LADENBURG THALMANN
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Ladenburg Thalmann Asset Management
Market Commentary
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Overview

The S&P 500 is up 16.44% this year due in large part to global stimulus by world-wide central banks and the continued strength of the United States' largest companies' earnings yet the US gross domestic product (GDP) is at only 1.3% annualized. Also supportive of the US economy is the personal savings rate of 3.7% and retail sales growth of 2.7% over the last year thereby implying consumer consumption has been healthy. Inflationary pressures remain generally well contained, a key reason why the Federal Reserve was comfortable easing monetary policy once again in September. While the Federal Reserve's loose monetary policy is designed to ultimately decrease unemployment, which is elevated at 7.8%, the number of people who have given up looking for work is near a 30 year high. Many are focusing on the potential Eurozone debt crisis; however, we see the potential for greater short term risks involving uncertainties surrounding the looming "Fiscal Cliff". Estimates show that tax increases and spending cuts set to go into effect at the end of 2012 would cause GDP to fall below 1%, sending the U.S. economy into a recession. We expect most of these talks to be tabled until after the U.S. presidential elections, at which point we see potential for increased volatility. Our portfolios have been defensively postured for the majority of the year, however, we have been able to capture much of the market run up experienced thus far.

Domestic Equity

The US equity market doubled its historical annualized return of 8%, however, stocks are still inexpensive considering that earnings are high relative to current stock prices. US corporations continue to post rising profits albeit at weaker levels as of late. On the other hand, manufacturing has been slowing, but companies may be postponing purchases of big ticket items until after the election with hopes of gaining more clarity on public policy. A decrease in these orders can cause companies to play catch up in the future, improving purchasing, leading to improved manufacturing down the road. Despite recent market performance, retail investors are still cautious on equities. Since December 2007 over $500 billion has been withdrawn from equity funds while over $1 trillion has been invested into bond funds. This shift across asset classes shows the overall consensus of investors about the risks associated with equities. We continue to overweight domestic allocations over international equities as well as large cap and growth investments over small cap and value investments to help protect the portfolios against future volatility.

International Equities

In September, the European Central Bank (ECB) announced that it would purchase bonds from struggling governments without limit. This eased pressure on the vulnerable Eurozone countries (i.e. Greece, Italy and Spain) and led to a rally in the equity markets across the globe. Despite recent optimism that European debt problems have been contained, many serious issues still need to be settled. International and emerging markets are lagging US equities due largely in part to their currency valuations. Ironically, emerging markets are starting to be viewed as safe investments relative to other international developed nations due to their strong growth of the middle class, lower level of government debt and younger populations. Frontier markets, in particular, have performed strongly and added diversification benefits to our strategies as we continue to reduce our international developed exposure to add to emerging and frontier markets.

Fixed Income

Interest rates have fallen to near historical lows, driving bond prices higher thus extending the 30 year bull market for bonds. To put this in perspective, more than half of the companies in the S&P 500 have a dividend yield higher than the 10-year Treasury bond yield. The Federal Reserve is committed to keeping interest rates at these levels through 2015 and recently launched a third round of quantitative easing. Interest rates on bonds remain artificially low, meaning bonds will continue to produce below average yields, despite US Government debt expanding above $16 trillion. This makes bonds more susceptible to inflation and therefore, we continue to favor high quality corporate and high yield debt over Treasuries. The credit quality of corporations continues to improve with default rates below historical norms. Internationally, emerging market bond funds have out performed international developed bonds largely due to their healthier economies and lower levels of debt.

Alternatives

In March, we added gold and MLPs (Master Limited Partnerships) to the alternative allocation in our portfolios due to the slowing global economy and looming US "Fiscal Cliff". Furthermore, concerns of global currency depreciation stemming from global central bank easing, such as QE3 in the US, have provoked investors to flock towards gold as a hedge. Gold is a currency that does not pose a liability to any country in that it can't simply be printed by the world's various central banks. Roughly $3 billion of investments were added to gold in September alone and the influx led gold prices to rise 11% over the third quarter. We believe we are on the cusp of a rapid US energy expansion with the US already saving $264 million dollars a day by using natural gas in lieu of foreign oil. The increase in activity in commodities has had a positive effect on MLPs and the Alerian MLP TR index returned 8.9% for the quarter. Similar to commodities, MLPs provide an inflation hedge to the portfolios but are less volatile and offer a strong dividend yield. Managed futures, which are almost flat for the year, have underperformed, but the long term benefits of our alternative investments continue to provide benefits to the portfolios due to their low correlation to the broad market.

Real Estate

Recent data suggests the housing market recovery is gaining traction. Existing-home sales during August increased at their fastest rate in two years, with prices on these homes rising nearly 10% over last year. Housing starts were also up during the month, though permits slipped a bit. The median price of a new home was up 11.2% in August, the largest monthly increase ever recorded (data going back to 1963). Continued improvements in the real estate market will help to boost GDP growth as new construction leads to increased employment and manufacturing.

Conclusion

The economy continues to be challenging and the political outlook remains uncertain. The European Monetary Union's structural limitations, the dysfunctional character of the American political system and the rigid nature of the Chinese economy remain unresolved. We therefore expect continued slow economic growth, with periodic increases in market volatility and less uniform performance. However, the deepening commitment by central bankers toward reflationary policies suggests that the risks of either a wide scale global economic contraction or a sharp sell-off in the financial markets are somewhat muted for now. Given the large amount of uncertainty, it is very difficult to predict how the markets will react in the coming months. We believe that planning for financial success includes applying core investment principles of portfolio diversification, risk management, and disciplined long-term investing. Our portfolios are currently positioned to potentially take advantage of further advances in the market as well as to navigate through periods of further volatility.