

The Fairlead Quarterly

Third Quarter of 2010



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Quarterly Overview

The equity markets posted a very solid third quarter, recouping all of the losses experienced during the second quarter, and leaving them...well, almost exactly where they were six months ago at the end of the first quarter. All of the major equity indices experienced double digit returns, with the growth side outperforming value in every instance. Large Cap (Russell 1000) posted an 11.55% gain (to offset last quarter's 11.44% loss), Mid Cap posted a 13.31% gain and Small Cap (Russell 2000) an 11.29% gain. The overseas markets were even more impressive with Emerging Markets (MSCI Emerging Markets Index) up 18.16% and EAFE, which was the big loser in the second quarter (down 13.75%), coming back nicely with a 16.53% gain. Concerns over the European Debt Crisis seem to have taken a back seat - at least for now. The bond markets continue to chug along as investors - tired of getting ZERO return on money markets have been pouring money into bonds - leading some to wonder if bonds, particularly treasuries, are the next bubble in the making.

The bulk of the positive returns in the equity markets across the globe came in September, the last month of the quarter and historically a month with a reputation as a losing month in the market.

It also bears mention that the dollar's significant decline against other currencies provided

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a significant tail-wind for the overseas returns.

The Backdrop

Macro vs. Micro: Over the past year we have witnessed a struggle between macroeconomics and microeconomics playing out in the equities (stock) markets. If we focus on microeconomics - looking at company level performance, things appear to be on the mend. Corporate sales and earnings are up, productivity is up, there are growth prospects in many emerging markets, and many companies are sitting on piles of cash contemplating growth through acquisition. This is all pretty good news and makes a pretty compelling case for equities.

But whenever the market focuses on the macroeconomic picture future prospects seem murkier and the landscape appears fraught with risk. Housing and employment continue to be the recovery's Achilles heel and while one might argue that a trillion dollars of stimulus stopped a free-fall, it casts a spotlight on significant fiscal and monetary challenges ahead.

Global Sovereign Debt: As our European counterparts have begun drafting and implementing austerity measures (as witnessed by rioting and protests in France and Greece) the threat posed by the global sovereign debt appears less imminent and this has allowed the markets to focus on the more encouraging microeconomic news.

Inflation: Remains very low as measured by the CPI with a slight increase of 0.16% over the past three months and 1.08% over the past year. The inflation we have seen has been primarily in food and gasoline. But there seems to be a bit of a disconnect between our inflation rates/expectations and what's going on in the commodities markets – where gold, tin, cotton, copper, and rubber are all trading at all time or 27 month highs.

Bond Credit Spreads: Bond credit spreads tightened over the quarter as investors look to generate some kind of yield off of their investments. September was the fifth straight month that the yield on Two Year Treasury Notes hit a record low. That investors are willing to accept such low returns reflects that investors expect low inflation and an accommodative monetary policy for some time to come.

The US Dollar: The dollar declined against most major currencies over the quarter. As noted, this decline helped commodities and overseas returns.

GDP, the Fed & Monetary Stimulus: The Fed was really a strong catalyst for the September rally. Let's look at some of the news highlights beginning with August 25th.

“The –27% drop in New Home Sales reported yesterday (Aug 24th) sparked a big rally in the Treasury market.” With the home-buyer tax

credit, which pulled demand forward, having expired this drop in activity was probably to be expected – but down –27% is worrisome.

The August 27th Wall Street Journal (WSJ) “U.S. economy grew more sluggish than initially estimated in the second quarter. Gross Domestic Product (GDP) rose at a seasonally adjusted annual rate of 1.6%, less than the 2.4% (33% less) originally estimated.”

September 12th WSJ News Alert, “Three in five economists surveyed by the Wall Street Journal expect the U.S. Federal Reserve to resume large-scale bond purchases in the face of a deteriorating economic outlook – but, by a 3-to-2 margin, most of them also think that would be a mistake.”

September 21st WSJ News Alert, “ Fed officials signaled at the end of their one-day policy meeting they are uncomfortable with the recent very low levels of inflation and said they expect the economy's recovery from a deep recession to be modest in the near term. This indicates that more bond purchases to stimulate growth could soon take place.”

The interesting thing here is that most of the economic news is essentially bad news, yet the belief that the Fed would continue with its easy money policies in light of the bad news, was enough to spur the market on.

These bond purchases by the Fed are referred to as “Quantitative Easing” (that's the only tool the Fed has left with interest rates at 0), and since this is the second round it is being referred to as QE2 – let's just hope it doesn't turn into the Titanic.

Housing: Housing is still the major threat to the recovery. In September it was announced that the S&P/CaseSchiller Home Price Index fell –.013%, a greater decrease than expected

and a reversal from the 0.24% increase in June. In other words, home prices are still falling. Mortgage delinquency rates continue to be high, default rates are high and there is little doubt that banks are manipulating their foreclosure inventory to help support the market.

Unemployment: Unemployment is persistent and published figures are not encouraging either for their content or accuracy. Does anyone really know the true number? Let's take a quick look at the announcements on September 3rd:

"The Bureau of Labor Statistics (BLS) reported this morning Total Non-Farm Payrolls fell a less than expected -54,000. This follows an upward revision in the July payroll data to a minus -54,000 compared to the -131,000 decline originally estimated".

So a loss of 54,000 jobs in August is good news because it's not as bad as was expected (less bad news = good news). Even if you buy that, how can you have any confidence in their numbers when they follow it with a revision for July which missed its original estimate by 60%??!!

All of the numbers keep getting revised upwards (better) - but they are hardly credible.

And as we predicted last quarter "as State's begin to grapple with their own fiscal challenges (they can't print money like the Federal Gov't) we will begin to see accelerating layoffs from state and local governments". These layoffs are beginning to show up in the employment data - so while private employment shows marginal improvement public employment deteriorates.

Oil & Commodities: The DJ/UBS Commodities Index was up 11.61% during the quarter - and while crude oil was up *only* 5.74%, the MSCI Metals and Mining Index was up 19.95% - that is huge. The decline of the dollar contributed to the size of these figures, but one has to wonder if inflation can remain almost non-existent when the costs of many raw materials are on the rise. In the near term it is possible these prices will pull back - the International Monetary Fund just announced "Global growth will slow more sharply than originally expected in 2011" - but we are still believers in a long-term bull market for commodities.

Gold continued its move to new highs closing up 5.06% for the quarter - and up 20.19% for the year.

Going Forward

While there are many challenges, the market is said to "climb a wall of worry". Optimism about the coming elections producing a more favorable business climate, the prospects for global (if not US) growth, and finally, the sheer volume of cash looking to be more productive could propel the markets upward. We continue to be cautious and focus on balanced portfolios that are well diversified with high quality global franchises. Higher taxes, high unemployment, weak housing and broken fiscal policy at a local, state and national level present challenges that will, as we said last month, "continue to weigh on the markets for some time to come leading to greater market cyclicity."

As always I am available to discuss the markets, the economy, your portfolio and your concerns.

JOHN VREELAND

SUMMARY OF INDEX RETURNS

Global Markets Year to Date				
INDEX	3rd QTR of 2010	Calendar Year 2009	Calendar Year 2008	UNMANAGED INDEX DESCRIPTION
Russell 1000	11.55%	28.43%	-37.6%	<i>US Large-cap Stocks</i>
Russell 1000 – Growth	13.00%	37.21%	-38.44%	
Russell 1000 – Value	10.13%	19.69%	-36.85%	
Dow Jones Industrials – Total Return	11.13%	22.68%	-35.65%	
S&P 500 – Total Return	11.30%	26.46%	-37.00%	
NASDAQ Composite	12.30%	43.89%	-40.54%	
NASDAQ – 100	14.89%	53.54%	-41.89%	
Russell Mid-Cap	13.31%	40.48%	-41.46%	<i>US Mid-cap Stocks</i>
Russell Mid-Cap – Growth	14.65%	46.29%	-44.32%	
Russell Mid-Cap – Value	12.13%	34.21%	-38.44%	
Russell 2000	11.29%	27.17%	-33.79%	<i>US Small-cap Stocks</i>
Russell 2000 – Growth	12.83%	34.47%	-38.54%	
Russell 2000 – Value	12.13%	20.58%	-28.92%	
MSCI World ex USA	16.21%	34.39%	-43.23%	<i>Morgan Stanley World ex USA (US\$)</i>
MSCI Emerging Markets	18.16%	79.02%	-53.18%	<i>Morgan Stanley Emerging Mkts (US\$)</i>
30 Day Money Market – All Taxable	0.01%	0.16%	2.03%	<i>Cash</i>
Consumer Price Index – US	0.16%	2.9%	4.31%	<i>Measure of Inflation</i>
Barclays US Corp. High Yield Index	6.75%	58.21%	-26.15%	<i>High Yield (Junk) Bonds</i>
Barclays US Aggregate Bond Index	2.48%	5.93%	5.24%	<i>General US Bond Index</i>
FTSE NAREIT REIT: All	11.24%	27.45%	-37.34%	<i>Real Estate Investment Trusts</i>
Dow Jones – UBS Commodity Index Tot Ret	11.61%	18.91%	-35.65%	<i>Basket of Commodities</i>
Crude Oil – Arab Light Crude	5.74%	77.94%	-49.94%	<i>Price of Arab Light Crude</i>
Gold – London PM	5.06%	25.04%	4.91%	<i>London Spot Price</i>

Source – Thomson Financial Company