned, ranging from a 20.5% return for materials down to a 12% gain in utilities. The pro-cyclical technology and materials sectors have been by far the top performing sectors this year among large-cap names, while the energy sector tops the small cap arena. Utility stocks have failed to capture much investor attention this year.

Stocks of developing markets (the asset class formerly known as emerging) again posted robust returns. The Emerging Markets index was up 21% for the quarter, pushing year to date returns to 65%. Despite China's relative economic strength, their stock market lagged during the third quarter, rising "just" 7.8%. In contrast, other BRIC countries gained 20% (India) and 27% (both Brazil and Russia). Regionally, emerging Asia was held back by China, but still gained 20%. Latin America rose 25% and emerging Europe led the way with a 29% return. The best performing developing country was Peru, with a 44% return. Brazilian stocks are up 102% this year, Indian 88%, and Russian 85%.

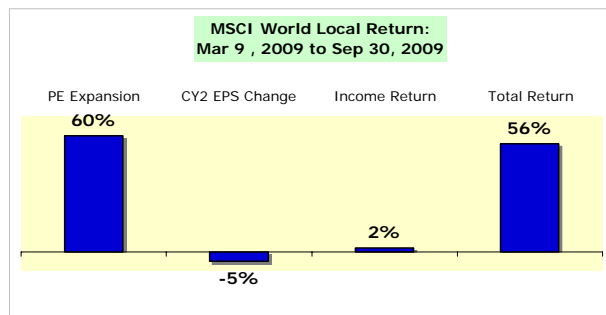
Table 8: International Markets Returns

<i>(index level = net)</i>	U.S. Dollar Return %		Local Currency Return %	
	3Q '09	YTD	3Q '09	YTD
EAFE + Canada	19.4	30.5	14.3	21.4
- EAFE Growth	16.8	24.2	12.2	15.9
- EAFE Value	22.1	33.9	17.4	25.6
- Europe	22.9	31.6	20.2	22.8
- Pacific, ex-Japan	27.4	64.3	19.7	40.3
- Japan	6.5	9.3	(1.6)	7.9
- United Kingdom	18.5	34.0	22.0	20.4
Int'l Small Cap	22.1	48.3	16.9	39.4
Emerging Mkts	20.9	64.5	16.8	51.4
- EM Asia	19.7	62.7	16.8	58.5
- EM Europe & ME	24.7	61.1	19.7	52.1
- EM Latin America	24.7	81.2	17.4	48.5
- EM BRIC	18.1	74.7	14.2	57.4

Table 9: Global Sector Returns in 2009

<i>as of Sept. 30, 2009</i>	Primary Market (Large Cap)		Extended Market (Small Cap)	
<i>(GICS Sector)</i>	3Q '09	YTD '09	3Q '09	YTD '09
Financial Services	26.7	37.9	22.3	18.6
Materials	20.5	47.9	24.8	52.5
Industrials	20.3	24.4	21.7	32.6
Cons. Discretionary	18.0	34.7	23.7	50.7
Telecom Services	17.2	13.5	12.8	33.6
Info Technology	17.0	43.5	21.8	56.8
Cons. Staples	13.7	15.6	17.3	24.3
Health Care	12.6	11.5	16.0	28.2
Energy	12.4	20.2	26.3	59.4
Utilities	11.9	5.1	10.3	10.6

Figure 6. Components of the Global stock rally



Heads Up

We've had quite a recovery. Despite the "wall of worry," improved market liquidity and macroeconomic stability have been the primary drivers of the current rally. Most major economies are expected to have improved during the third quarter, reflecting GDP numbers that are at least stabilized, if not growing. Developing countries have been much quicker to recover, led by China, where governments have been able to provide proportionately more aggressive stimulus packages. Select markets have soared in price.

We noted last quarter that, "to sustain the rally, stock markets will ultimately need to see earnings recover." As Figure 5 on the prior page reveals, this rally has so far been built on expectations of better days, rather than the realization. A sustainable recovery, supported by fundamental valuations, will be one that makes the critical transition from *stimulus* driven growth to growth driven by *real demand*, which translates into sustainable revenue and earnings growth. On this score, emerging economies are generally expected to be positioned better than developed markets. At some point, this advantage trickles down to the debt, equity, and currency markets, and should drive investment opportunities.

As the year began, the global stock market capitalization broke down as follows –

Primary Category	Region	12/31/08 Market Cap (\$bn)	% of Total
Developed	North America	13.64	32.0%
Developed	Asia	9.11	21.3
Developed	Europe	9.10	21.3
Emerging	Asia	5.20	12.2
Emerging	Europe & ME	2.57	6.0
Emerging	Latin America	1.32	3.1
Frontier	All	1.77	4.1
TOTAL		30.14	100

We know of no US institutional investor with a target equity allocation of 32% US, 43% Non-US Developed Markets, and 25% Emerging Markets. Yet, that is how the world's stock market valuations were aligned. From a strategic perspective, domestic investors need to ask themselves to what degree they need to continue to actively overweight domestic stocks and sharply disfavor non-US (especially emerging markets) stocks.

as of September 30, 2009

Market Index	Price/Earnings	Price/Book
S&P 500	21.8x	2.6x
MSCI EAFE	14.6x	1.6x
MSCI Emerging Mkts	19.0x	2.0x

Domestic non-financial corporations are doing quite well. Their profits in the 1st half of 2009 were 11% above 4th quarter lows. S&P 500 operating earnings bounced back to a \$58 annual rate during the second quarter, which translates into a non-financial ROE of 15%. This occurred because managements have slashed corporate overheads, pared spending, and cut inventories (as we also observed in the GDP data), which has had the corollary benefit of juicing free cash flow generation. Haver Analytics estimates the non-financial corporation *financing gap* – the difference between internally generated funds and capital expenditures – has turned from negative to positive. Much of this excess cash flow has been used to repay debt. Companies have also taken advantage of more hospitable capital markets to aggressively issue long-term bonds and retire short-term debts. This contrasts with the US Treasury, which has sharply increased the proportion of its reliance on short-term obligations.

Company balance sheets and P&L's are in good shape because firms have been ruthless in cutting capex and employment levels. Perhaps the quarter's most important economic factoid was the report that U.S. business productivity increased at an annual rate of 6.6% during the second quarter, even as output declined at a 1.5% rate, because unit labor costs fell 5.9% and hours worked declined 7%. At some point, re-employment and job creation must begin in earnest in order to drive consumer spending growth. But, corporate *earnings* growth, particularly that of multinational enterprises, is not tethered as tightly to the job growth story as the popular press would suggest.

During the third quarter we spoke at an investment conference attended primarily by investment officers and trustees of some of our country's largest endowments and foundations, and investment consultants. Two issues dominated discussions – managing liquidity and managing inflation risk/opportunity. The former was not surprising, since so many large endowments were tripped up in 2008 by the illiquidity associated with their private equity and hedge fund portfolios.

It was the inflation discussion that we found most intriguing. Recent data and numerous economists are pointing in the direction of benign inflation due to substantial global overcapacity. Yet, no one believed the US will *not* experience elevated levels of inflation in the medium term, in excess of most other developed market economies. In fact, much of the talk was about whether we could position portfolios to profit from high inflation, not just hedge against it.

Sell high, buy low. See you next quarter!

Natalka Bukalo

Richard Shaffer, CFA