

Lookout Report

from S&P Valuation and Risk Strategies

Could The Fourth Quarter Be "Déjà Vu All Over Again" For Stocks?

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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.

One year ago, the S&P 500 Index ended the third quarter at 1,141.20 (Sept. 30, 2010), about 10 points higher than last Friday's third-quarter 2011 closing mark of 1,131.42. At this point a year ago, when the market was trading at similar levels to today, S&P 500 corporations were expected to deliver 12-month forward earnings per share of \$87.50 (firms eventually reported \$93.30). Both metrics of year-ago forward earnings per share are considerably lower than today's quarter-end 12-month forward estimate of \$104, according to the Capital IQ consensus. Investors meanwhile have completely lost faith in Wall Street analysts' collective optimism and are clearly pricing in a lower future trajectory for economic growth and corporate earnings, and as some might even argue, recession.

Investors have good reasons to question expectations for growth and profits. Economic activity appears to have slowed dramatically since the start of the second quarter of this year, prompting analysts to reduce 12-month forward earnings forecasts by 2% to \$104 from over \$106 just two months ago at the end of July. The third-quarter 2011 quarter-end mark of 1,131.42 values the S&P 500 Index at just 10.9 times forward-estimated earnings. We believe that such a low market valuation indicates that investors are now defensively pricing the equity market for recession. In the U.S. Treasury market, a 10-year T-note yield lower than 2% and a five-year T-note yield lower than 1% seem to be conveying the exact same message.

Hopefully on a much more positive note, third-quarter earnings reporting season unofficially commences next week, and S&P 500 corporations are expected to report the eighth consecutive quarter of double-digit earnings growth. If the U.S. economy is either already in recession or on the verge of recession, third-quarter earnings could disappoint the Street. If on the other hand reported earnings once again exceed consensus expectations, as has been the case for the last two years, then perhaps we are just in a slow-growth period, as opposed to recession. Second-quarter 2011 results exceeded analysts' expectations by 5.95%, lower than the 8.25% average earnings surprise recorded over the last eight quarters. Should the economy actually be settling into a period of modest but sustained economic growth, then a less pessimistic price-to-earnings (PE) valuation ratio may be more appropriate for the stock market.

Our research team started 2011 with an unofficial year-end target of approximately 1,425 for

October 7, 2011

the S&P 500 Index based on a year-end 12-month forward assumption of \$105 per share, to which we applied what we then believed would be a fairly conservative 13.5 PE multiple. While S&P 500 corporations so far have managed to exceed market expectations for quarterly earnings, slowing GDP growth, combined with sovereign fiscal turmoil in the U.S. and Europe, have decimated investor confidence in the economy and the future ability of corporations to grow earnings.

With the U.S. economy recently providing some evidence that weakness may not be as prevalent as previously assumed (improving ISM PMI and jobless claims data), corporate earnings may once again provide an upside catalyst to the stock market, as was seen a year ago when the S&P 500 Index rallied 10.2% in the final quarter of the year. Considering that Wall Street analysts continue to forecast 12-month forward S&P 500 earnings in excess of \$100 per share, it seems counterintuitive that we should be speculating about a 10% rally just so that the market can end the year unchanged. As far as the math is concerned, and assuming the U.S. economy avoids recession and settles into modest GDP growth and profits trajectory, minimum forward earnings of \$100 to \$105 per share should still deserve a historically conservative 12.5 PE ratio, in our opinion. Under this relatively optimistic scenario, as Yogi Berra once said, the final quarter of 2011 could turn out to be a case of "Déjà vu all over again."

Inside This Issue:

Economic And Market Outlook: Earnings In North America And Europe

In North America, the S&P Capital IQ growth rate currently stands at 12.80%. If we end the season with this number, it will represent the eighth consecutive quarter of double-digit earnings growth. However, in an uncertain global economic environment in which analysts are continually ratcheting estimates down, there is much doubt we'll see continued strength in corporate earnings. Meanwhile, analysts continue to cut European estimates amid market volatility and uncertainty regarding the debt crisis.

Leveraged Commentary And Data: Leveraged Loans Return 0.43% In September; Decline 1.34% Year To Date

Secondary loan prices stabilized in September as technical conditions stopped eroding, but the performance of the S&P/LSTA Leveraged Loan Index shows that market conditions didn't get much better.

R2P Corporate Bond Monitor

In the fixed-income markets, despite increasing economic pressures, risk-reward profiles--as measured by average Risk-to-Price (R2P) scores--stabilized in most sectors in September after sharp score declines in July and August.

Market Derived Signal Commentary: CDS Investors Express Fear Of Financials Sector

We believe that fear of a 2008-style collapse, more than fundamentals, is driving the recent CDS expansion in financials. However, a Greek debt default or other exogenous shocks, or a double-dip recession in the U.S., which we do not currently forecast, would likely mean all bets are off for this sector.

Capital Market Commentary: Despite A Shutout Month For IPOs, Things Could Improve For Equities

September marked the first shutout month since March 2009 and only the 11th month since 2000. Although this development could reflect a future decrease in underwriting fees and overall capital market activity, we found that, on average, the S&P 500 Index has increased by 13.3% in the one-year periods following months without IPOs.

S&P Index Commodity Commentary: Where's The Consumer Relief?

Commodity prices have marked time so far in the new quarter following sharp declines in September, and in the near term, commodities remain under pressure related to the "risk-off" mode in financial markets and fears of recession.

Quantitative View: Return Correlation And Dispersion Means The Tough Times For Active Managers Aren't Abating

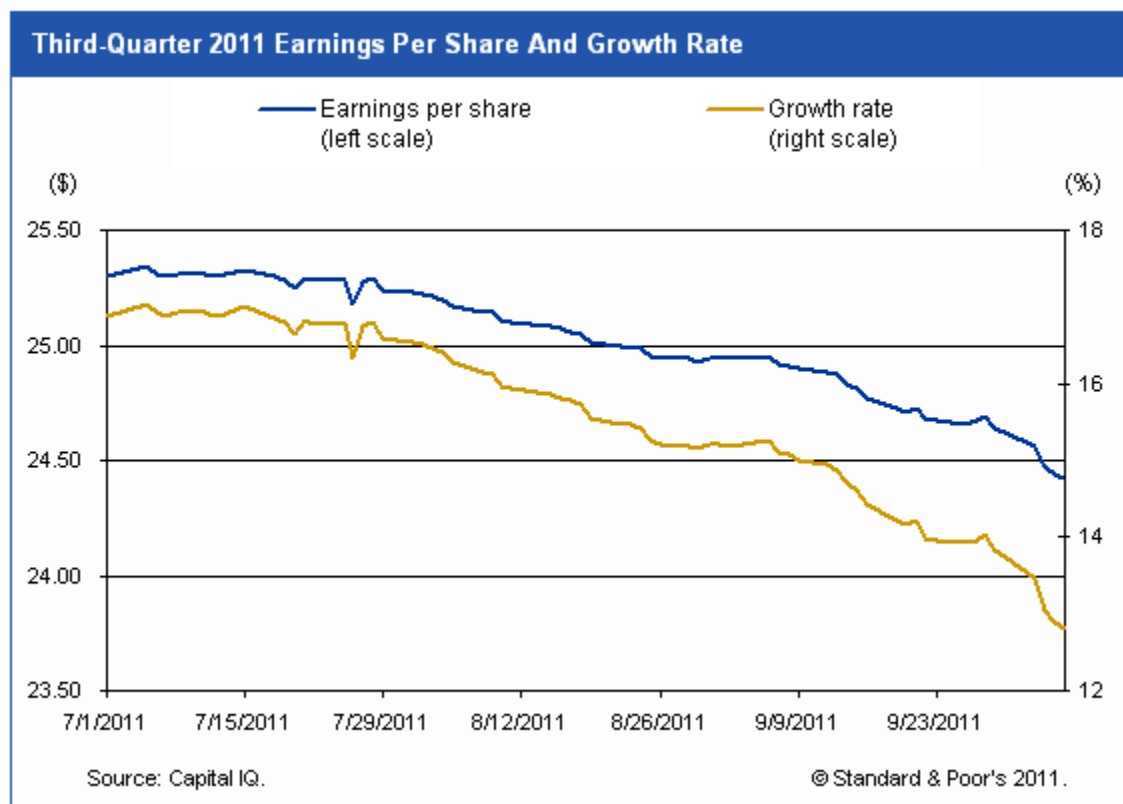
The financial market fixation on macro risks has led to a correlation of stock returns within the S&P 500 Index of 40% in September, up from 35% in August and at levels not seen since the 2008 financial crisis. For perspective, a correlation of 40% places the current relationship in the 91st percentile historically.

Economic And Market Outlook: Earnings In North America And Europe

North America

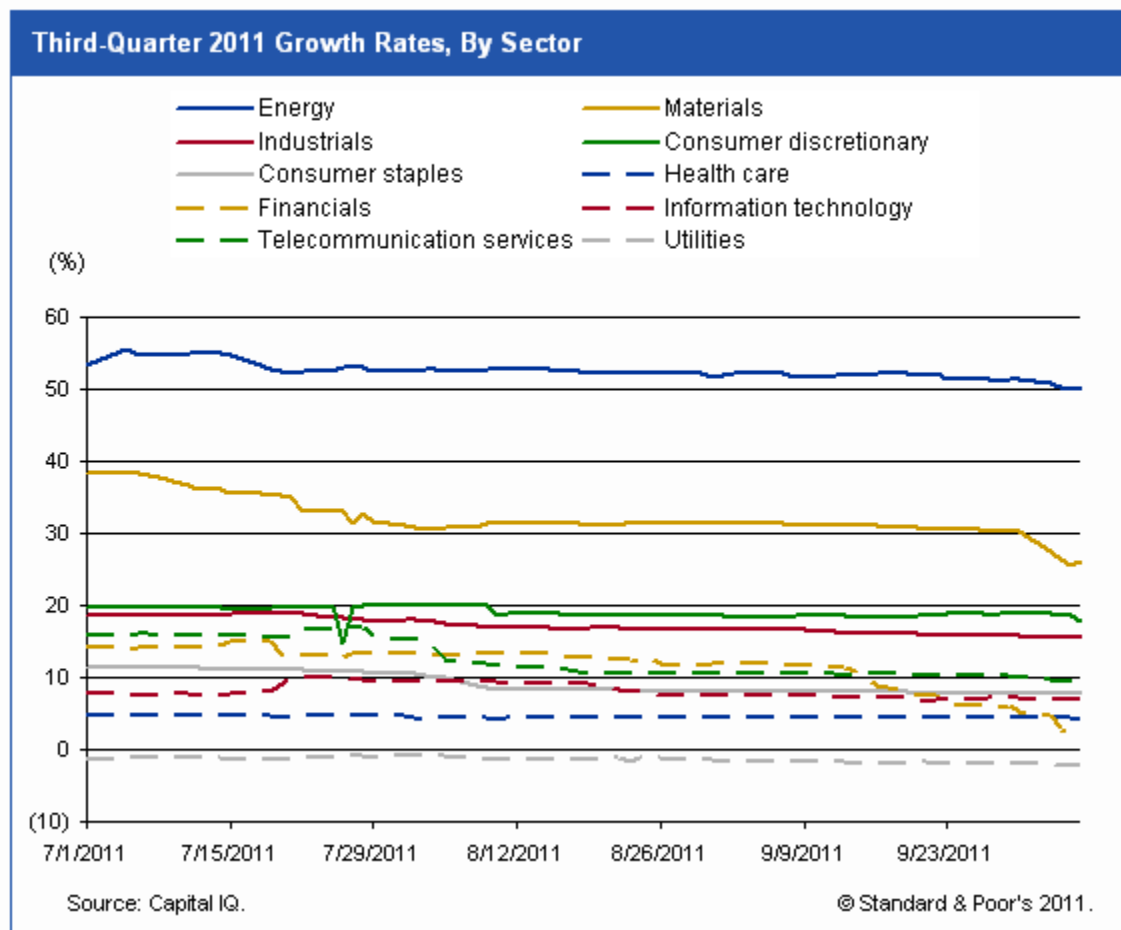
Entering the unofficial start of earnings season next week, the S&P Capital IQ growth rate currently stands at 12.80% (see chart 1). If we end the season with this number, it will represent the eighth consecutive quarter of double-digit earnings growth. However, in an uncertain global economic environment in which analysts are continually ratcheting estimates down, there is much doubt we'll see continued strength in corporate earnings. Since the beginning of the calendar quarter, third-quarter expected growth rates have fallen more than 4%, to 12.80% from 16.88% on July 1.

Chart 1



Again in the third quarter, we expect strong growth in the energy (50.16%) and materials (26.04%) sectors, driven by higher commodity prices, which have since decreased (see chart 2). Despite lower commodity prices, these two sectors are expected to remain top performers for the fourth quarter.

Chart 2



Last quarter, a number of companies that exceeded estimates did so by expanding international segments, particularly in Asia and Latin America. With the U.S. economy continuing to weaken and global growth slowly following suit, many wonder if companies can expect to see the same international success this quarter as in the second quarter. While the environment is certainly more difficult than companies expected for the second half of the year, many firms (mainly in the consumer discretionary, information technology, and materials sectors) issued bullish press releases in the second quarter, suggesting they expected to find growth opportunities internationally for the remainder of the year. So far only 29 companies have reported results for the third quarter, but we are already seeing some similar trends. Just this week alone, three of the five companies that have reported attribute their strong results to revenue growth abroad.

- Yum! Brands reported earnings of \$0.83 Tuesday after the closing bell, beating estimates by \$0.01. The company attributed this to sales growth in China and other emerging markets, and reaffirmed a 12% increase in full-year earnings per share. Yum's profit from China increased by 7%. However, a 16% decline in U.S. profits offset the company's impressive international growth.
- On Wednesday Monsanto beat earnings estimates by \$0.05, reporting earnings per share loss of \$0.22. The company said that Latin America continues to be a significant driver for their seeds and genomics segment. The growth potential in this area, specifically Brazil and Argentina, is helping to drive 2012 earnings per share guidance of \$3.34 to \$3.44.
- Costco, which also reported on Wednesday, grew net sales by 14%; ex-Mexico, sales rose 11%. Comparable store

sales for the quarter came in at 19% for the international segment, and only 10% for the U.S.

While two of these three companies were able to beat expectations due to international strength (Costco missed by \$0.02), they each reported that weakness in the U.S. offset those gains. If the global economy continues to weaken along with the U.S. and Europe, can we expect the impressive earnings run to come to an end?

Europe

Over the last two weeks ended Sept. 30, analysts lowered their consensus calendar-year 2011 expectations for the S&P Europe 350 Index an additional 0.6% to €100.17 from €100.74. The current expectation is now at the lowest level since the start of the third quarter, according to Capital IQ data aggregated by VRS Research. Consensus expectations for S&P Europe 350 2012 calendar-year earnings decreased by 0.9% to €111.79 as of Sept. 30, compared with €112.84 on Sept. 16 (see chart 3).

Analysts have consistently lowered earnings forecasts for S&P Europe 350 corporations since the early summer. Despite the German parliament's vote by an overwhelming majority in favor of measures to bolster the €440 billion eurozone rescue fund last week, markets remain volatile, investors remain uncertain, and the European debt crisis is still unresolved.

For the past two weeks, analysts have made their most significant cuts in the earnings consensus for the cyclical materials, industrials, consumer discretionary, and financials sectors. Health care is the only sector experiencing an uptick in mean estimates.

Analysts lowered their consensus estimates for major mining companies, including Rio Tinto, Xstrata, Anglo-American, BHP Billiton; and for banks, including HSBC, Deutsche Bank, UBS and Santander. Analysts also cut estimates for industrials giants such as Siemens, ABB, A.P.Moller-Maersk, Man AG, Schneider Electric, and Deutsche Lufthansa.

Chart 3



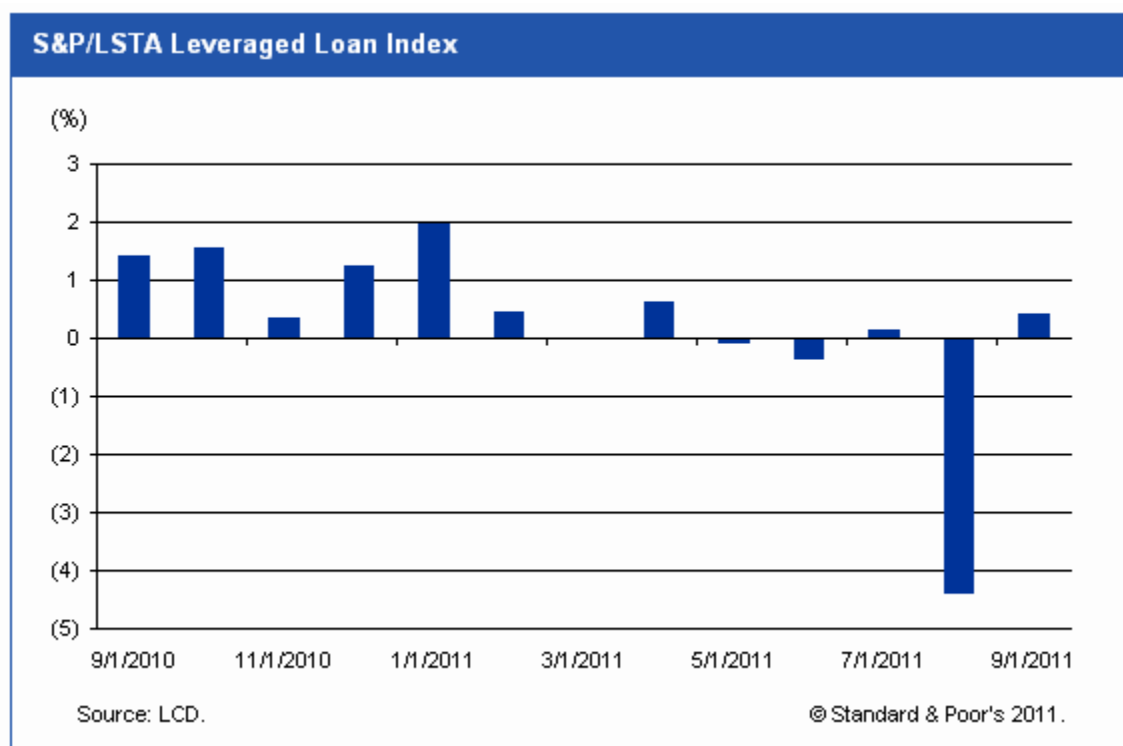
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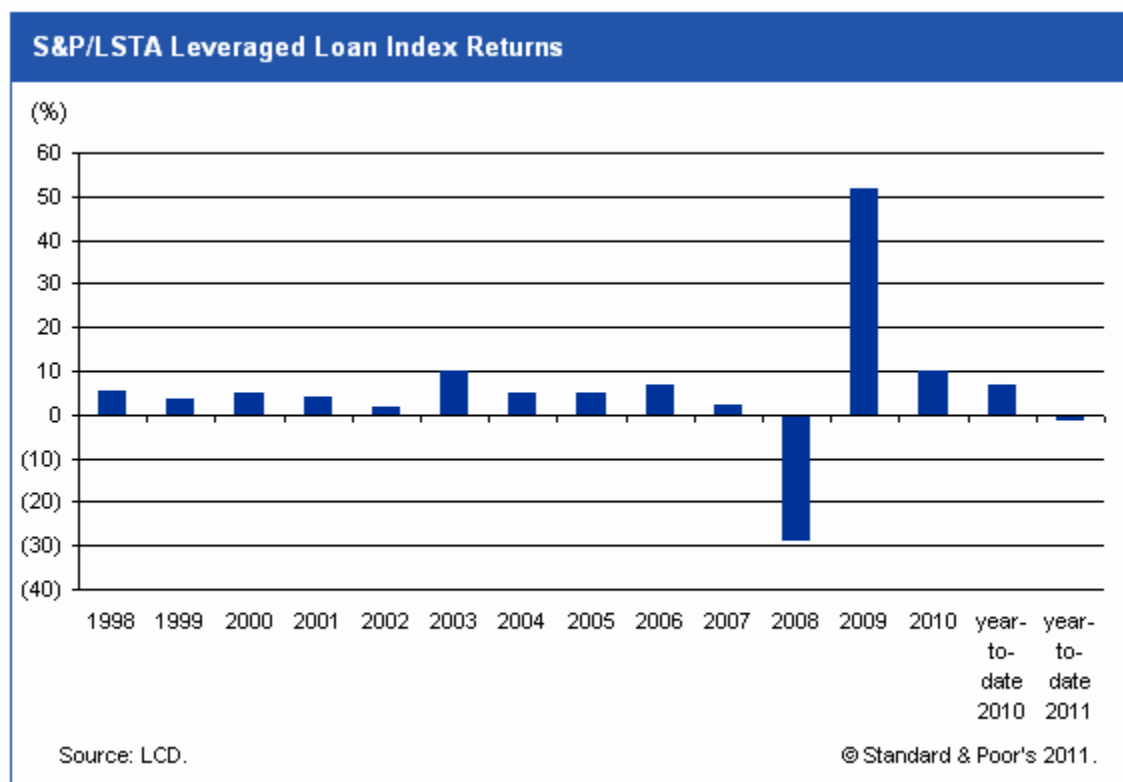
Leveraged Commentary And Data: Leveraged Loans Return 0.43% In September; Decline 1.34% Year To Date

Secondary loan prices stabilized in September as technical conditions stopped eroding, but the performance of the S&P/LSTA Leveraged Loan Index shows that market conditions didn't get much better. Indeed, after a fall of 4.4% in August--the largest decline since November 2008--the index returned 0.43% during the month, with price increases accounting for just 0.03 percentage points of this figure (see chart 4).

Chart 4



Despite September's modest advance, the S&P/LSTA Index declined 1.34% for the first three quarters of 2011, putting the index on pace to post the second calendar-year loss in its nearly 15-year history (see chart 5). (The other, of course, was 2008's astonishing 29.1% setback).

Chart 5

For the large loans that comprise the S&P/LSTA Leveraged Loan 100 Index, September was less kind. High-beta names remained under pressure as investors sought to free up cash to meet potential redemptions. Therefore, the Loan 100 was unchanged in September. Year to date, the index lags the broader index, with a drop of 2.94%. As fear continues to drive sentiment in the loan market, better-rated paper continued to outperform in September (see table 1).

Table 1

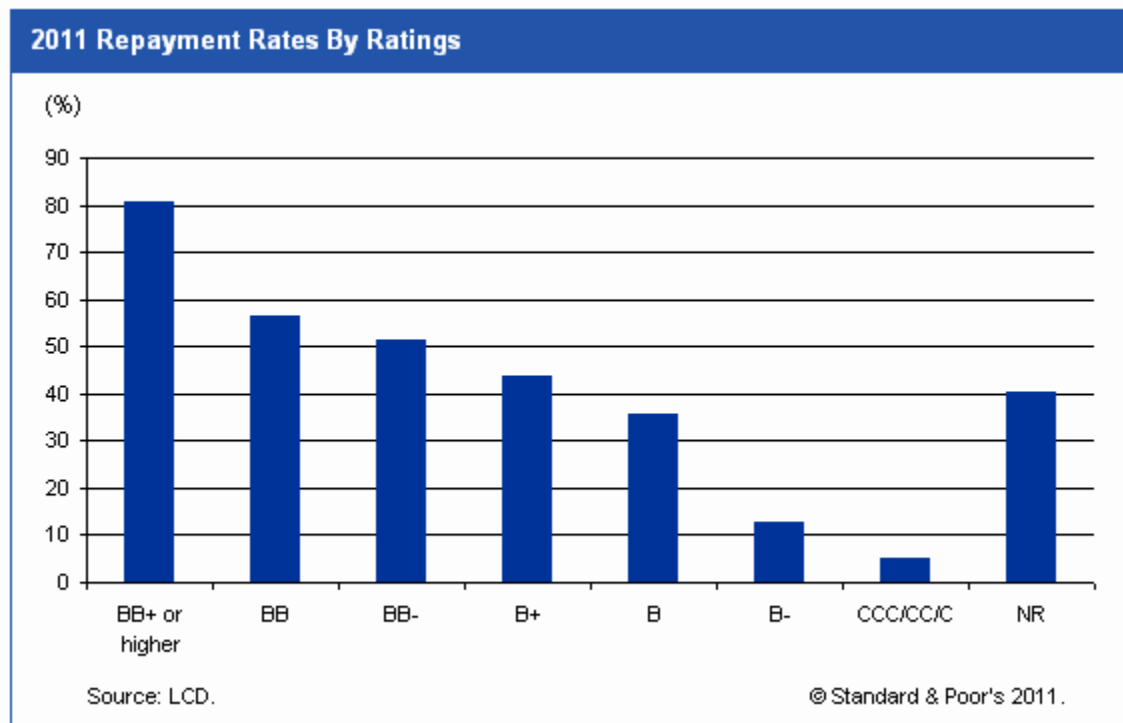
Returns By Type Of Debt		
	Year to date (%)	September 2011 (%)
All loans	(1.34)	0.43
Performing loans	(1.36)	0.45
BB	(0.34)	1.81
B	(1.26)	0.18
CCC	(6.94)	(5.50)
D	(15.23)	(6.24)
S&P/LSTA 100	(2.94)	(0.00)

Source: LCD.

As table 1 shows, 'BB' loans were the big winners for the month. The reason is fourfold. First, there is a clear flight to quality underway given growing concerns about the U.S. economy and the fragile state of Europe's sovereign debt situation. Second, arrangers say that commercial banks and insurance companies have waded into the market over the past several months to buy up 'BB' loans, which play well in their risk-adjusted-return models as a result of their ratings profile and wide average spread to maturity of Libor+492 basis points (bps). Third, the CLO bid for 'BB' loans remains strong for similar reasons, as these loans work well in the context of their covenant tests. Finally, in addition to these

demand-driven factors, 'BB' loans have also benefited from contracting supply. As chart 6 shows, year-to-date repayment rates correlate with credit quality.

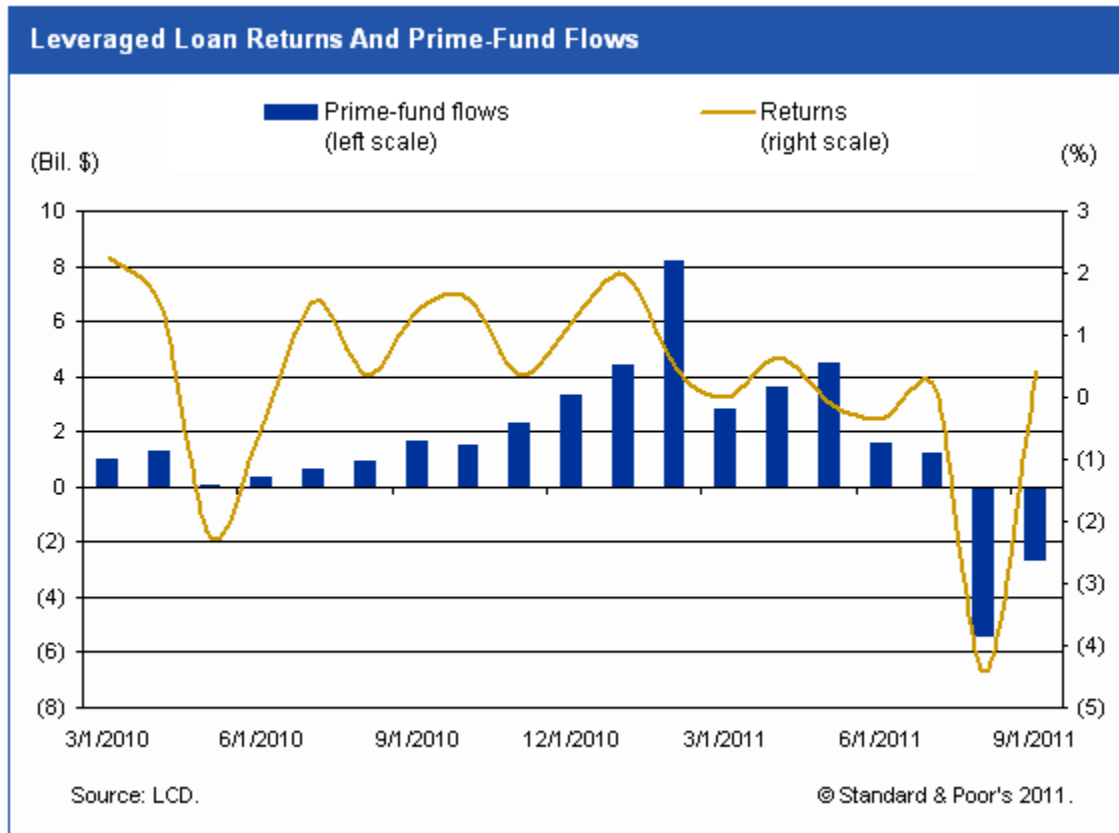
Chart 6



Looking ahead to the final quarter of 2011, visibility is low. Decisions yet to be made by mutual fund investors will, in the end, prove the deciding factor.

Here's what is known as the fourth quarter of 2011 unfolds. On the supply side, there remains \$13.3 billion of new deals on the calendar, including the soon-to-be-launched \$2.6 billion institutional loan from Kinetic Concepts. Beyond that, arrangers say, there's not much else. On the other side of the ledger, there is a roughly equal amount of visible repayments in offing, including fourth-quarter amortizations totaling \$11.2 billion.

That brings us back to the critical variable: retail fund flows. If investors continue to withdraw capital from loan mutual funds, the market bias will likely remain negative for the balance of 2011. After all, loan returns have followed retail money for all of 2011 (see chart 7).

Chart 7

If outflows persist, there's little doubt that investors will continue to husband cash and sell selectively. It follows that underwriters will remain cautious, deal flow will remain light, and secondary prices will remain under pressure.

However, if retail investors re-embrace the risk trade, managers think loan funds will be a major beneficiary, attracting investors interested in the same compelling combination of wide yields of 5% to 6% and short duration that brought a record \$26.3 billion to the asset class over the first seven months of 2011, according to Lipper FMI, EPFR, and Yahoo! Finance. That leaves the loan market--and most other capital markets--waiting for good news to restore confidence and reinvigorate spirits.

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R2P Corporate Bond Monitor

European officials are scrambling to avoid a Greek bankruptcy, which would damage the balance sheets of European banks, jeopardize the future of the single currency, and potentially plunge the world into a new global financial crisis. Inspectors from the International Monetary Fund, European Union, and European Central Bank, known as the troika, are in Athens scouring the country's books to decide whether to approve a loan tranche. Without that installment, Greece would run out of cash as soon as this month. The troika's assessment of Greece's future prospects could determine whether it needs to demand more debt relief from private creditors, a measure that could effectively amount to default. To persuade the troika to release the next tranche of loans, Greece has promised to raise taxes, cut state wages, and speed up plans to reduce the number of public sector workers by one-fifth by 2015.

In the U.S., figures show economic activity slowing down. According to the Commerce Department, income slipped 0.1% in August, the first decline since October 2009, with private wages and salaries dropping \$12.2 billion. In addition, consumer spending growth, which accounts for about 70% of U.S. economic activity, slowed sharply to a 0.7% annual pace in the second quarter after advancing 2.1% in the first three months of the year.

In the fixed-income markets, despite increasing economic pressures, risk-reward profiles--as measured by average Risk-to-Price (R2P) scores--stabilized in most sectors in September after sharp score declines in July and August (see tables 2 and 3).

Overall, probability of default (PD), as assessed by Valuation and Risk Strategies' statistical models, increased by 37% and 23% in North America and in Europe, respectively. However, 20-day average historical bond price volatility decreased by 32% and 17% in the month ended Sept. 30, 2011.

With option-adjusted spreads (OAS) widening on average by 21 basis points (bps) in North America and 36 bps in Europe, financials securities provide better risk-reward profiles as of Sept. 30, with scores increasing by 23% and 5%, respectively.

On the other hand, North American materials and European energy securities' scores declined the most, with decreases of 16% and 6%, respectively.

Table 2

North American Risk-Reward Profiles By Sector--Average R2P Score And Components Changes				
	Scores (%)	OAS (bps)	PD (%)	Bond price vol. (%)
Consumer discretionary	(2)	4	25	(30)
Consumer staples	0	(17)	24	(27)
Energy	(2)	1	80	(33)
Financials	23	21	32	(37)
Health care	1	(21)	36	(34)
Industrials	(9)	(19)	7	(32)
Information technology	2	(14)	30	(27)
Materials	(16)	(13)	76	(32)
Telecommunication services	5	17	31	(34)
Utilities	9	(7)	31	(30)

Change as of Sept. 30, 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	7	9	42	(29)
Consumer staples	8	3	23	(12)
Energy	(6)	16	52	(11)
Financials	5	36	45	(9)
Health care	9	(2)	34	(12)
Industrials	(3)	12	30	(21)
Information technology	2	(3)	(16)	(3)
Materials	15	7	(12)	(46)
Telecommunication services	(2)	6	30	(15)
Utilities	(1)	8	7	(14)

Table 3**European Risk-Reward Profiles By Sector--Average R2P Score And Components Changes (cont.)**

Change as of Sept. 30, 2011, from Aug. 31, 2011.

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Market Derived Signal Commentary: CDS Investors Express Fear Of Financials Sector

As uncertainty about the global economy persists, expected third-quarter earnings growth for S&P 500 firms has decreased since the beginning of the third quarter, to less than 13% as of Oct. 5 from 16.9% on July 1. Yet, the cuts have been most severe in the financials sector. On July 1, analysts polled by Capital IQ expected financials to report earnings per share of \$4.29, implying an increase from the third quarter of 2010 of 14.5%. As of Oct. 5, analysts expect a collective per-share profit of \$3.83, or growth of 2.2%.

Worries about contagion in the U.S. from Europe is one factor driving the revisions. According to a Wall Street Journal report on Sept. 30, Morgan Stanley's share price declined in recent weeks and its five-year credit default swap (CDS) spread expanded on concerns about the company's exposure to eurozone banks. In addition, low interest rates (and weak loan demand) have squeezed loan margins, while volatility in the markets has sparked a downturn in revenues from trading and underwriting activities. Table 4 shows the top 20 largest cuts to estimates among companies in the financials sector.

Table 4**Largest Cuts To Estimates**

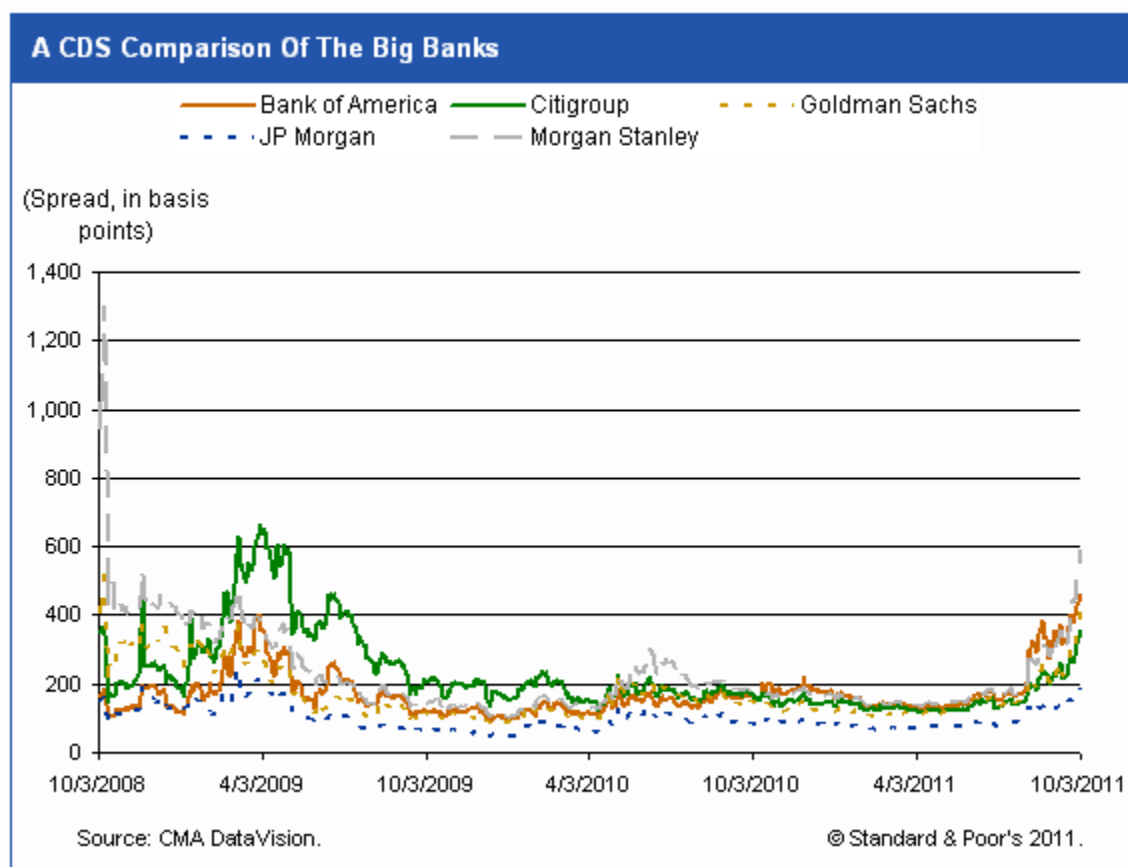
Ticker	Company	Industry	--Estimate (\$)--		
			July 1	Oct. 5	Change
GS	The Goldman Sachs Group Inc.	Capital markets	3.64	0.66	(2.98)
CB	Chubb Corp.	Insurance	1.37	0.77	(0.59)
ALL	Allstate Corp.	Insurance	0.78	0.20	(0.58)
BLK	BlackRock Inc.	Capital markets	3.19	2.92	(0.28)
HIG	Hartford Financial Services Group Inc.	Insurance	0.92	0.69	(0.23)
JPM	JPMorgan Chase & Co.	Diversified financial services	1.20	0.97	(0.23)
TRV	The Travelers Cos. Inc.	Insurance	1.37	1.09	(0.28)
C	Citigroup Inc.	Diversified financial services	1.01	0.85	(0.16)
L	Loews Corp.	Insurance	0.84	0.74	(0.11)
PCL	Plum Creek Timber Co. Inc.	Real estate investment trusts (REITs)	0.40	0.30	(0.10)
HCN	Health Care REIT Inc.	Real estate investment trusts (REITs)	0.35	0.26	(0.09)
WY	Weyerhaeuser Co.	Real estate investment trusts (REITs)	0.19	0.11	(0.07)
SLM	SLM Corp.	Consumer finance	0.43	0.36	(0.07)
VTR	Ventas Inc.	Real estate investment trusts (REITs)	0.34	0.32	(0.01)
MMC	Marsh & McLennan Cos.	Insurance	0.34	0.27	(0.07)
MCO	Moody's Corp.	Diversified financial services	0.56	0.49	(0.06)
AMP	Ameriprise Financial Inc.	Capital markets	1.41	1.31	(0.10)
PGR	Progressive Corp.	Insurance	0.36	0.30	(0.06)
GNW	Genworth Financial Inc.	Insurance	0.27	0.21	(0.06)
AIG	American International Group Inc.	Insurance	0.68	0.33	(0.35)

Source: Capital IQ.

As earnings estimates for financials have declined over the past three months, the CDS spreads for this sector widened by an average of 153%, according to CMA DataVision (see chart 8). Among the bulge-bracket firms, which are most closely tied to the financial crisis in Europe, confidence in Morgan Stanley, Goldman Sachs Group Inc., Bank of America Corp., and Citigroup Inc., has eroded rapidly. JPMorgan Chase & Co. has fared the best in this group, though its spread has widened 126% to 184 basis points (bps) over the past 90 days.

The cost to purchase protection against default on some financials' CDS is, in some cases, at the most expensive point since 2009.

Chart 8



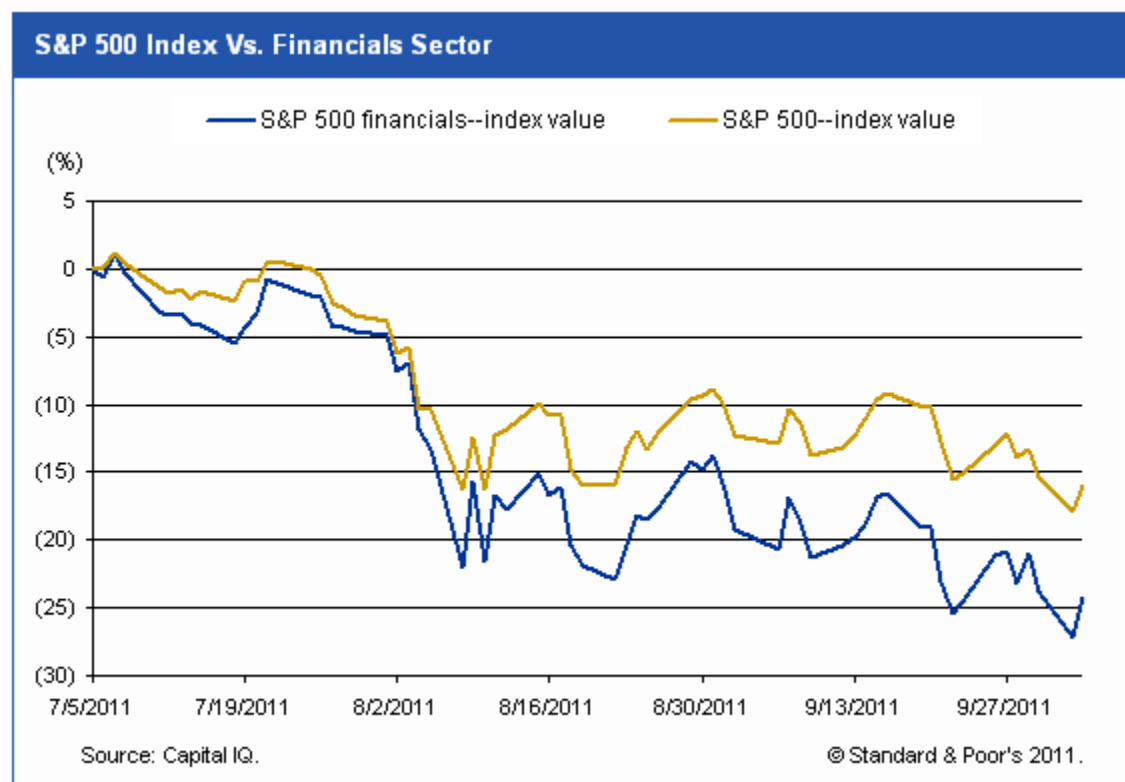
For each bank, the Market Derived Signal ratings, which incorporate credit rating, currency, sector, and recovery risks, are lower than Standard & Poor's investment-grade ratings assigned to the companies (see table 5).

Table 5

Credit Rating Vs. Market Derived Signals		
Issuer	Credit rating/Outlook	Market Derived Signal rating
Bank of America	A/Negative	bb+
Citigroup	A/Negative	bbb-
Goldman Sachs	A/Negative	bb+
JP Morgan Chase	A+/Stable	a
Morgan Stanley	A/Negative	bb

Equity investors are also pessimistic--the sector declined more than 24% over the past three months. In comparison, the S&P 500 Index fell 16% (see chart 9).

Chart 9



Despite the credit and equity markets signaling declining confidence, analysts polled by Capital IQ expect year-over-year earnings growth for financials in both 2011 (12.64%) and 2012 (17.93%). We also note that credit strength has improved, with most of the large banks showing steady improvement in Tier 1 ratios (except Bank of America) and net charge-offs (see "Industry Report Card: Large U.S. Banks Have Shored Up Credit Fundamentals, But The Economy Remains Cause For Concern," published Aug. 9, 2011, on the Global Credit Portal).

Table 6

U.S. Large Banks--Tier 1 Common Ratios							
	2010 (%)--				--2011 (%)--		Q/Q (bps)
	Q1	Q2	Q3	Q4	Q1	Q2	
Wells Fargo	7.1	7.6	8.0	8.3	8.9	9.2	28
U.S. Bancorp	7.1	7.4	7.6	7.8	8.2	8.4	20
PNC Financial Services Group	7.9	8.3	9.6	9.8	10.3	10.5	20
Citigroup Inc.	9.1	9.7	10.3	10.8	11.3	11.6	30
J.P. Morgan Chase & Co.	9.1	9.6	9.5	9.8	10.0	10.1	10
Bank of America Corp.	7.6	8.0	8.5	8.6	8.6	8.2	(41)
Median	7.8	8.2	9.0	9.2	9.5	9.7	26
Morgan Stanley	8.3	9.2	10.8	10.5	11.7	14.6	290
The Goldman Sachs Group Inc.	12.4	12.5	13.0	13.3	12.8	12.9	10

Source: Standard & Poor's Ratings Services.

Table 7

Large U.S. Banks--Net Charge-Offs							
	--2010 (mil. \$)				--2011 (mil. \$)		Q/Q (%)
	Q1	Q2	Q3	Q4	Q1	Q2	
Wells Fargo	5.3	4.5	4.1	3.8	3.2	2.8	(11.59)
U.S. Bancorp	1.1	1.1	1.0	0.9	0.8	0.7	(7.20)
PNC Financial Services Group	0.7	0.8	0.6	0.8	0.5	0.4	(22.33)
Citigroup Inc.	8.4	8.0	7.7	6.9	6.3	5.1	(17.90)
J.P. Morgan Chase & Co.	7.9	5.7	4.9	5.1	3.7	3.1	(16.59)
Bank of America Corp.	10.8	9.6	7.2	6.8	6.0	5.7	(6.02)
Citicorp	3.1	3.0	3.0	2.7	2.3	2.2	(7.12)

Source: Standard & Poor's Ratings Services.

"For the largest U.S. banks, the improvement in delinquency and credit loss statistics during the second quarter paints a picture of declining risk and increasing capital," Standard & Poor's Ratings Services wrote in the report. "But the U.S. economic recovery remains slow, and this underscores risks to our outlooks for these institutions, particularly their consumer credit exposures. Adding uncertainty to our forecast are Standard & Poor's Ratings Services' downgrade of the U.S. and the rising debt burdens for European sovereigns, new regulations, and the legal fallout from the 2008-2009 crisis... We continue to evaluate possible adverse conditions in the housing market, rules from new legislation, and possible representation and warranty costs and litigation concerns as they apply to the industry."

Valuation and Risk Strategies Research believes that fear of a 2008-style collapse, more than fundamentals, is driving the recent CDS expansion in financials. However, a Greek debt default or other exogenous shocks, or a double-dip recession in the U.S., which we do not currently forecast, would likely mean all bets are off for this sector. With the global economy still in flux, we would not take a long position on financials at this time.

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Capital Market Commentary: Despite A Shutout Month For IPOs, Things Could Improve For Equities

IPOs

According to Capital IQ data, September was a shutout month for IPOs as no U.S. companies, excluding public funds, closed-end funds and real estate investment funds (REITs), were priced on a major U.S. exchange. This marked the first shutout month since March 2009 and only the 11th month since 2000. Although this development could reflect a future decrease in underwriting fees and overall capital market activity, we found that, on average, the S&P 500 Index has increased by 13.3% in the one-year periods following months without IPOs (see table 8).

Table 8

S&P 500 Performance In One-Year Period After A Month Without IPOs			
	Month end	One year later	Change (%)
September 2001	1,040.94	815.28	(21.7)
September 2002	815.28	995.27	22.1
March 2003	848.18	1,126.21	32.8
April 2003	916.92	1,107.30	20.8

Table 8

S&P 500 Performance In One-Year Period After A Month Without IPOs (cont.)			
May 2003	963.59	1,120.68	16.3
June 2008	1,280.00	919.32	(28.2)
September 2008	1,166.36	1,057.08	(9.4)
December 2008	903.25	1,115.10	23.5
January 2009	825.88	1,073.87	30.0
March 2009	797.97	1,169.43	46.6
Average			13.3
September 2011	1,131.42		

U.S. companies only on major U.S. exchanges. Excludes public funds, REITs, and closed-end funds. Source: Capital IQ.

September was particularly harsh for U.S. IPOs--over the past 30 days ended Oct. 5 a typical issue lost 12.5% in value (see table 9). While only five issues managed to post gains of 10% or greater, 53 IPOs declined by 10% or more. Another cautionary note is the dip in IPO filings. In the past month, 19 companies filed plans to sell securities, compared with 34 in the preceding 30-day period. We believe that underwriters may be taking to the sidelines until conditions improve.

Table 9

Best And Worst Performers	
Top performing stocks	Change (%)
Pacira Pharmaceuticals Inc.	32.88
KiOR Inc.	24.27
TMS International Corp.	14.94
Tangoe Inc.	12.39
Fluidigm Corp.	10.24
Worst performing stocks	
Imperial Holdings Inc.	(65.11)
Kips Bay Medical Inc.	(59.07)
Tibet Pharmaceuticals Inc.	(51.53)
Tudou Holdings Ltd.	(50.45)
C&J Energy Services Inc.	(45.49)

Data as of Oct. 5, 2011. Source: Capital IQ.

M&A

On Oct. 2, The Carlyle Group L.P. and Hellman & Friedman LLC signed a definitive merger agreement to acquire Pharmaceutical Product Development Inc. for \$3.7 billion in cash, marking the year's second-largest buyout and the biggest private equity acquisition of a U.S. company since Apax Partners, CPP Investment Board, and Public Sector Pension Investment Board entered into a definitive merger agreement to acquire Kinetic Concepts Inc. for \$5 billion in cash this past July. Despite that recent transaction, U.S. leveraged buyout (LBO) activity, as measured by transaction proceeds, currently remains flat with year-ago activity. According to Capital IQ data, proceeds relating to U.S. LBOs to date this year total \$60.45 billion, essentially matching the comparable prior year-to-date total of \$60.47 billion (see table 10). Still, with just four LBOs of over \$1 billion announced since July 2011, financial sponsors will have to pick up the pace to match the 12 billion-dollar LBOs announced in the second half of last year. Barring a rebound in private equity acquisitions in the upcoming weeks, U.S. M&A activity in 2011 might increase overall but decline for financial sponsor acquisitions.

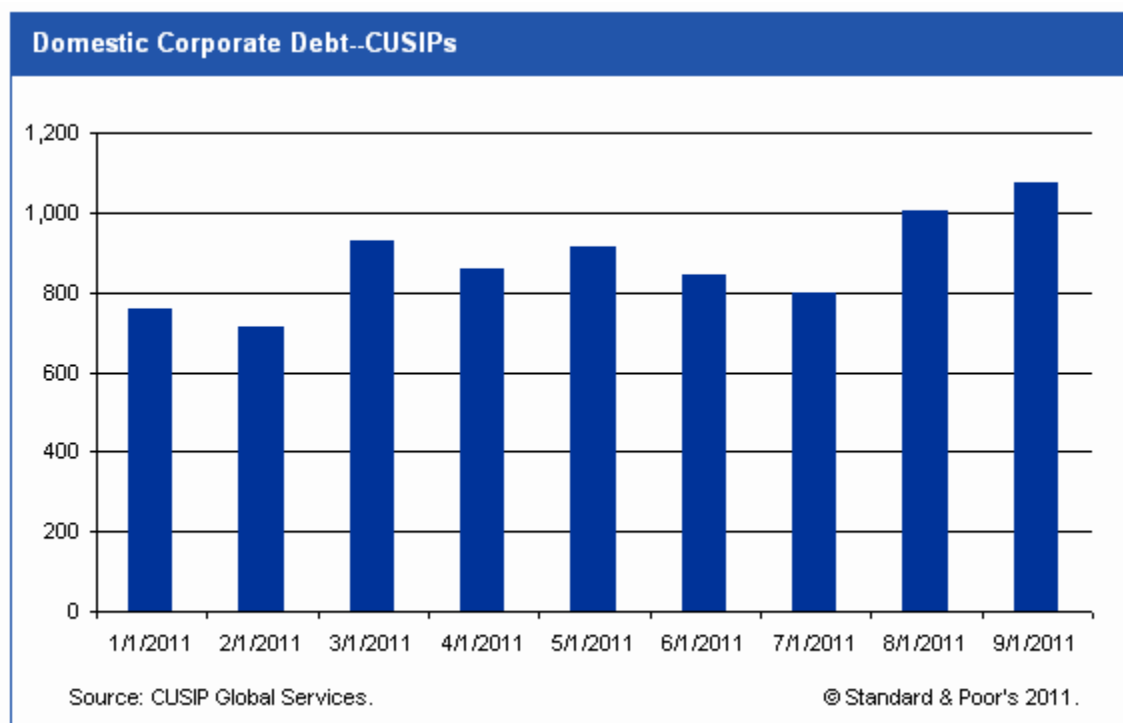
Table 10

U.S. LBOs			
Number of transactions by sector	1/1/10 - 10/5/10	1/1/11 - 10/5/11	Change (%)
Energy	28	18	(0.36)
Materials	61	50	(0.18)
Industrials	135	138	0.02
Consumer discretionary	227	187	(0.18)
Consumer staples	36	43	0.19
Health care	72	67	(0.07)
Financials	141	110	(0.22)
Information technology	94	95	0.01
Telecommunication services	8	4	(0.50)
Utilities	9	6	(0.33)
No primary industry assigned	24	45	0.88
Total	835	763	(0.09)
Valuation summary			
Total deal value (mil. \$)	60,473.71	60,451.38	0.00
Average deal value	195.7	257.4	0.32
Average TEV/Revenue	2.4	3.9	0.66
Average TEV/EBITDA	11.2	10.3	(0.08)
Average day prior premium (%)	23.5	22.1	(0.06)
Average week prior premium (%)	27.6	19.2	(0.30)
Average month prior premium (%)	33.9	18.9	(0.44)

Source: Capital IQ.

Fixed Income

In a credit world in which the five-year U.S. Treasury yield is lower than 1%, and 10-year maturities offer less than 2%, it would seem reasonable that corporate borrowers would want to tap the market under current conditions. Based on recent information from CUSIP Global Services, this seems to be the case, as security identifier requests for domestic corporate securities have accelerated. For the month of September, 1,074 CUSIPs were ordered for domestic corporate debt issues (see chart 10). Besides ranking as the top monthly count of the year for identifier requests, the results revealed back-to-back months of over 1,000 requests. Should this demand translate fully into new offerings, it may bode well for underwriters and capital market participants this quarter.

Chart 10

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S&P Index Commodity Commentary: Where's The Consumer Relief?

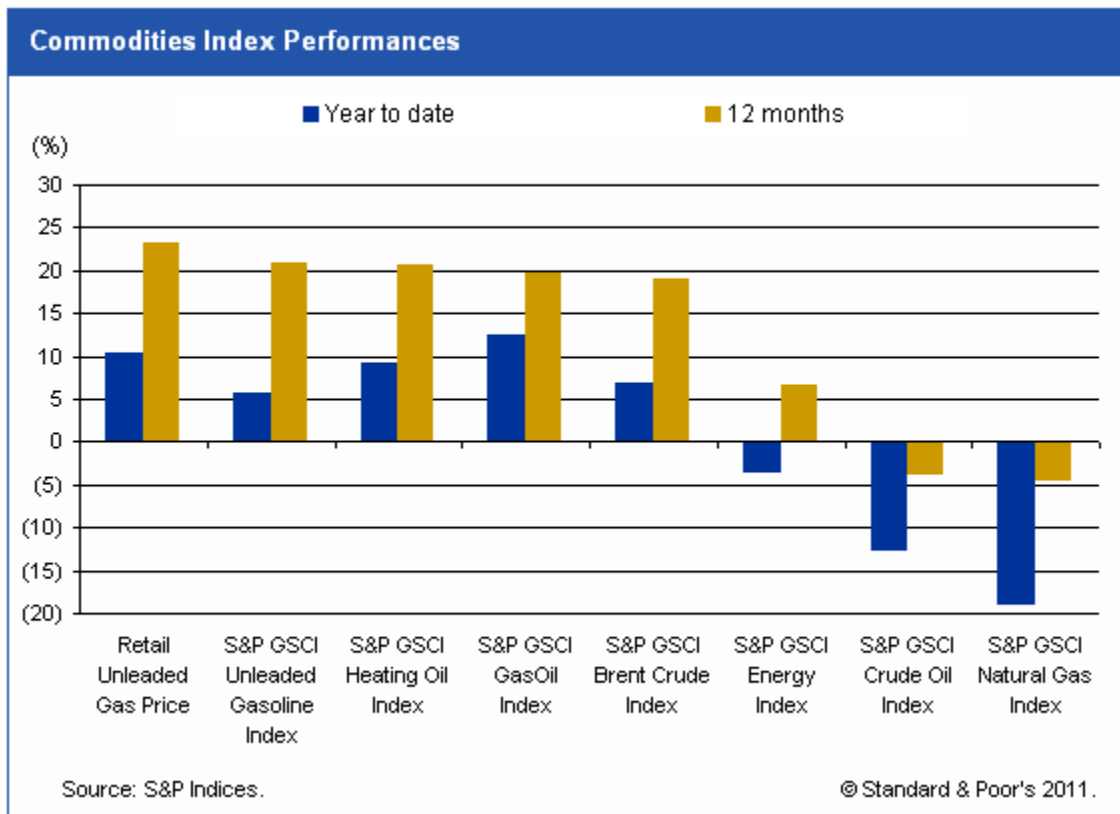
There has been little recovery in commodity prices as of Oct. 5, following the sharp September declines due to the "risk-off" mode in financial markets and fears of a potential global economic slowdown. Among the major sectors, the most significant movement in the fourth quarter as of Oct. 5 continued to be weakness in the industrial metals--the S&P GSCI Industrial Metals declined 1.1% month to date and 24.3% year to date. However, the precious metals performed the best--S&P GSCI Precious Metals Index added 1.2%. The sustained disparity between industrial metals and precious metals remains a negative economic indicator.

Blame Unleaded Gas

High energy prices, most notably unleaded gas, have been a key burden on consumer spending in 2011. Chart 11 shows an increase of 10.4% in 2011 and 23.3% over the past 12 months in the average price per gallon of U.S. retail unleaded gas as of Oct. 5. Spiking energy prices earlier in 2011 are partially to blame for global economic weakness now evident, but despite declining from recent highs, many cash-strapped consumers remain constrained by gasoline bills. Among the individual S&P GSCI Energy indices, the spot S&P GSCI Unleaded Gas showed the greatest increase of 20.9% (past 12 months). The persistence of high prices for unleaded gasoline in the U.S. partially reflects higher overseas prices and strong global demand for refined petroleum products. Indicating declining domestic demand, the U.S. will export more fuel than it imports in 2011 for the first time, while U.S. gasoline use has declined to the lowest level since 2001, according to a recent U.S. Department of Energy forecast. Year to date as of Oct. 5, only the S&P GSCI Gold Index (up 15.02%) has surpassed the performance of the S&P GSCI Unleaded Gas Index, up 12.64%.

Unless unleaded gas prices decline precipitously, consumers should expect little relief.

Chart 11



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Quantitative View: Return Correlation And Dispersion Means The Tough Times For Active Managers Aren't Abating

As we commented last week, 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.

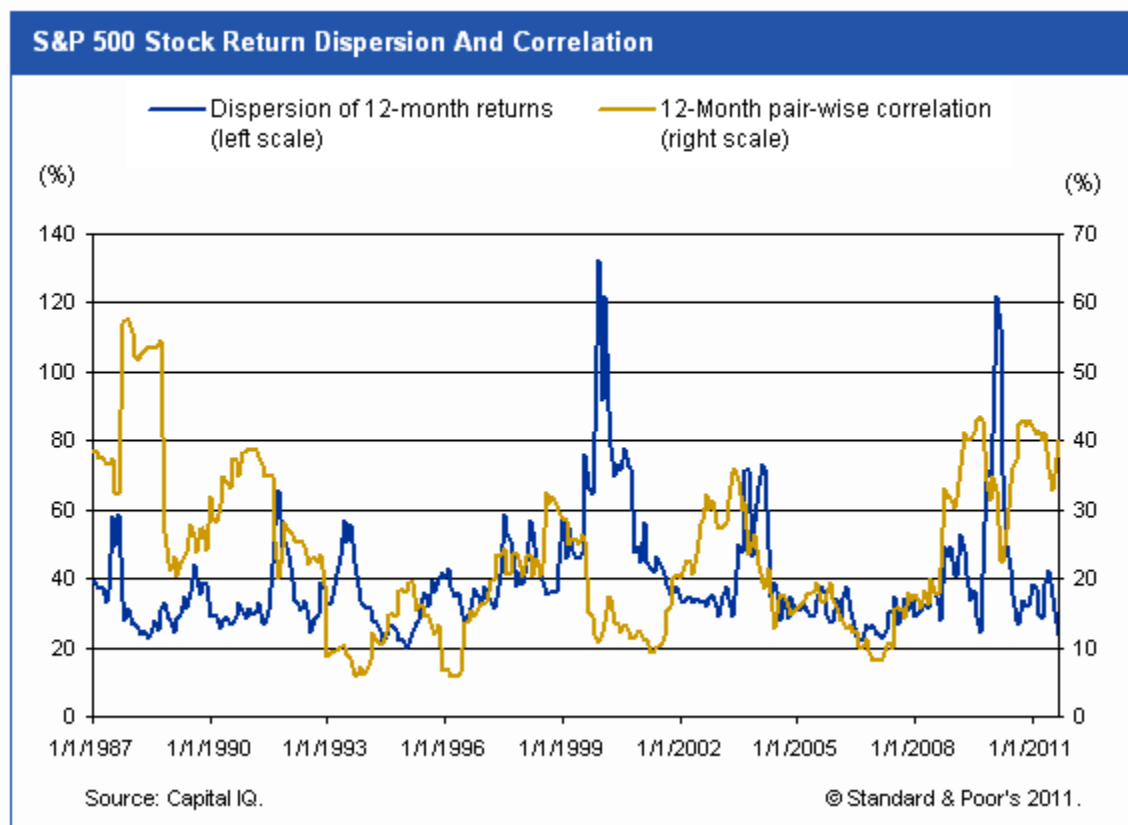
The financial market fixation on macro risks has led to a correlation of stock returns within the S&P 500 Index of 40% in September, up from 35% in August and at levels not seen since the 2008 financial crisis. For perspective, a correlation of 40% places the current relationship in the 91st percentile historically. Simultaneously, the dispersion of returns is tight, currently measuring in the 4th percentile.

Periods of higher return correlations typically coincide with higher market volatility. We measured a 46% correlation between pair-wise correlations and the VIX Index. As of Sept. 30, the VIX stood at 43%. Tarun Chordia, Amit Goyal, and Qing Tong, authors of studies on pair-wise correlations, measured a 27% increase in correlation when stocks decline. They suggest that coordinated selling by retail investors drives the correlation spike, and the popularization of ETF's has

only strengthened 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.

Chart 12 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 12



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