

DiNuzzo Index Advisors, Inc.

FEE-ONLY WEALTH MANAGERS

Quarterly Market Update

October 1, 2012

Climbing the Wall of Worry

It seems like every quarter we find ourselves saying the same thing: what a difference a quarter makes! In the first two months of 2012, the U.S. stock market was recording excitingly positive returns. The U.S. economy seemed to be back on track and there was talk that the Euro crisis was finally behind us. Even the pullback in March left the markets in positive territory. Then came a difficult second quarter where the indices fell across the board, nearly wiping out the first quarter gains. Now, in the last three months, while many investors were still anxious about Europe, deficits, paralysis in Washington and unemployment, the markets have delivered an unexpected gift: a steady, gradual rise in stock prices that seemed, week by week, contrary to the mood expressed in the financial press.

Here at the end of the third quarter, entering the home stretch for the year, the returns on many of the broad stock indices are, surprisingly, well into double-digit territory. Market historians will look back on the past three months as a bullish quarter, and probably conclude that investors in the first three quarters of 2012 must have been feeling ebullient bordering on giddy.

Overall, the Wilshire 5000--the broadest measure of U.S. stocks and bonds--was up 6.15% for the third quarter, and is returning a robust 15.85% so far this year. The comparable Russell 3000 index rose 6.23% during the third quarter, and is now up 16.13% for the year.

The other stock market sectors moved in a very similar pattern. Large cap stocks, represented by the Wilshire U.S. Large Cap index, were up 6.25% for the quarter, and now stand at a 15.97% overall gain so far in 2012. The Russell 1000 large-cap index gained 6.31% for the third quarter, putting it up 16.28% for the first nine months of the year. The widely-quoted S&P 500 index of large company stocks gained 5.76% in the same time period, and is up 14.56% so far this year.

The Wilshire U.S. Mid-Cap index rose 5.59% in the three months ending September 30, up 11.86% for the year. The Russell midcap index was also up 5.59% in the recent quarter, with a 14.00% gain so far this year.

Small company stocks have posted returns nearly identical to the large multinationals. The Wilshire U.S. Small-Cap gained 5.16% in the third quarter, up 15.19% in the first nine months of 2012. The Russell 2000 small-cap index gained 5.25% in the three months ending September 30, and has returned 14.23% for the year so far. The technology-heavy Nasdaq Composite Index was up 6.17% in the third quarter, up 19.62% year to date. Twelve years after the "tech wreck" disaster in this sector, tech stocks appear to be market leaders again.

The next time you read gloomy headlines about the economy, remember that every single industry sector in the S&P 500 is posting gains so far this year, led by telecommunication stocks (up 21.04%), information technology (up 20.64%), consumer discretionary goods manufacturers (up 19.99%), and financial stocks (19.88% gains so far this year).

Global stocks have not been as robust as American shares, but they, too, are in positive territory. The broad-based EAFE index of developed economies rose 6.14% for the third quarter, and is now in firmly positive

territory, with a gain of 6.95% so far this year. For the first time this year, European stocks are showing gains for their investors, in dollar terms, up 8.13% for the recent quarter, now up 8.00% for the year.

The EAFE Emerging Markets index of lesser-developed economies rose 6.97% in the third quarter, and is now up 9.41% for the year. Interestingly, the highest returns of any global index came from emerging African nations (minus Zimbabwe, which is one of the ways that EAFE calculates its indices), which are up an aggregate 34.70% so far this year. Second place goes to an index made up of the Jordanian, Egyptian and Moroccan stock markets, up 32.81% in the first three quarters of 2012.

Commodities have also moved into positive territory, with the S&P GSCI index rising 11.54% for the quarter, now up 3.47% this year. Energy and petroleum prices are up very modestly (0.55% and 0.93% on the year respectively); the biggest mover is agriculture (up 18.44% so far this year), with grain prices rising 31.05% due to the Midwestern drought.

On the bond side, those of us who could not imagine how U.S. Treasuries could possibly offer lower yields are watching it happen. The 12-month T-Bonds are now yielding just 0.15%, as investors seem to be happy to essentially lend the government money with a promise that they will get it back again 12 months later. Locking up your money for three years gets you 0.31% a year. Ten-year issues yield 1.63%, and 30-year Treasuries bring a 2.82% annual coupon yield. Muni bonds are also down from where they were last quarter, with aggregate yields of 0.203% (1-year), 0.286% (2-year), 0.624% (5-year) and 1.742% (10-year). The aggregate of all AAA corporate bonds is yielding 0.76% for bonds with a five-year maturity.

Is there an explanation for this three-month bull market during what can only be described as trying economic times? People who have long experience with the investment markets are fond of saying that rallies "climb a wall of worry;" that is, the markets go up most steadily when it requires courage to buy into them. These past three months seem to be one of the best examples of this adage that you are likely to see. Today, it requires a certain degree of courage to believe in the long-term future of the economy and the long-term return on investments, and yet the market rise is evidence that many investors are finding that courage amid the discouraging headlines.

Some economists think that the stock rally was a gift from the central banks. For months, it was rumored that the U.S. Federal Reserve Board would engineer another stimulus package, which had already been dubbed "QE3"--and indeed Fed Chairman Ben Bernanke announced that the Fed would inject \$40 billion a month into the market for securitized home mortgages, adding to the money supply, possibly driving down mortgage rates and (again possibly) stimulating the housing and homebuilding sectors of the economy into hiring again.

Meanwhile, the European Central Bank has finally announced that it would do what economists were calling for three years ago: purchase Eurozone government bonds to reduce the borrowing costs of countries that are restructuring their finances--notably Spain and Italy. After two press conferences on different sides of the Atlantic, some of our worst-case economic scenarios (a 2008-like collapse of the Eurozone banking system; a U.S. recession) seem to have become less likely to occur.

The U.S. economy is certainly not in danger of breaking any speed records as it continues to climb out of the Great Recession; in the last week of September, the government announced that from April through June, GDP grew just 1.3%. Economists remain wary of the "fiscal cliff"--the simultaneous expiration of lower tax rates and automatic federal budget cuts--that will take place, absent Congressional intervention, at the stroke of midnight, December 31. Add in the discouraging 8.1% unemployment rate, and there is plenty of reason not to be bullish on stocks for the last three months of the year.

But of course that was also true before stocks went up the past three months. Optimists can point to 96,000 new jobs added in August, and the fact that long-term, the unemployment rate has been trending downward from around 10% at this time three years ago. A Bloomberg News survey recently forecast that the U.S. economy will grow 2.1% over the next three months, and the forecasts from the Federal Reserve Board anticipate 2.5% to 3% GDP growth in 2013. At the upper end of that estimate, we are talking about a return to economic normalcy, and a chance to chip away at the jobless rate.

Who's right? Who knows? All we know for sure is that the global economy is in a slow-growth recovery, with little indication that growth will accelerate dramatically or that the U.S. will slide back into recession. Buying stocks today is a bet that the hard work of millions of people still employed will produce positive results over the long term, which will ultimately reward the owners who hold their shares.

Sincerely,

A handwritten signature in black ink, appearing to be 'P.J. DiNuzzo', with a stylized, cursive script.

P.J. DiNuzzo, CPA, PFS®, MSTx, MBA
President, Founder, and Chief Investment Officer

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