Lookout Report
from S&P Valuation and Risk Strategies

The Precariously Positioned U.S. Economy Warrants Heightened Scrutiny Of Jobless Claims

Michael Thompson
Managing Director
Valuation and Risk Strategies
(1) 212-438-3480
michael_thompson@standardandpoors.com

Robert Keiser
Vice President
Valuation and Risk Strategies
(1) 212-438-3540
robert_keiser@standardandpoors.com

The Lookout Report provides cross-market and cross-asset views based upon the unique combined capabilities of S&P Valuation and Risk Strategies, S&P Index Services, Capital IQ, and S&P Leveraged Commentary and Data. Published by S&P's Valuation and Risk Strategies research group, the Lookout Report is a compendium of current data and forward looking insights from leading S&P market specialists. Key areas of focus and differentiation include aggregated corporate earnings, market and credit risk evaluation, capital market activity, index investing and proprietary data and analytics. Featuring interpretations of the investing horizon, the report previews the issues most likely to drive market expectations or cause a disturbance in the weeks ahead.

Regular readers of the Lookout Report are aware that we have been patiently waiting for the U.S. economy to begin to show signs of emerging from whatever has weighed heavily on some aspects of economic growth, notably employment, since the middle of the second quarter. Although we continue to believe that stunted growth is at least partially the result of supply-chain issues related to Japan, the clock is ticking as we seek clarity as to how and when the economy will make more significant progress.

Nonexistent nonfarm payroll growth has recently accentuated the relatively flat GDP growth over the first half of 2011, leading to concerns that the economy is helplessly sliding toward recession. Meanwhile, other indicators such as retail sales, industrial production, and durable goods orders suggest that the economy continues to grow at a moderate pace.

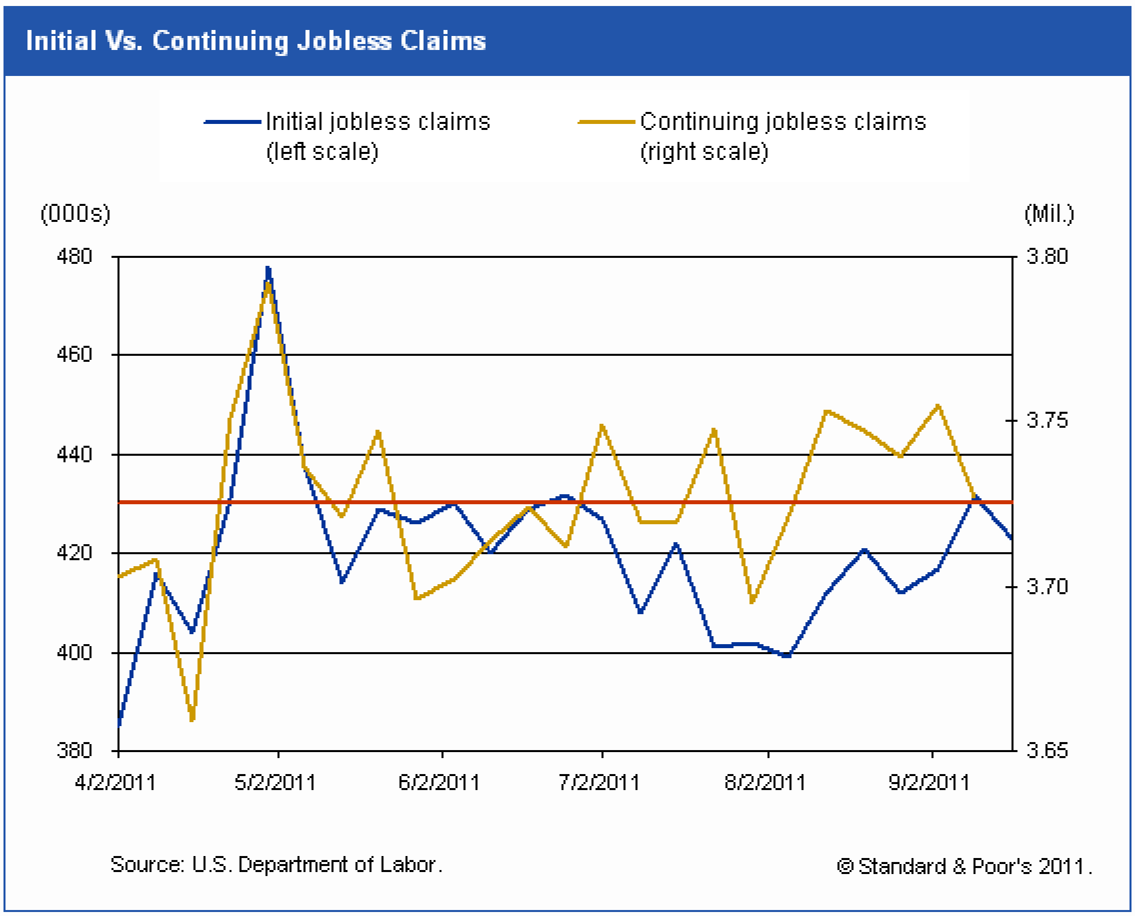
Considering the highly uncertain investor climate and precarious nature of U.S. economic growth, we have been suggesting that investors pay close attention to U.S. unemployment insurance data, which are released on a more frequent weekly basis than the monthly employment and quarterly GDP reports. Nevertheless, the unemployment insurance data has recently been fairly mixed and less conclusive than we would prefer, adding to the many unknowns that investors already face.

U.S. unemployment insurance data are mainly reported in two related series: weekly initial jobless claims that newly displaced workers file, and the continuing claims data of all individuals that currently receive unemployment benefits in the standard state-run programs. Unfortunately, we have recently noticed a divergence between these closely related economic data series. These two series, however, may also be in the process of aligning and correcting themselves.

Weekly initial jobless claims were at 385,000 at the beginning of April but then rose to 478,000 by the end of the month. In addition, continuing claims were at 3.66 million in mid-April but spiked to 3.79 million by the end of the month. Despite volatility in April, both series have remained within their respective minimum and maximum values established during the first month of the second quarter (see chart 1). Initial jobless claims meanwhile have mostly been lower than the 430,000 midpoint of the April range, but have recently drifted higher toward that level. Continuing claims on the other hand have mostly spent recent weeks above the 3.725 million April midrange.

In the weeks ahead, if these related indicators can start moving in the same direction to either side of their respective April midpoints, they will provide a better perspective of actual conditions. From this perspective, the recently released jobless data is somewhat encouraging. Initial jobless claims inflected lower to 423,000 as of the week ended Sept. 17, lower than the 431,500 midlevel. Similarly, continuing claims have dipped to 3.727 million as of Sept. 10 (latest available data) and have now returned to the vicinity of the 3.7255 million April midpoint for the first time since the first week of August. We are also watching the post-April minimum and maximum jobless claims range of 399,000 to 438,000, as well as the 3.695 million to 3.755 million continuing claims post-April range, to see which way these data series may be evolving.

Chart 1



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Economic And Market Outlook: Markets Signal Concern Over The Economic State Of The Eurozone

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At this point, companies are continuing to use buybacks for dividend reinvestment programs and to prevent earnings dilution from employee options. Few companies are venturing outside of the box to purchase additional shares, as became the common practice in late 2005 through mid-2007. We haven't seen any boost in earnings per share as a result of reduced share count, and at this point in the third quarter, we don't expect any increase.

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The loan default rate is running at a microscopic 0.09% year to date through Sept. 16, but loan managers are wary when looking to 2012 and particularly 2013, according to LCD's latest quarterly buyside straw poll conducted in mid-September.

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Market Derived Signal Commentary: Italy's Downgrade Is Costly For The CDS

The cost to purchase protection on Italy's five-year credit default swap (CDS) increased by 10% to 448 basis points (bps) on Monday after Standard & Poor's Ratings Services lowered its rating on the country to 'A' with a negative outlook from 'A+'. We think there is a strong possibility that the CDS will continue to expand, raising the risk of default.

Capital Market Commentary: The Third Quarter Has Been Marked By Cancellations And Caution

According to data retrieved from Capital IQ, just 17 IPOs have been priced on major U.S. exchanges in the third quarter. Still, not all developments have been pessimistic. A steady stream of filings has kept the IPO backlog at multiyear highs, and as earnings season approaches, many newly publicly traded companies will be reporting their recent quarterly results.

Quantitative View: Return Correlation And Dispersion Mean Tough Times For Active Managers

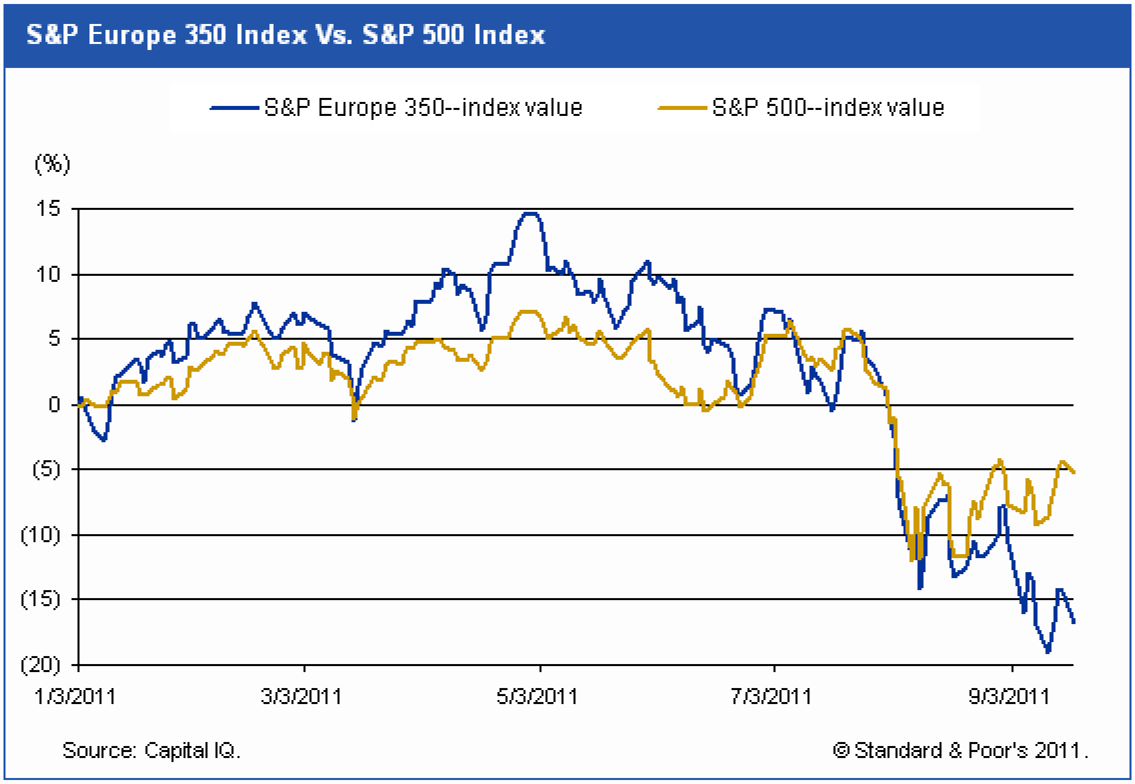
The financial market's fixation on macro risks has led to a correlation of stock returns within the S&P 500 Index of 35%, a level not seen since the 2008 financial crisis, placing the current relationship in the 83rd percentile historically.

Economic And Market Outlook: Markets Signal Concern Over The Economic State Of The Eurozone

With threats of a Greek debt default, French banks under pressure from their exposure to Greece, and Standard & Poor's downgrade Monday of Italy's credit rating, concerns about contagion and the overall state of the economies in the eurozone have never been higher. These fears are reflected prominently in credit default swap (CDS) spreads for European sovereigns, in stock market valuations, and in lower earnings estimates for the S&P Europe 350 Index.

Year to date through Sept. 19, the S&P Europe 350 Index has declined nearly 17% (see chart 2). In contrast, the S&P 500 Index, which has also had its earnings estimates lowered for the third quarter and for 2011, lost 5.3%, implying that investors may be more optimistic about the ability of U.S. companies to weather economic challenges.

Chart 2

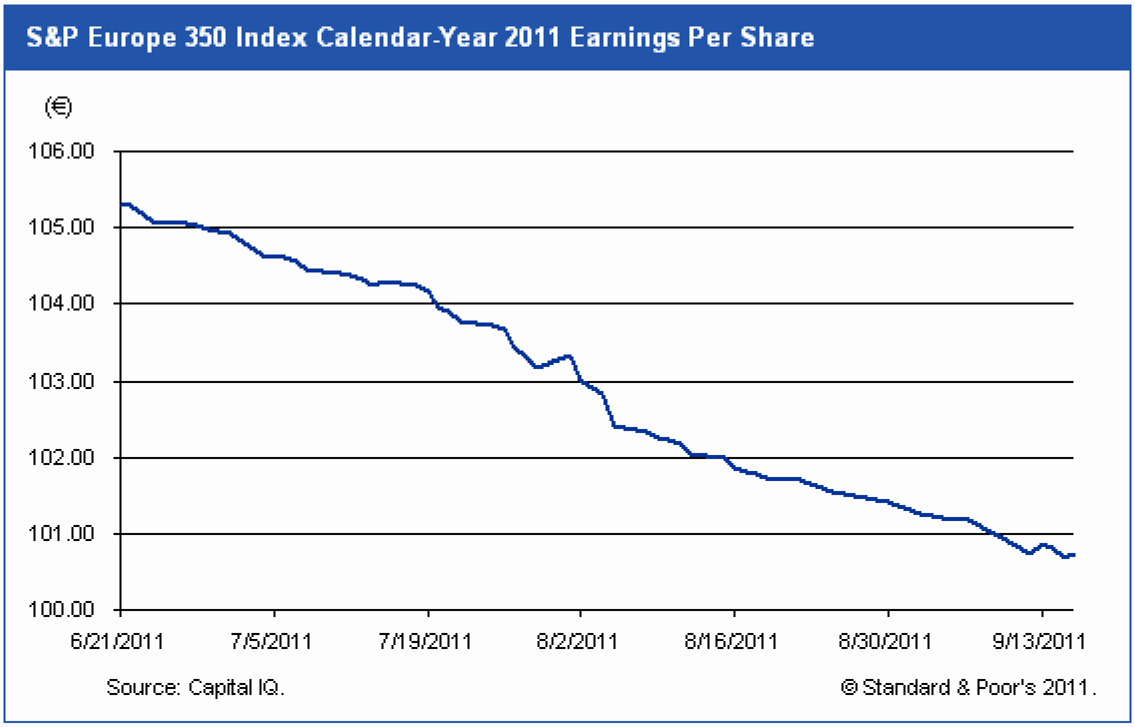


However, the International Monetary Fund (IMF) warned Tuesday that both the U.S. and Europe could regress into recession next year if swift steps aren't taken to manage fiscal and financial uncertainty. The IMF, which said that the global economy is "in a dangerous new phase," now expects global GDP growth of 4% in 2011 and in 2012, down from 4.3% and 4.5%, respectively, three months ago. The IMF expects advanced economies, including the U.S. and European countries, to expand only by 1.6% in 2011 and 1.9% in 2012. "Market worries about the ability of countries to stabilize their public debt have spread from a few small countries on the periphery of Europe to more countries in Europe and beyond to the U.S. and Japan," the IMF said.

Analysts have steadily cut 2011 European earnings estimates over the past three months. Forecast S&P Europe 350 calendar-year earnings of €100.74 (Sept. 16) are now at the lowest level since the start of the third quarter, according to aggregated Capital IQ data (see chart 3). Analysts could further lower estimates unless the economic situation stabilizes. Reflecting the uncertain outlook, Standard & Poor's Ratings Services lowered its rating on Italy to 'A' from 'A+' and assigned a negative outlook, citing ongoing deterioration in the country's economic growth outlook and strife within Parliament limiting the government's ability to "respond decisively to domestic and external economic challenges."

Consensus expectations for S&P Europe 350 2012 calendar-year earnings decreased to €112.84 as of Sept. 16, compared with €113.19 on Sept. 12. With global equity markets remaining volatile after the decision of the European central banks last week to temporarily stabilize the funding situation in Europe, analysts appear to be very cautious regarding earnings forecasts for S&P Europe 350 corporations. The markets seem to expect further government interventions as eurozone sovereign debt worries and ongoing economic uncertainty persist.

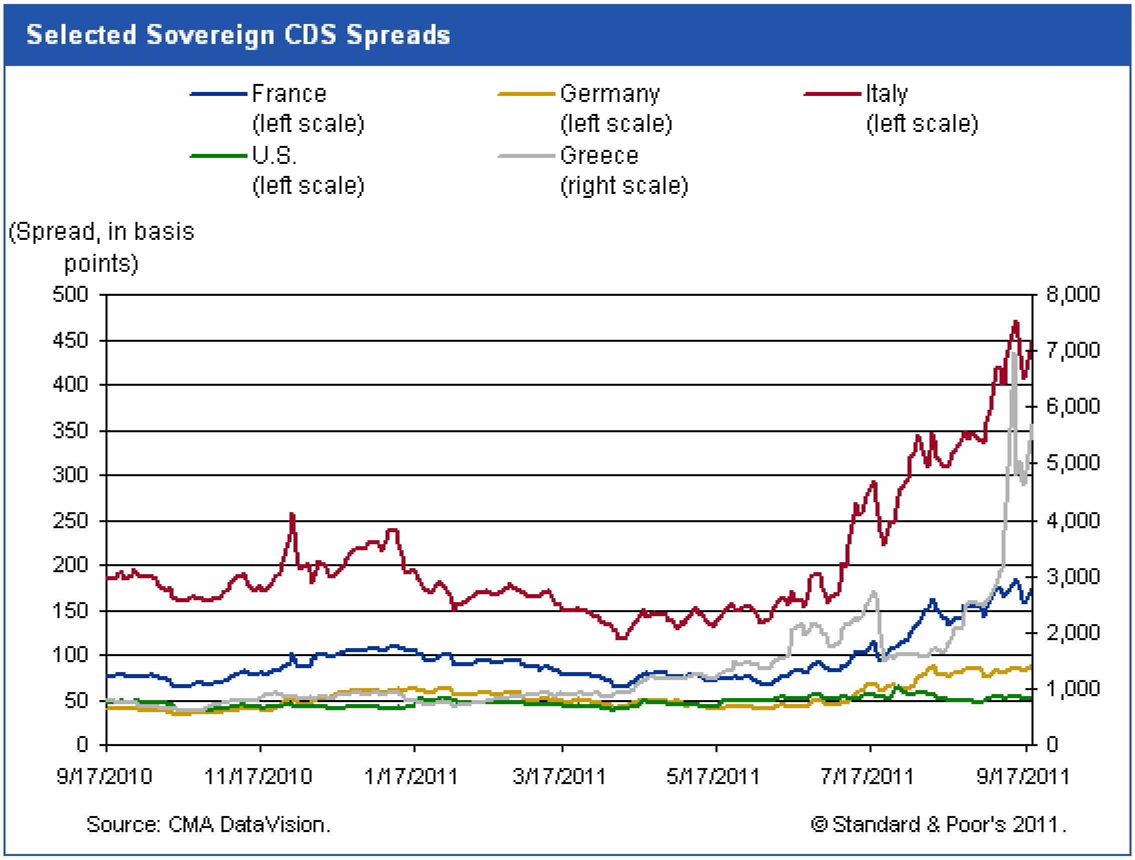
Chart 3



Sector leaders for calendar-year 2011 earnings include the materials sector (25.59% expected growth) and consumer discretionary (25.30% expected growth). Current earnings laggards for calendar-year 2011 include the utilities sector (decline of 15.69% expected) and financials (a drop of 4.41% expected).

Meanwhile, sovereign spreads have eclipsed or are near their highs of the past year, according to CMA DataVision (see chart 4). France's five-year CDS was trading at 173 bps on Monday after setting an all-time high of 184 bps on Sept. 13. Italy's CDS was most recently trading at 448 bps, tight of the all-time high of 470 bps set on Sept. 13 but far wide of the spread of 139 bps for its former Standard & Poor's 'A+' credit rating. Greece's CDS of 5,685 bps remains at stratospheric levels, though tight of the all-time record of 6,984 bps set on Sept. 12, and Germany's CDS of 89 bps is at its widest point of the past year. In comparison, the U.S. has the lowest risk premium of any sovereign at 53 bps, tighter than its high of 65 bps set on July 28, 2011.

Chart 4



Currently, the research team does not see any positive signs from Europe in the equity or credit markets or the broad profit outlook for S&P Europe 350 earnings. Since we have a negative outlook for eurozone sovereigns, we believe that investors may want to consider buying CDS protection at this time. The research team will continue to monitor earnings and the CDS market for changes in the trajectory of these signals.

Contact Information: Lisa Sanders, Director, Research—Valuation and Risk Strategies, Lisa_Sanders@standardandpoors.com

Victoria Chernykh, Director—Valuation and Risk Strategies, Victoria_Chernykh@standardandpoors.com

S&P Index Equity Commentary: Buybacks Have Returned To The $100 Billion Quarterly Level, But Don't Look For Any Earnings Per Share Help

According to S&P Indices' second-quarter S&P 500 Index buyback report released Sept. 20, quarterly stock repurchases returned to the $100 billion mark for the first time since the first quarter of 2008 ($114 billion), when buybacks were declining from the third-quarter 2007 high of $172 billion (see table 1). Buyback levels, which were 30% less than dividends in 2009, are now 65% higher than dividends on a trailing 12-month period, and we expect the pace to increase (see chart 5).

According to the report, preliminary buybacks increased by 21.6% to $109.2 billion during the second quarter of 2011, up from $89.8 billion during the first quarter of 2011 and up 40.7% from $77.6 billion in the second quarter of 2010. The gain represents the eighth consecutive quarterly increase for buybacks. At this point, companies are continuing to use buybacks for dividend reinvestment programs and to prevent earnings dilution from employee options. Few companies are venturing outside of the box to purchase additional shares, as became the common practice in late 2005 through mid-2007. We haven't seen any boost in earnings per share as a result of reduced share count, and at this point in the third quarter, we don't expect any increase. Nevertheless, earnings per share didn't need much help--they reached an all-time high in the second quarter, and we expect strong results for the third quarter as well.

On a sector basis, information technology continues to dominate the buyback market, accounting for 22.2% of all buybacks. Financials posted the largest increase, with $14.4 billion spent in the second quarter, a 96% increase from $7.3 billion in the first quarter, but still 48% lower than the $27.8 billion repurchased in the third quarter of 2007. ExxonMobil Corp. continues to be the poster child for share repurchases, spending $5.5 billion on buybacks during the second quarter. Ironically, Exxon's buyback program has reduced the share count by 18.5% over the past five years, which may cause the company to lose its position as the largest company in the world.

For the third quarter of 2011, we expect companies to maintain the $110 billion buyback level, protecting their earnings and adding a slight boost for the third quarter as share counts are reduced. The fourth quarter will depend--as so many things will--on the economy.

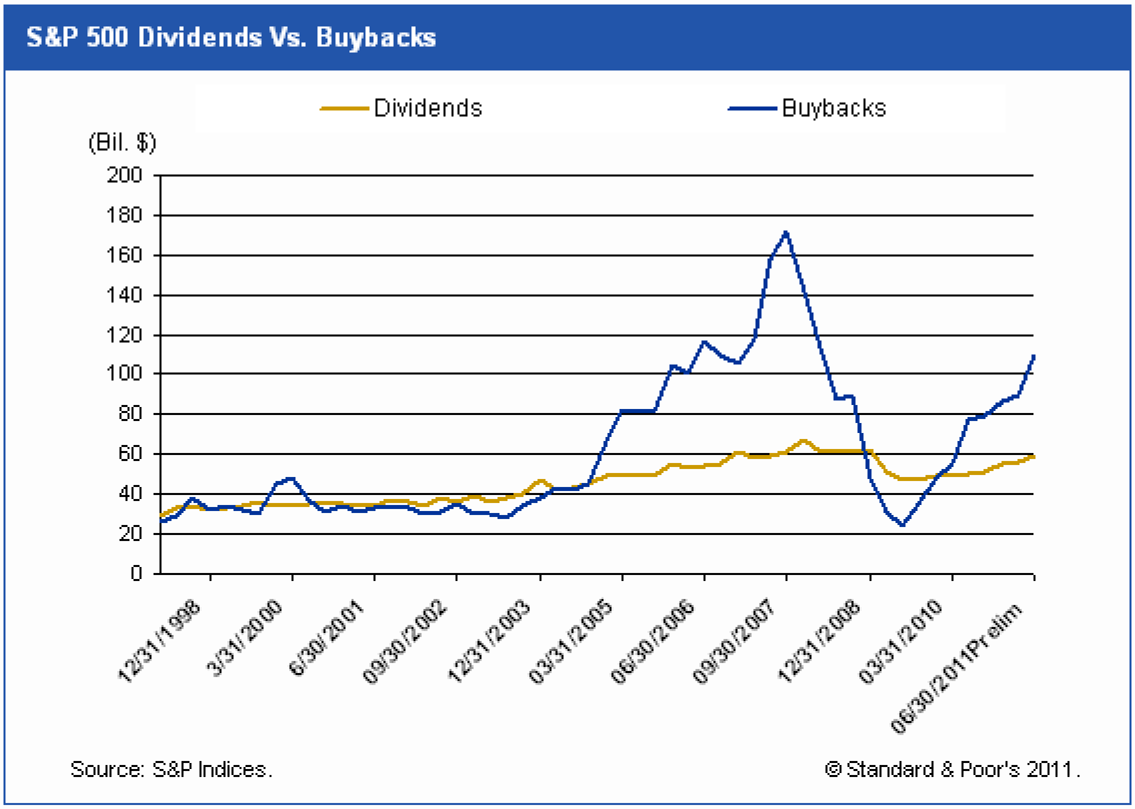
Table 1

S&P 500 Index

	--(Bil. $)--					--Yield (%)--		
Period	Market value	Operating earnings	Earnings as reported	Dividends	Buybacks	Dividend	Buyback	Dividend and buyback
6/30/2011 prelim.	12,021.16	226.20	202.44	59.03	109.24	1.84	3.04	4.88
3/31/2011	12,067.74	205.71	195.33	56.08	89.84	1.76	2.76	4.52
12/31/2010	11,429.83	199.40	187.67	54.85	86.36	1.80	2.61	4.42
9/30/2010	10,336.29	195.28	176.80	51.26	79.56	1.94	2.52	4.45
6/30/2010	9,322.58	189.04	178.00	50.44	77.64	2.10	2.31	4.41
3/31/2010	10,560.00	175.00	157.85	49.28	55.26	1.83	1.54	3.36
12/31/2009	9,927.54	152.77	135.14	49.04	47.82	1.97	1.39	3.36
9/30/2009	9,336.51	139.37	130.37	47.21	34.85	2.24	1.48	3.71
6/30/2009	8,044.82	120.85	118.22	47.63	24.20	2.77	2.40	5.17
3/31/2009	6,927.59	87.78	65.29	51.73	30.78	3.43	3.70	7.13
12/31/2008	7,851.81	(0.78)	(202.11)	62.19	48.12	3.15	4.33	7.48
9/30/2008	10,181.46	142.90	86.16	61.44	89.71	2.48	4.26	6.73
6/30/2008	11,162.57	148.43	112.15	61.94	87.91	2.26	4.62	6.88
3/30/2008	11,510.68	144.63	135.24	61.72	113.90	2.17	5.08	7.25
12/31/2007	12,867.85	133.38	68.53	67.09	141.71	1.92	4.58	6.49
9/30/2007	13,469.72	184.13	133.66	61.21	171.95	1.79	4.10	5.89
6/30/2007	13,349.73	213.65	194.30	59.76	157.76	1.76	3.67	5.44
3/31/2007	12,706.32	200.23	190.75	58.53	117.70	1.81	3.54	5.35
12/31/2006	12,728.86	197.35	181.65	61.79	105.18	1.77	3.39	5.16

Source: S&P Indices.

Chart 5



Contact Information: Howard Silverblatt, Senior Index Analyst—S&P Indices, Howard_Silverblatt@standardandpoors.com

Leveraged Commentary And Data: Loan Managers Cast A Wary Eye On 2013 In LCD's Latest Default Survey

The loan default rate is running at a microscopic 0.09% year to date through Sept. 16, but loan managers are wary when looking to 2012 and particularly 2013, according to LCD's latest quarterly buyside straw poll conducted in mid-September.

On average, the managers polled in the broad but unscientific survey expect the default rate to rise to 1.87% next year before climbing to 3.0% in 2013. This is the first time managers have weighed in on 2013, but the latest figure for 2012 is up from 1.45% in June.

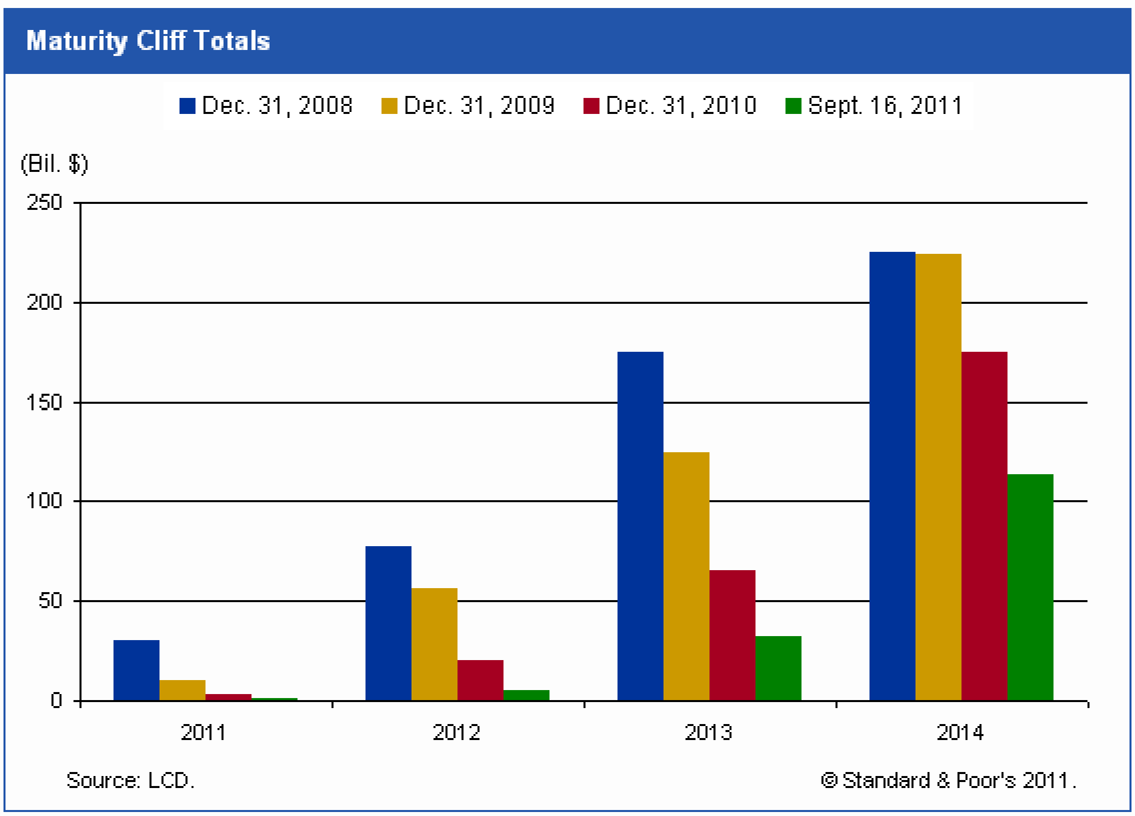
That sentiment eroding over the past three months is understandable. The summer months, after all, brought a dour slew of news, including a litany of weaker-than-expected economic reports on both sides of the Atlantic, Standard & Poor's unsettling downgrade of the U.S., and a challenging political, fiscal, and monetary environment in Europe, which has been a rally killer over the past 18 months. Under the weight of these macro factors, the S&P 500 Index traded off by 10% to 1,216 on Sept. 16 from a recent peak of 1,353 on July 7.

Even so, loan market participants remain relatively sanguine about 2012. After all, the 1.87% default-rate estimate is barely half the historical average of 3.58% and far short of the November 2009 peak of 10.81%. The relative optimism of these managers is rooted partly in macro factors and partly in micro factors.

We start with the big picture; most managers qualified their forecast by assuming that the U.S. economy continues its sluggish growth but skirts an outright double dip, and that no exogenous shocks unhinge the markets. If either of these proves false, all bets are off.

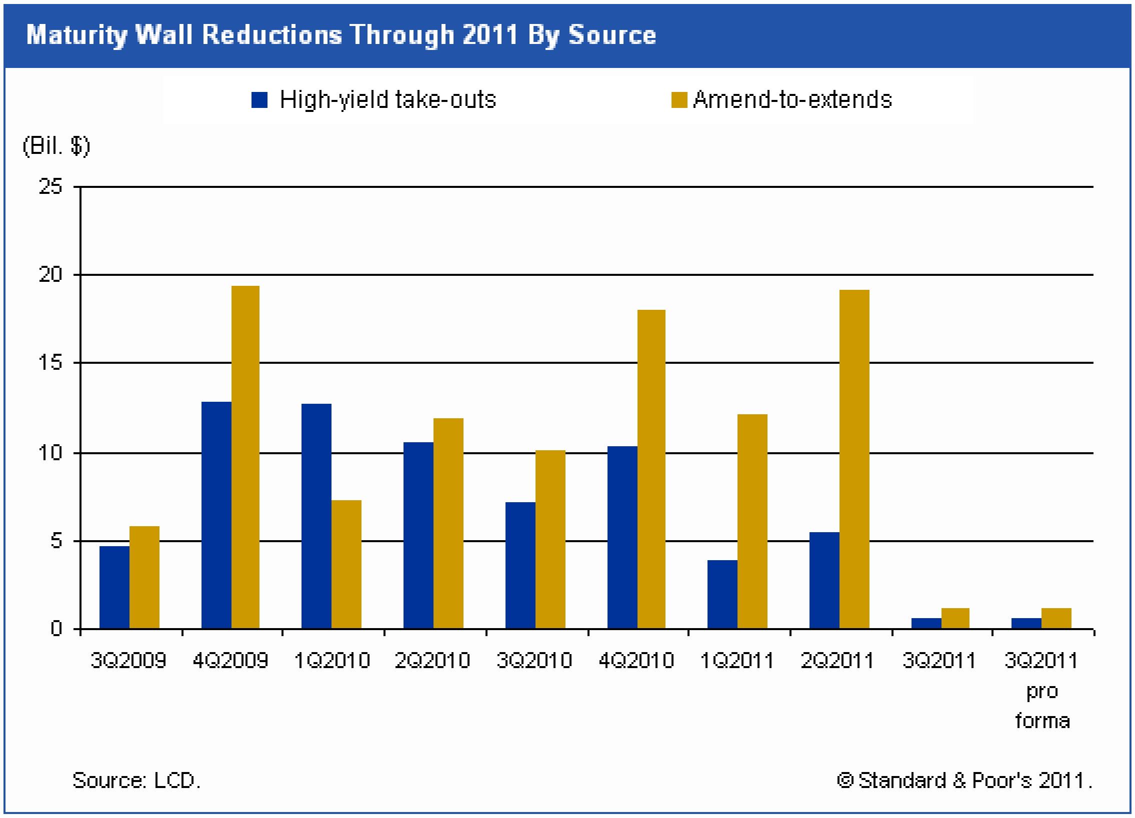
If not, managers generally think market fundamentals will help keep default rates low at least through 2012, for three reasons. First, the default spike of 2008 and 2009 already dispatched many of the most leveraged issuers in the most vulnerable sectors--building materials, auto, publishing, and gaming--into bankruptcy. Second, the issuers that weathered the credit crunch have now enjoyed two years of strong cash-flow growth, which led to expanded coverage ratios. Third, issuers have worked down 2012 maturities to just $5.2 billion as of Sept. 16, creating little refinancing risk in the coming year (see chart 6).

Chart 6



Looking out to 2013, however, account managers worry that default rates could rise toward the historical average, as issuers facing loan maturities during the year are potentially forced into bankruptcy (of particular concern are $3.3 billion of loans rated 'CCC+' or lower and $5.2 billion of loans to unrated, largely middle-market companies with limited access to the capital markets). Such anxieties have increased since August, with the window for amend-to-extend executions and bond takeouts narrowing, at least for now (see chart 7).

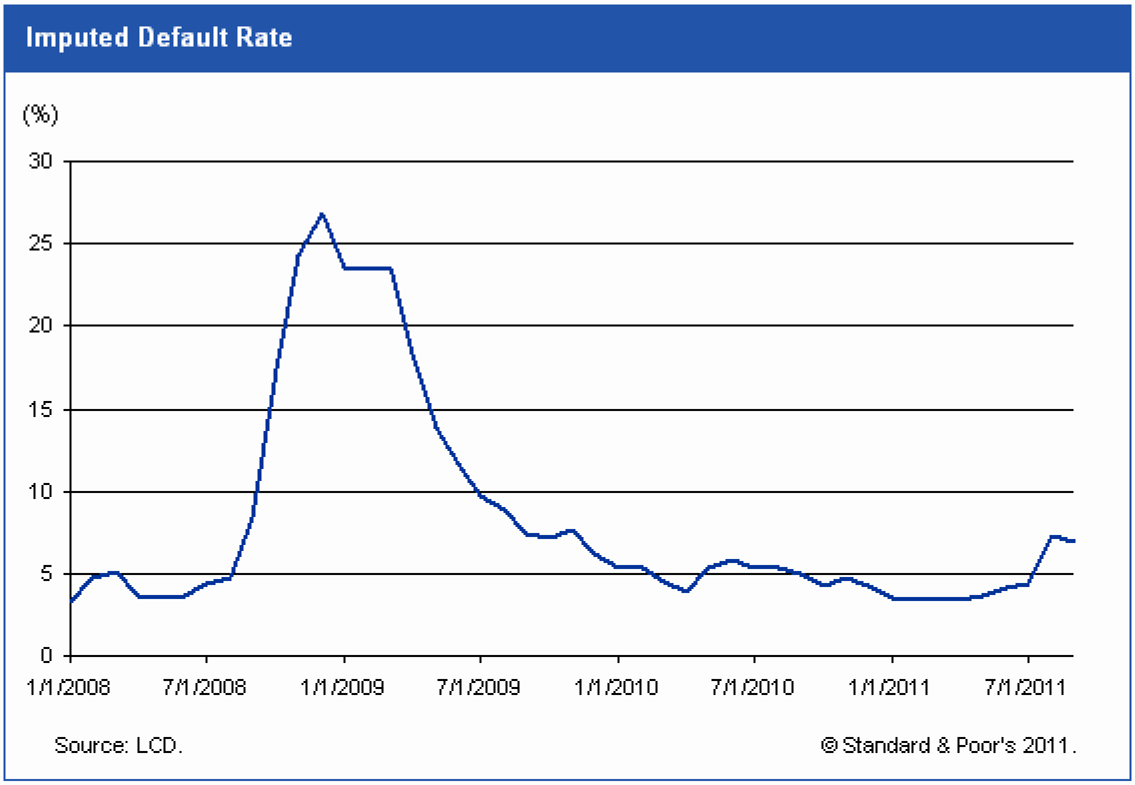
Chart 7



In the final analysis, players say that if the economy muddles along in the years ahead but refinancing options remain limited, default rates could rise toward the historical average by 2013. In the more bullish scenario, default rates will remain low. In a more bearish case, there will be a second spike in default rates that accounts speculate could rise to the 4% to 6% range by 2013 or 2014.

For the moment, the market is taking a more bearish view. Indeed, the S&P/LSTA Index's average yield was 6.84% on Sept. 16, implying an imputed default rate of 7%, up from 4.1% three months earlier. Of course, the market is famously fickle (see chart 8).

Chart 8



Contact Information: Steve Miller, Managing Director—Leveraged Commentary & Data, Steven_Miller@standardandpoors.com

R2P Corporate Bond Monitor

Europe's ongoing sovereign debt crisis continues to dominate headlines, with concerns continuing to center around the possibility of a Greek debt default and the potential consequences for Europe's banks. The European Union Finance ministers failed to make any real progress in solving the bloc's financials crisis. In addition, they have put pressure on the Greek government to accelerate its privatization program and implement deeper spending cuts after they told Athens they were delaying a crucial €8 billion bailout payment until next month. Greek officials have already warned they will be out of money by mid-October.

In the U.S., the Federal Reserve just announced additional stimulus measures that will extend the average maturity of its security holdings. The Fed says that "this program should put downward pressure on longer term interest rates and help make broader financial conditions more accommodative." This latest in a long string of policy accommodation announcements from the Fed is designed to underpin the U.S. economy that is currently facing "significant downside risks to the economic outlook, including strains in global financial markets," according to the Sept. 21 FOMC press release.

Despite the economic context, risk-reward profiles--as measured by average Risk-to-Price (R2P) scores--improved overall since the beginning of the month (see tables 2 and 3). Only a few sectors in Europe deteriorated, such as information technology, energy, and telecommunication services. The improvement in the scores on European bonds was mainly the result of an average 23% decline in bond price volatility, while the probability of default (PD) continued to increase, rising 29% from Aug. 31, 2011, to Sept. 16, 2011. In the U.S., however, risk-reward balances improved as a result of a decline in the average PD of 17% and a drop in bond price volatility of 29%.

Table 2

North American Risk-Reward Profiles By Sector--Average R2P Score And Components Changes

	Scores (%)	OAS (bps)	PD (%)	Bond price vol. (%)
Consumer discretionary	12	(26)	(33)	(32)
Consumer staples	13	(37)	(74)	(27)
Energy	16	(7)	(7)	(31)
Financials	14	7	14	(26)
Health care	11	(21)	(13)	(34)
Industrials	7	(27)	(46)	(32)
Information technology	12	(9)	6	(25)
Materials	5	(6)	(5)	(29)
Telecommunication services	6	(8)	(27)	(30)
Utilities	11	(1)	3	(29)

Change as of Sept. 16, 2011, from Aug. 31, 2011.

Table 3

European Risk-Reward Profiles By Sector--Average R2P Score And Components Changes

	Scores (%)	OAS (bps)	PD (%)	Bond price vol. (%)
Consumer discretionary	20	(15)	22	(27)
Consumer staples	13	(2)	39	(24)
Energy	(6)	3	61	(17)
Financials	7	13	25	(18)
Health care	0	(6)	34	(26)
Industrials	6	(1)	20	(29)
Information technology	(13)	36	44	(1)
Materials	22	0	(6)	(39)
Telecommunication services	(5)	(3)	27	(23)
Utilities	3	7	24	(22)

Change as of Sept. 16, 2011, from Aug. 31, 2011.

Contact Information: Fabrice Jaudi, Director—Valuation and Risk Strategies, Fabrice_Jaudi@standardandpoors.com

Market Derived Signal Commentary: Italy's Downgrade Is Costly For The CDS

The cost to purchase protection on Italy's five-year credit default swap (CDS) increased by 10% to 448 bps on Monday after Standard & Poor's Ratings Services lowered its rating on the country to 'A' with a negative outlook from 'A+'. In its rationale, Standard & Poor's explained that its decision was based on a deteriorating economic outlook for the country--it now expects Italy's annual GDP to grow just 0.7% from 2011 to 2014, compared with a previous estimate of 1.3%. In addition, Standard & Poor's believes that political infighting would limit Parliament's ability to act decisively to manage domestic and external challenges.

"The negative outlook reflects our view of additional downside risks to public finances related to the trajectory of Italy's real and nominal GDP growth, and implementation risks of the government's fiscal consolidation program," Standard & Poor's said. It noted that Italy's net general government debt exceeds that of its 'A' rated peers, and now sees the debt peaking later and at a larger amount than previously estimated (see table 4).

Table 4

Italy (Republic of)--Base-Case Assumptions

Selected indicators

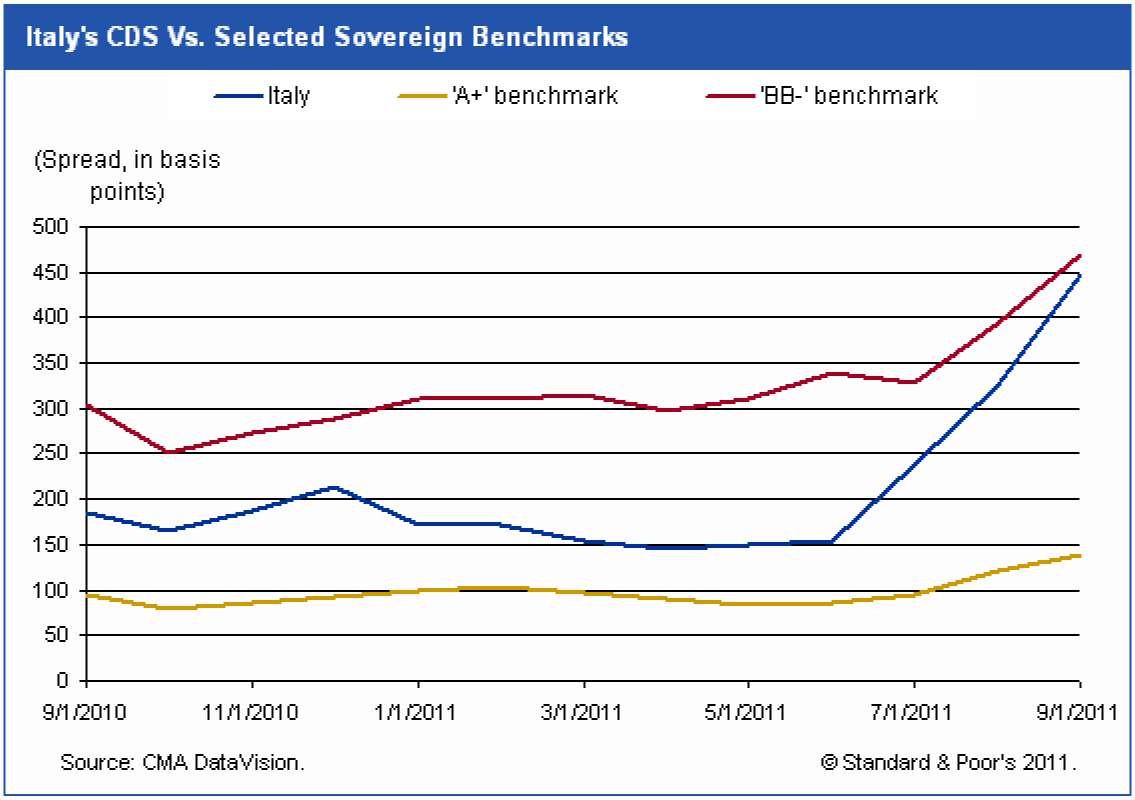
(%)	2007	2008	2009	2010	2011e	2012f	2013f	2014f
GDP per capita, $US	35,788	38,519	35,160	33,995	35,680	37,975	38,720	39,509
Real GDP (% chg)	1.5	(1.3)	(5.2)	1.3	0.7	0.5	0.7	0.7
Real GDP per capita (% chg)	0.8	(2.1)	(5.9)	0.8	0.2	0	0.2	0.2
General govt. balance/GDP	(1.8)	(3)	(5.7)	(4.9)	(4.5)	(2.9)	(1.8)	(1.7)
General govt. debt/GDP	103.6	106.3	116.1	119	121.4	122.4	121.4	120
Net general govt. debt/GDP	100	102.9	111.6	113.8	117.1	117.9	116.8	115.4
GG interest/GG revenues	10.8	11.2	9.9	9.7	10.6	11.6	12.4	12.8
Dom. credit private & NFPEs/GDP	107.1	111.9	117.6	119.5	119.6	119.5	119.9	120.3
CPI (% chg)	2.1	3.5	0.7	1.7	2.4	1.8	1.8	1.8
Current account balance/GDP	(3)	(3)	(2)	(3)	(4)	(4)	(3)	(3)
Narrow net ext. debt/CARs	223.4	192.3	276.8	247	238.5	224.2	223.5	222.7

e--Estimate. f--Forecast. GG--General government. CARs--Current account receipts. Source: Standard & Poor's Ratings Services.

The IMF expressed its own concerns about Italy Tuesday, lowering the country's GDP growth forecast to 0.6% for 2011 and to 0.3% for 2012 from 1% and 1.3%, respectively, in June. The IMF warned that both the U.S. and Europe could regress into recession next year if the governments don't take swift steps to manage fiscal and financial uncertainty. The IMF, which stated that the global economy is "in a dangerous new phase," now expects global GDP growth of 4% in 2011 and 2012, down from 4.3% and 4.5%, respectively. Advanced economies, including the U.S. and European countries, are expected to see expansion of only 1.6% in 2011 and 1.9% in 2012. "Market worries about the ability of countries to stabilize their public debt have spread from a few small countries on the periphery of Europe to more countries in Europe and beyond to the U.S. and Japan," the IMF said.

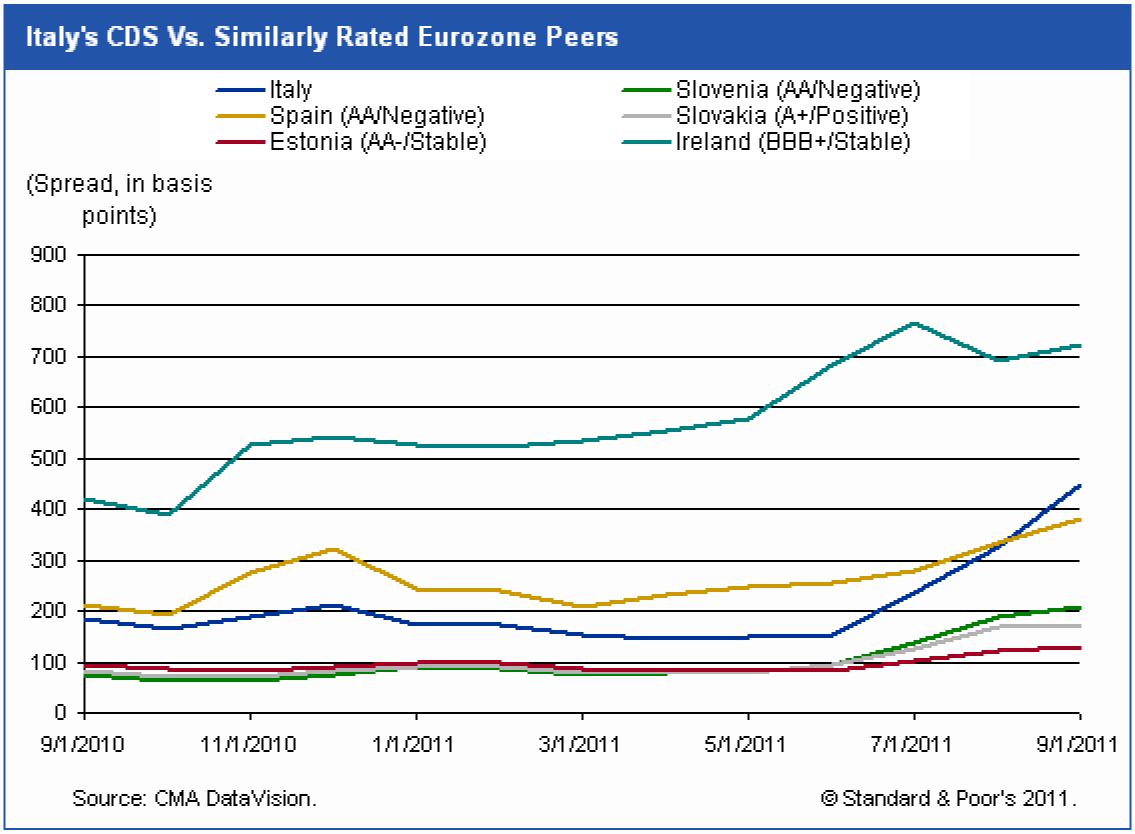
At 448 bps, Italy's spread is 178 bps wider than it was on May 23, 2011, the day before we last commented on the country's CDS. At that time, Standard & Poor's had lowered its outlook on the sovereign to negative from stable and said there was a 33% probability it could lower the credit rating within 24 months (see "Credit Market Commentary: Market Derived Signal: Standard & Poor's Outlook Revision On Italy Rattles The Sovereign's CDS," published May 24, 2011, on the Global Credit Portal). The spread, which hit an all-time high of 470 bps on Sept. 13, is currently 309 bps wide of its former 'A+' credit rating, but only 22 bps tight of the Market Derived Signal rating of 'bb-', which also factors in country, credit rating, recovery, and currency risks in addition to the CDS spread (see chart 9).

Chart 9



Relative to similarly rated peers, Italy's CDS is rationally trading wide of those sovereigns rated one or two notches higher, but is tight of Ireland, which is rated two notches lower, at 'BBB+' (see chart 10).

Chart 10



The research team does not expect an immediate resolution to Italy's economic situation at this time, particularly given Standard & Poor's decision to downgrade the country. We also note that the MDS rating, currently in speculative-grade territory, is signaling heightened risk relative to the CDS spread. Therefore, we think there is a strong possibility that the CDS will continue to expand, raising the risk of default. At this point, we would be buyers rather than sellers of protection.

Contact Information: Lisa Sanders, Director, Research—Valuation and Risk Strategies, Lisa_Sanders@standardandpoors.com

Capital Market Commentary: The Third Quarter Has Been Marked By Cancellations And Caution

IPOs

After a solid second-quarter for initial public offerings (IPO) volume, with 47 issues including two that raised more than $1 billion, the present quarter was marked by cancellations and caution.

According to data retrieved from Capital IQ, just 17 IPOs have been priced on major U.S. exchanges in the third quarter. Furthermore, nine of these new issues are currently trading below their offer price, and seven have declined by more than 10%. Also, the $3.34 billion in proceeds raised to date this quarter is less than half of the amount from the prior period.

Still, not all developments have been pessimistic. A steady stream of filings has kept the IPO backlog at multi-year highs, and as earnings season approaches, many newly publicly traded companies will be reporting their recent quarterly results. Also, with potential offerings from such social media companies as Zynga and Groupon likely to be completed in the months ahead, investors should have plenty to digest in the way of new technologies and industries in the fourth quarter (see table 5).

Table 5

Recent IPOs

Closed date	Target/Issuer	Total transaction value (mil. $)	Industry	Recent price ($)	Offer price per share ($)	Change (%)
7/26/2011	Dunkin' Brands Group Inc.	422.75	Restaurants	28.30	19.00	48.95
7/19/2011	Zillow Inc.	69.24	Internet software and services	27.77	20.00	38.85
8/10/2011	Carbonite Inc.	62.50	Internet software and services	13.80	10.00	38.00
7/26/2011	Tangoe Inc.	87.70	Application software	13.18	10.00	31.80
7/27/2011	Teavana Holdings Inc.	121.43	Specialty stores	20.00	17.00	17.65
7/21/2011	Francesca's Collections, Inc.	170.00	Apparel retail	20.00	17.00	17.65
7/13/2011	Oiltanking Partners L.P.	215.00	Oil and gas storage and transportation	24.00	21.50	11.63
8/11/2011	SandRidge Permian Trust	540.00	Oil and gas exploration and production	18.88	18.00	4.89
7/27/2011	Chefs' Warehouse Holdings LLC	135.00	Food distributors	14.34	15.00	(4.40)
7/26/2011	American Midstream Partners L.P.	78.75	Integrated oil and gas	19.95	21.00	(5.00)
7/28/2011	Horizon Pharma Inc.	49.50	Biotechnology	8.02	9.00	(10.89)
7/21/2011	Apollo Residential Mortgage Inc.	200.00	Thrifts and mortgage finance	16.33	20.00	(18.35)
7/27/2011	Wesco Aircraft Holdings Inc.	315.00	Airport services	12.20	15.00	(18.67)
7/20/2011	SunCoke Energy Inc.	185.60	Diversified metals and mining	13.01	16.00	(18.69)
7/19/2011	Skullcandy Inc.	188.83	Consumer electronics	14.77	20.00	(26.15)
8/16/2011	Tudou Holdings Ltd.	174.00	Internet software and services	20.00	29.00	(31.03)
7/28/2011	C&J Energy Services Inc.	333.50	Oil and gas equipment and services	19.87	29.00	(31.48)
	Average					2.60

Source: Capital IQ.

M&A

The more than $24.5 billion in canceled global M&A deals this month may give the impression that recent financial anxiety pushed dealmakers to the sidelines. Indeed, the volume of pulled transactions in September to date is more than double the $11.4 billion in scrapped deals that occurred in August. Yet, for the third quarter, according to Capital IQ, it appears that canceled global M&A deals, presently at $63 billion, will fall short of the prior-period total of more than $101 billion (these statistics include competing bids for the same target).

With less than $59 billion in announced global deals, compared to more than $200 billion in the prior month, the third quarter is ending on a decidedly downbeat note. As the final quarter approaches, we take comfort in the fact that some of 2010's top deals, including Caterpillar's $9 billion purchase of Bucyrus International and KKR's $5.5 billion buyout of Del Monte Foods--the top U.S. LBO last year--occurred in the final three months of 2010.

Table 6

Top Cancelled Global M&A Deals In September 2011

Cancellation date	Announced date	Days from announcement to cancellation	Target/Issuer	Total transaction value (mil. $)	Buyers/Investors
9/19/2011	3/22/2011	181	Ralcorp Holdings Inc.	7,525.93	ConAgra Foods Inc.
9/16/2011	6/12/2011	96	Transatlantic Holdings Inc.	4,198.28	Allied World Assurance Co. Holdings AG
9/14/2011	7/28/2010	413	Dollar Thrifty Automotive Group Inc.	3,126.17	Avis Budget Group Inc.
9/9/2011	9/9/2010	365	Axpo Holding AG	2,109.42	Thurgau Kanton
9/16/2011	12/9/2010	281	Cementos Balboa, Corrugados Azpeitia, Corrugados Lasao, Stahlwerk Thuringene and Gallardo Sections	1,251.24	Companhia Siderurgica Nacional
9/9/2011	5/16/2011	116	Niscayah Group AB	1,111.65	Securitas AB
9/8/2011	8/31/2011	8	Jotun AS	943.49	Lilleborg A/S
9/15/2011	5/14/2011	124	Cninsure Inc.	774.39	TPG Capital; CDH Investments
9/14/2011	5/24/2011	113	King of Prussia Mall	545.00	Morgan Stanley Real Estate Fund, Inc.; Prime Property Fund, LLC
9/16/2011	6/26/2011	82	Fundtech Ltd.	312.47	S1 Corp.

Source: Capital IQ.

Debt

Recent activity for security identifiers of debt securities shows a mixed picture. According to data from CUSIP Global Services, domestic corporate debt identifier demand dropped in the week ended Sept. 16 compared with the prior week. On the other hand, municipal securities CUSIP requests jumped by almost 59% over the same period, making it one of the more active periods in several weeks. Still, year-over-year municipal CUSIP volume is down 19.2%.

Meanwhile, international debt CUSIP requests inched higher in the past week, providing evidence that foreign borrowing activity may be stabilizing following several months of declining identifier demand for this security class. Finally, private-placement note CUSIP orders slipped in the recent reporting week (see table 7).

Table 7

CUSIPs Processed And Billed

	Week ended Sept. 16	Week ended Sept. 9	Year-to-date 2011	Year-to-date 2010	Year-over-year change (%)
Domestic corporate debt	158	278	7,708	N/A	N/A
Municipals	302	190	8,708	10,782	(19.2)
International debt	18	15	1,155	955	20.9
PPN domestic debt	22	39	1,312	1,152	13.9

N/A--Not applicable. Source: CUSIP Global Services.

Contact Information: Richard Peterson, Director, Research—Valuation and Risk Strategies, Richard_Peterson@standardandpoors.com

Quantitative View: Return Correlation And Dispersion Mean Tough Times For Active Managers

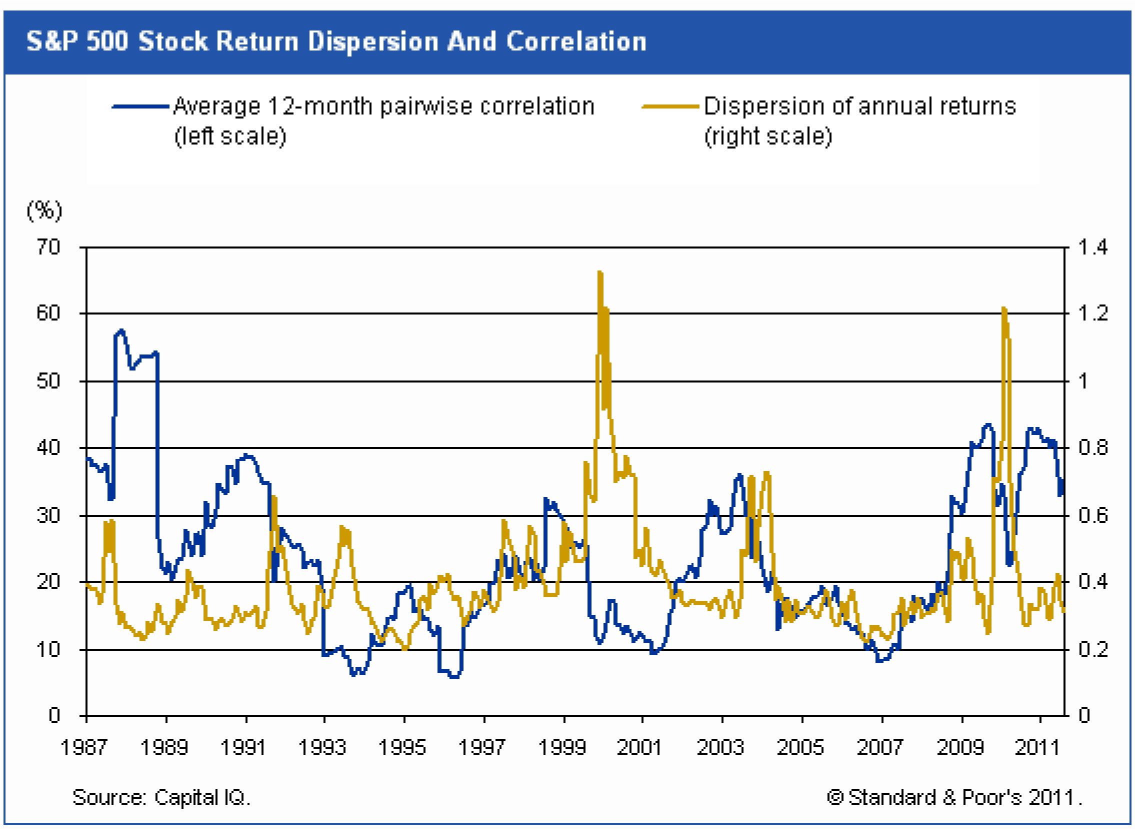
The financial market's preoccupation with the European sovereign debt crisis creates a challenging environment for active equity managers who have traditionally made their living on stock selection. When investors become fixated on a common risk factor, the correlation between stocks tends to rise. During periods of high correlations, coupled with low return dispersion, managers have more difficulty in correctly identifying winners, while at the same time the margin of outperformance of those winners is tighter than normal.

The financial market's fixation on macro risks has led to a correlation of stock returns within the S&P 500 Index of 35%, a level not seen since the 2008 financial crisis, placing the current relationship in the 83rd percentile historically. Simultaneously, the dispersion of returns is tight, currently measuring in the 32nd percentile. Larry Gorman, Steven Sapra, and Robert Weigand, who published a series of papers on this issue in 2010, suggest that the absolute return investor might use cross-sectional dispersion and the VIX Index to provide timing signals for alpha strategies.

Periods of higher return correlations typically coincide with higher market volatility. We measured a 45% correlation between pair-wise correlations and the VIX Index. Tarun Chordia, Amit Goyal, and Qing Tong, who have written about pair-wise correlations, measured a 27% increase in correlation when stocks decline. They suggest that the correlation spike is driven by coordinated selling by retail investors, and the popularity of exchange-traded funds only strengthens this effect. High correlations accompanied by high volatility create an additional challenge as there are reduced benefits to diversification at the very time at which it is needed.

The following chart shows the average 12-month pair-wise correlation of stock returns in the S&P 500 Index overlaid with the 12-month return dispersion. The historical inverse correlation between pair-wise correlation and dispersion has been negative 12%.

Chart 11



We examined eight general classes of strategies and observed their performance using Capital IQ's AlphaWorks custom regime monitor in periods of high correlation and low dispersion (HCLD). We measured valuation, price momentum, growth, earnings quality, analyst estimates, capital efficiency, size, and volatility.

From 1987 to the present, we identified 38 months out of 296 months that represented the top third of correlation and bottom third of dispersion. This is our definition of HCLD.

The analysis below shows that the losing strategies during an HCLD period include those strategies that focus on idiosyncratic attributes, namely growth, capital efficiency, and quality. These three strategies produce significant results in 258 months out of 296. Also, valuation and price momentum are winning strategies in both HCLD and non-HCLD periods. The spread-to-valuation strategies are twice as large in HCLD periods as non-HCLD periods. And while analyst expectations factor into a successful strategy in both regimes, it is three times more profitable in HCLD periods. Therefore, investors might want to focus on these periods to identify winners with greater return dispersion.

Summary | Current v. Hist

Display: Style Composites Order: Top Sector: Sector Neutral Portfolio: Absolute Return

HCLD

Style	Factor	Q1	Q5	Sprd% ▼	Ann Sprd%	Q1 Hit	Q5 Hit	Avg IC	Best IC	Worst IC	IC T-Stat	%Pos IC
Val	Valuation	2.45	1.20	1.24	16.00	65.79	57.89	0.05	0.21	(0.11)	3.75	71.05
AE	Analyst Expectation	2.19	1.32	0.87	10.91	63.16	60.53	0.04	0.24	(0.24)	2.80	76.32
Vol	Volatility	2.06	1.36	0.70	8.67	60.53	65.79	0.02	0.38	(0.31)	0.60	50.00
PM	Price Momentum	2.10	1.41	0.68	8.51	65.79	60.53	0.04	0.21	(0.18)	2.73	68.42
Sz	Size	1.79	1.37	0.42	5.11	60.53	63.16	0.01	0.25	(0.17)	0.74	47.37
HG	Historical Growth	1.89	1.58	0.31	3.79	68.42	57.89	0.02	0.19	(0.12)	1.56	65.79
CE	Capital Efficiency	1.75	1.61	0.14	1.72	63.16	63.16	0.01	0.31	(0.17)	0.71	55.26
EQ	Earnings Quality	1.79	1.82	(0.03)	(0.31)	65.79	55.26	(0.00)	0.15	(0.17)	(0.06)	52.63

Rest

Style	Factor	Q1	Q5	Sprd% ▼	Ann Sprd%	Q1 Hit	Q5 Hit	Avg IC	Best IC	Worst IC	IC T-Stat	%Pos IC
Val	Valuation	1.23	0.57	0.65	8.12	65.12	58.91	0.03	0.35	(0.22)	4.53	61.63
PM	Price Momentum	1.10	0.56	0.54	6.68	63.57	59.69	0.03	0.41	(0.28)	5.99	65.12
EQ	Earnings Quality	1.02	0.70	0.32	3.91	64.34	60.85	0.02	0.24	(0.21)	3.48	55.43
CE	Capital Efficiency	0.99	0.70	0.28	3.46	60.85	60.08	0.02	0.32	(0.26)	3.35	58.53
AE	Analyst Expectation	0.93	0.66	0.27	3.27	61.63	60.08	0.02	0.23	(0.25)	3.22	59.69
Sz	Size	0.96	0.78	0.18	2.19	61.63	63.18	(0.00)	0.29	(0.30)	(0.69)	47.29
HG	Historical Growth	0.99	0.84	0.15	1.81	61.63	61.24	0.01	0.21	(0.28)	2.69	56.59
Vol	Volatility	0.89	0.84	0.05	0.60	60.08	63.18	(0.01)	0.56	(0.40)	(1.21)	46.12

Contact Information: David Pope, CFA, Managing Director of Quantitative Research—Capital IQ, David_Pope@standardandpoors.com

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