Ladenburg Thalmann Asset Management
LAMP Market Commentary
October 2009

Summary

We have seen a strong market rally since the March lows consisting of consecutive quarters with the S&P returning over 15% and recouping some of what was lost in 2008. While we remain cautiously optimistic, we do not expect to see this pace continued until there are further improvements in the economy since the rally has been largely lead by the government stimulus. A prolonged recovery is not sustainable without job creation and wage growth especially since unemployment has reached a 26-year high of 9.8%. While consumer spending has increased slightly, much of this can be attributed to government stimulus such as “cash for clunkers.” Instead of reducing overall debt, government debt has replaced the private sector debt increasing the Fed’s budget deficit from $459 billion last year to $1.4 trillion. As a result, the dollar continues to decline against other currencies, which can be beneficial in making American exports more competitively priced, but will ultimately hurt our purchasing power. While we continue to have concerns over the general health of the U.S. economy, there are positive indicators that suggest the worst may be behind us. The credit freeze has subsided, liquidity is returning to the market, and home prices posted a second consecutive month of gains. The most recent Consumer Sentiment survey showed an increase in September of 4.5 points to 70.2, which is near a 12-month high. While the economic indicators are mixed, our disciplined investment approach has allowed us to stay on course. Our portfolios have performed strongly, most outpacing their benchmarks year to date. The tactical shifts that we made to our portfolios throughout 2008 and 2009 have proven to be beneficial and should continue to protect on the downside if there is a pullback in the market. Some of these shifts include the addition of a managed futures position, international and high yield fixed income exposure, growth and large cap bias, and in the conservative portfolios we replaced a portion of the cash allocation with a conservative higher yielding position made up of US Government securities.

Domestic equities

The S&P 500 returned 15.61% in the third quarter, up 19.26% year to date. The rally in US equity markets was mostly driven by a severe undervaluation and increased appetite for risk while economic conditions improved such as manufacturing and the restocking of inventory. We are carefully monitoring corporate earnings reports and economic factors such as consumer spending to determine the trends going forward. Traditionally coming out of a recession, small caps tend to outperform large caps and value outperforms growth. However, since we have on going concerns about the economy, we are maintaining our large cap and growth bias because they have historically provided downside protection. This may result in giving up some returns, but we will still benefit if the market continues to rally.

International Equities

International developed and emerging markets returned 19.46% and 20.91% respectively for the third quarter and are up 28.97% and 64.45% year to date. Much of the outperformance, when compared to domestic equity markets, can be attributed to a declining dollar. In fact, year to date returns between the S&P 500 and MSCI EAFE (an index representing international developed equities) is comparable when you remove the added return caused by the dollar fluctuation. Since emerging markets have proven to be less reliant on developed markets, have a growing middle class, and a greater capacity to reduce debt based on their manufacturing capabilities, we expect stronger growth from this asset class over developed markets.

Fixed Income

The Federal Reserve is likely to keep the federal funds target rate at the range of zero to 0.25% for an extended period of time and continues to buy mortgage backed securities to facilitate a full recovery in the economy. We have seen credit spreads, which is the difference in yield between securities of different credit quality, narrow signaling that investors' appetite for risk has returned. Treasuries have been the worst performing fixed income sector (-2.3% YTD) and high yield has been the best (+49% YTD). The massive amount of stimulus that the government has pumped into the market is weakening the dollar which recently sank to a one year low against the Euro. Our international fixed income exposure provides protection against a continued decline in the dollar. With the possibility of inflation due to excess government stimulus, the shorter duration of our fixed income allocation will act as a hedge while continuing to provide income with less price fluctuation.

Real Estate

The real estate sector has improved shown by the MSCI REIT Index gaining 34.42% in the third quarter. However it's too early to tell whether the housing market has bottomed and if the commercial real estate market is still deteriorating. Rents and occupancies are weakening, property values are down, and delinquencies and defaults continue to rise. Because of the overall weak fundamentals of the industry, we are reviewing our allocation to the sector which we have held due to its diversification benefits and traditional dividend yield.

Natural Resources

Although volatile, the long term outlook for natural resources is positive due to improving global fundamentals and increased demand from expanding emerging markets. The Goldman Sachs Commodity Index has rallied 30% year to date, outpacing the S&P 500. Signs of global economic stabilization and an anticipated recovery are already being priced into resources with industrial metals up 50% since the start of April and oil prices up about 40% to around $70 a barrel. Natural resources also act as a hedge against the devaluing dollar in the event that the massive amount of debt issued by the Fed ultimately leads to inflation.

Conclusion

We continue to monitor the equity markets and have the portfolios hedged for a possible pullback since the current fundamentals indicate the market is somewhat overvalued. Our tactical changes have lowered the risk of the portfolios and allowed us to secure some profits throughout the year. We maintain exposure to equities in case this rally continues.