SELECTOR® Money Management
2012 Third Quarter Review

The third quarter, like the first quarter, was constructive and benefitted from the Federal Reserve's QE3 announcement. That late push boosted the S&P 500 up through a resistance level that had effectively turned markets back in April and May. While the actual announcement was hardly a surprise, the equity markets' reaction was a relief, as historically they have been known to 'rise on the rumor and sell on the news.' The economic reports preceding the Fed's announcement were so consistently bleak. Anything but a QE3 announcement would have indicated that the Federal Reserve had lost touch with the seriousness of the nation's economy. So the potential selling was reserved for no QE3. An interesting twist, all in all. The surprise came from the Fed's proclamation that they intended to keep interest rates low into mid 2015.

A quick review of the numbers for the third quarter reflect the breadth of the markets advance. The Dow Jones Industrial Average (DJIA) rose +5.02% in the quarter and now stands at +12.19% for the year. The S&P 500 gained +6.35% in the quarter and is +16.44% YTD. Mid Cap equities continued to trail the Large Caps, with the S&P 400 MidCap Index gaining +5.44% for the quarter and the Russell 2000 gaining +5.25% in the third quarter. These indices now stand +13.77% and +14.23% YTD, respectively. A significant shift in the third quarter was the surge in the international equity markets, after a most difficult second quarter, and in spite of their highly publicized financial difficulties. The MSCI EAFE Index, which is heavily weighted with European equities, gained +6.92% in the third quarter and is now +10.08% YTD. The MSCI Emerging Markets Index gained an even more impressive +7.74% in the quarter to finish with a gain of +11.98% YTD.

Bond markets also enjoyed a good quarter, which marks yet another period when bond markets and equity markets advanced hand in hand. This high level of correlation between equity and bond prices continues to beguile market historians and technical market analysts alike. Historically, this relationship is quite opposite, such as we saw in the second quarter when bond markets were as strong as equity markets were weak. When they advance in concert it defies the non-correlation themes of classical asset allocation. Of course, you aren't going to hear any investors complaining when both their stocks and bonds show gains simultaneously. The Barclays Capital U.S. Aggregate Bond Index rose +1.58% in the third quarter to stand at +3.99% YTD. The Barclays Capital Municipal Bond Index gained +2.32% in the quarter to finish up +6.06% YTD. The Barclays Capital U.S. Corporate Investment Grade Index advanced by +3.83%, to finish the third quarter up +8.66%, with the Barclays Capital U.S. Corporate High Yield Bond Index chasing the equity markets' advances by gaining +4.53% in the quarter and standing with a YTD gain of +12.13%. Government bonds continued their muted responses, with the Barclays Capital 1-3 Year Government Bond Index +0.02% in the quarter and up +0.44% YTD, and the Barclays Capital US Treasury 20+ Year Index up +0.07% for the quarter and up +4.34% YTD.

With all of this good news, there are two sectors which had very different third quarters. The most striking diversion has been occurring in the transportation sector. This sector had been lagging through the first half of 2012 but in the third quarter it fell sharply, as evidenced by the drop in the Dow Jones Transportation Average (DJTA) of -5.70%. The DJTA was -1.34% YTD at the end of the third quarter. The transportation sector is composed of trucking, railroad, airline and shipping companies that move goods and people across the nation. They are generally regarded as indicators of the industrial condition of the country and their very poor relative performance gives one pause as to the true state of our economy. The second sector which had a less than stellar third quarter was the real estate sector as represented by the S&P U.S. REIT Index. This was one of the top performing sectors through the second quarter of 2012. But in the third quarter it managed only a +0.09% gain, still sitting with a gain of +15.03% YTD. The price action for the REIT sector has been broadly lower the last two weeks of September.

The final big story of 2012 lies in the upcoming elections. Regardless of the outcome, the winners will be faced with an anemic economy and a number of very difficult fiscal decisions. It will be very interesting to see how financial markets react as they continue to digest QE3 and the prospect of the longest period of suppressed interest rates in our nation's history. We remain in a three and a half year old Bull Market. The fourth quarter may prove to be the most interesting of the year.

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