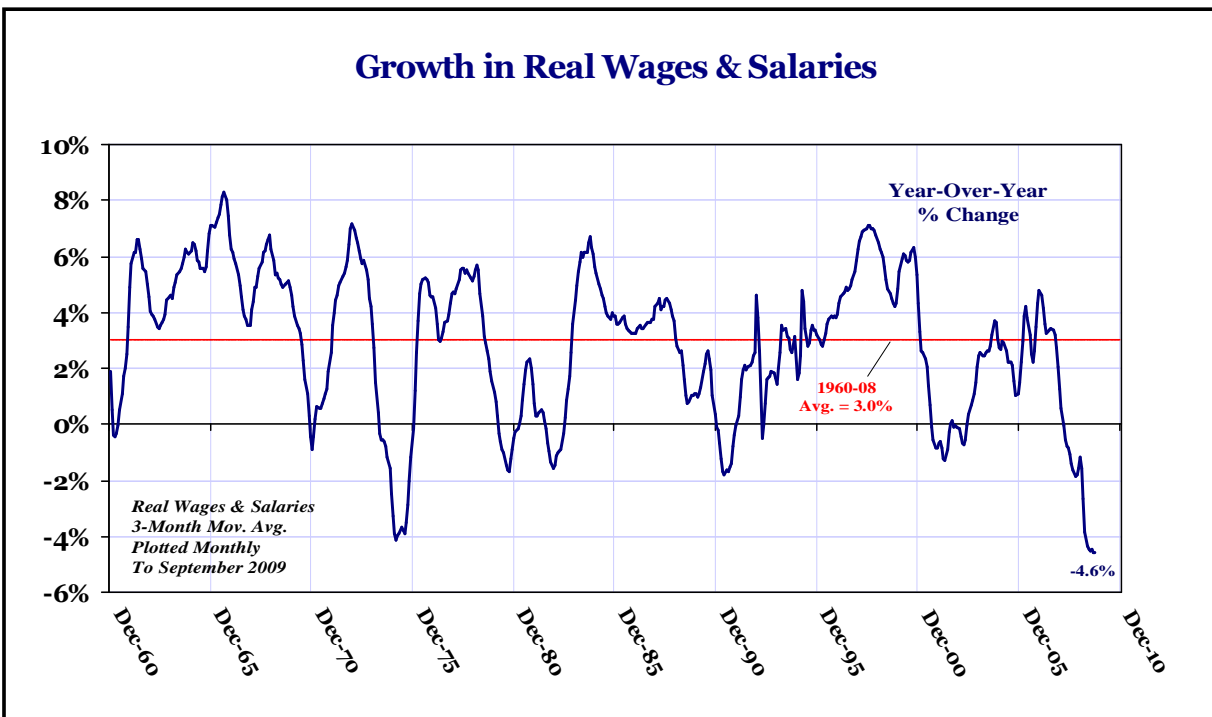


Stocks yo-yo lower for their first monthly decline since February...

October 30, 2009...Stock price volatility reared its ugly head again Friday, with the major market averages declining between 2.5% and 3% and the VIX volatility measure climbing to its highest level since July. The S&P 500's 2.8% drop today was the biggest one-day decline for the market since July 2 – as the last semi-serious correction of this year's rally was winding down – and it easily pushed the big-cap benchmark into the red for the month (-2.0%). After seven positive months for stocks, the tail end of October was indeed disappointing for investors, although a correction that amounts to only one-tenth of the prior gains (roughly 6% down after 62% up) cannot come as too great a surprise. Also disappointing was the jump in volatility to end the month, especially Friday's increase, when the VIX increased by almost one-quarter, from 25% to 31% – the biggest percentage increase in just over a year. The meaning of October's final three days, when the S&P 500 fell 2.0% (Wed.) then bounced 2.3% (Thu.) only to fall 2.8% (Fri.), was somewhat difficult to fathom. Certainly the week's mix of economic news cannot account for the pre-Halloween spooking.



- While Thursday's ebullient market action was probably an exaggerated assessment of economic conditions in the wake of the 3.5% increase in Q3 GDP reported by the Commerce Department, Friday's sharp downdraft following the news that consumer spending declined 0.5% in September was equally puzzling. After four months of increased spending, September's pull-back by consumers was virtually guaranteed by the August ending of the Cash for Clunkers program; realistically, it will take at least another month to assess how robust consumer spending will be in the post-clunkers world. Granted, the retail environment going into the holiday season is somewhat dour, but it is nowhere as bleak as it was one year ago. What's more, a large amount of

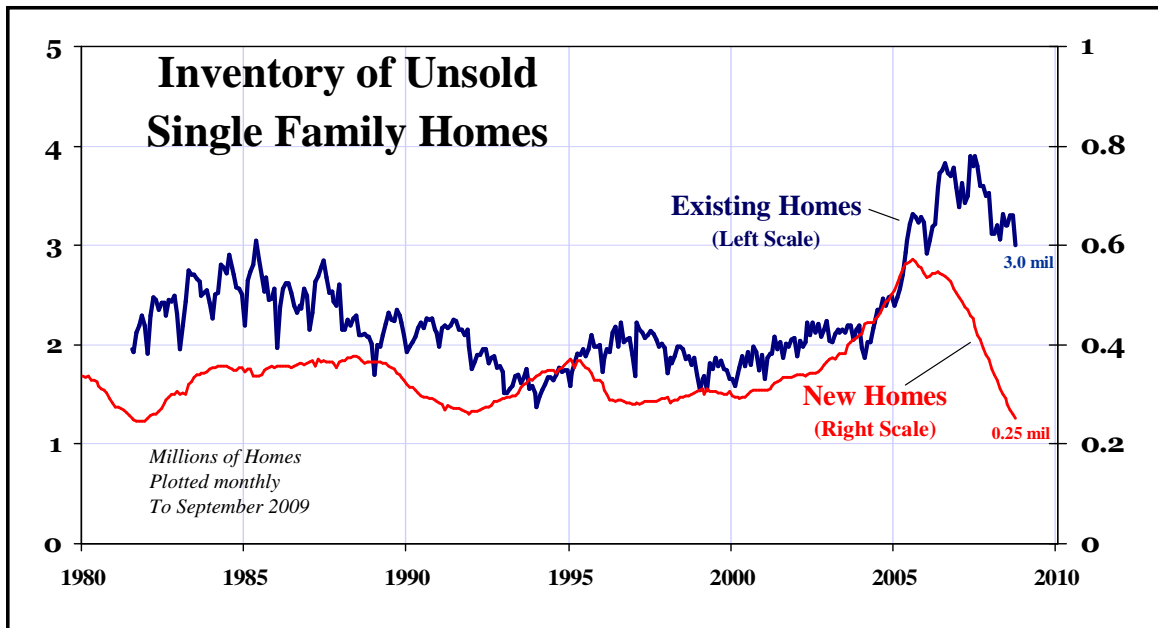
fiscal stimulus dollars have yet to work their way through the economic system, and we don't expect the Fed to begin raising interest rates for quite some time – perhaps not for another 12 months or so. To our way of thinking, the most distressing aspect of Friday's personal income release is the poor trend in wage and salary income (see chart above). Consumer confidence probably won't move decisively higher until the job market starts to improve. And that brings us to one of the better statistics of the past week: continuing unemployment claims hit their lowest level since March. If next Friday's employment report for October substantiates the improvement seen in claims, then wages, salaries, and other personal income ought to begin showing a lot more favorable trends.

INVESTMENT OUTLOOK...Pretty clearly the U.S. economy is no longer in the steep swoon it was in late last year and early in 2009, when GDP declined at an average annual rate of 6%. But, as the latest Fed beige book report made clear, neither is it in the sort of robust recovery typically seen following a steep recession. Still, “cash for clunkers” and inventory restocking pushed real GDP growth to a 3.5% annual rate for Q3, effectively ending the recession. The powerful monetary and fiscal policy actions taken over the past 18 months will likely keep the recovery starting in Q3 going into Q4 and 2010. But consumers may continue to drag their feet and commercial real estate may be a drag on economic growth for some time yet, and we won't be surprised if it takes several more quarters before U.S. real GDP returns to a trend growth rate around 2.5%. While the persistence of the stock market rally that began in March and improvement in the credit market have been indeed impressive, most market rallies do not go so long without experiencing a correction of some significance.

October 28, 2009...Stock prices declined for a fourth straight session Wednesday (and for the seventh time in 10 days), putting the major market averages in the red for October, with the exception of the Dow, which is 0.5% above its September close. By comparison, the S&P 500 is off 1.4% for October, and other indexes have been even softer: Nasdaq, -3.0%; S&P MidCaps, -4.0%; S&P SmallCaps, -5.0%. From their mid-October highs – which also happen to be 12-month highs – the S&P 500 is down 5.0%, compared with 3.3% for the Dow, 5.4% for Nasdaq, 7.3% for the MidCaps, and 8.3% for the SmallCaps. For the S&P 500, this represents the biggest correction since its 7% retreat during the June-July period. Generally speaking, financial stocks and cyclical sectors led the way lower today.

- **Financial stocks and materials stocks were the weakest sectors of the S&P 500 Wednesday, each losing 3.2%, followed closely by energy stocks, which lost 2.9%, and consumer discretionary stocks, which lost 2.8%.** What do these sectors have in common? Each is acutely leveraged to economic growth, and except for the energy sector, each was among the leaders off the March bottom. In other words, they were ripe for profit taking, particularly given the spate of weak economic data seen in recent days. The sell-off in energy shares – and stocks generally – was abetted by renewed weakness in commodities prices, which again reflected

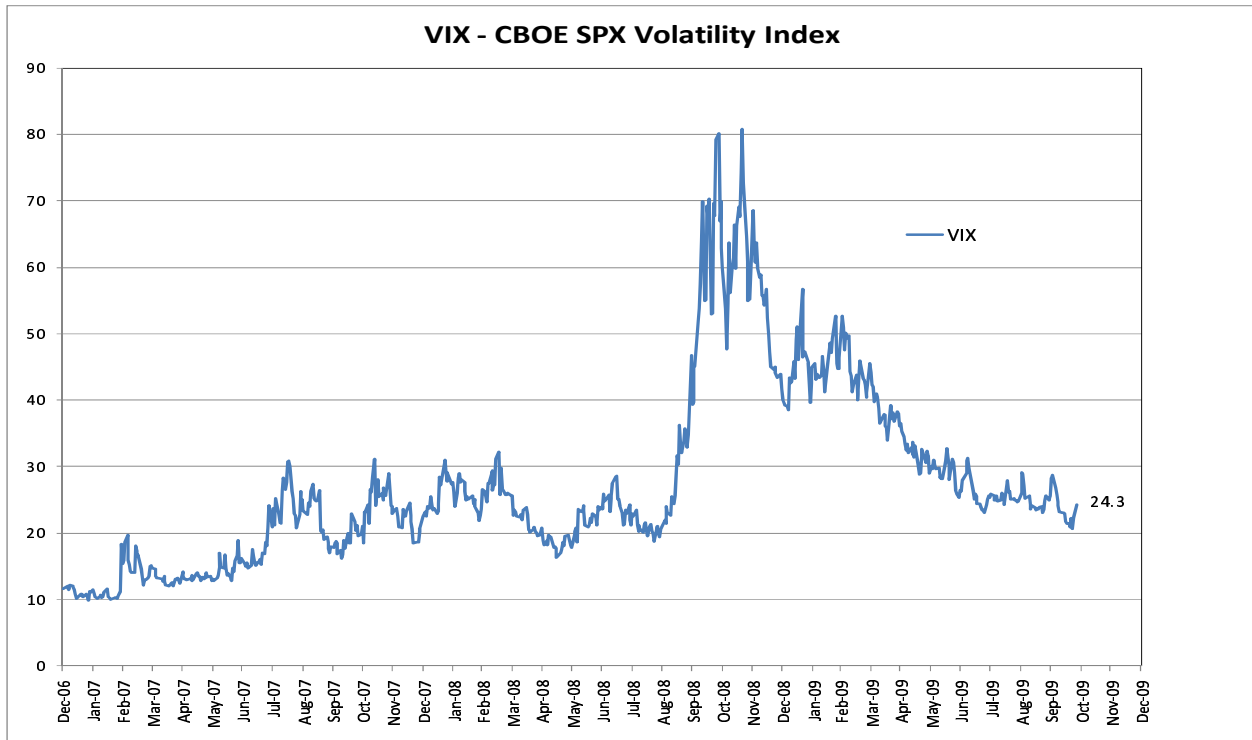
concerns about the economic recovery. Crude oil futures prices were down another 3% today, and gasoline lost more than 4%, as gasoline and crude inventories rose in the latest week. The nation's stocks of crude oil, gasoline, and distillate are all above the high end of their normal ranges for this time of year – another sign of subdued economic demand.



- **Today's economic reports were mixed to weaker, with the surprise decline in new homes sales during September apparently doing the most damage to investor psyches.** The Dow was actually up on the day prior to the report that, after five months of increase, single-family new home sales fell roughly 4% last month (as against the 3% rise that was expected). On the bright side, the inventories of unsold homes fell to the lowest level in more than 25 years. Congress is expected to extend the tax credit for first-time home buyers, which is scheduled to end in November, and to expand it to those who have owned a home up to five years (\$6,500). Congress is also close to extending unemployment benefits by 14-20 weeks, another in the myriad measures designed to stimulate a consumer sector that lately looks to be moribund.

October 26, 2009...Stocks declined for a second day in a row Monday, swinging from an early rally – which had the Dow up to 10050 – to a sharp downdraft just before noon – which lopped 200 points off the blue chip index within an hour. After hitting 13-month highs over the past several days – crude oil futures as high as \$82 a barrel and copper up to \$3.06 a pound – crude oil and copper prices tumbled starting around 10:00 EDT today. Copper ended nearly 3% off its high, while crude oil lost more than 3%. The *Wall Street Journal Online* attributed the fall in commodities prices and stocks to a return of the “risk” trade, and indeed the dollar rallied fairly convincingly against the euro Monday. The chart below shows a sharp rise in VIX, the implied stock market volatility as expressed in the options market. Over a longer-term perspective, the current VIX reading is hardly excessive; still, the failure of VIX to get below 20% is worthy of note. Also noteworthy is the fact that stocks are hanging on to small gains for October (historically

one of the market's weaker months), having posted respectable increases in September (statistically the market's weakest month). Treasury bonds failed to offer a safe haven today, with the 10-year T-note tumbling more than half a point, its yield climbing to a two-month high of 3.55%. The Treasury began Monday to sell \$123 billion in debt securities, which no doubt played a role in today's weakness in Treasuries.



October 23, 2009...Stocks retreated on Friday despite good earnings reports from Amazon and Microsoft and the report of a better-than-expected increase in existing home sales in September. Earlier this week the market reached new highs for this rally, with the S&P up 62% from its low; in this context some retreat in the market, even in the face of good news, is not unreasonable. The Dow closed down 1.1% for the day and 0.2% for the week, moving back under 10000; the S&P 500 was down 1.2% on Friday and 0.7% for the week. Nasdaq, which got some support on Friday from the upbeat reports from Amazon and Microsoft, closed with a more modest 0.5% loss for the day and was down 0.1% for the week. Overall, Q3 corporate profits are coming in about 15% better than expected, though still down year-over-year; revenues are coming in about where Wall Street expected them to be.

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