Outlook for October, 2012: "Politics is front and center now…"

With an estimated 70 million people (almost half the electorate) tuning in to watch Governor Romney and President Obama at the debate last week, politics is now front and center when it comes to determining the near term direction for markets and the longer term direction for fiscal and regulatory policy. Both candidates offer a stark contrast in visions for the future and with less than a month to go when we Americans exercise our time honored right of citizenship, the outcome of the elections on November 6th is more than just academic.

The US economy posted a gain of 114,000 jobs in September with the private sector responsible for the bulk of those gains (+104,000). Notable gains from health care (+44k), transportation and warehousing (+17k), and financial activities (+13k) were partially offset by declines in manufacturing (-16k) and information (-6k). It was encouraging to see revisions for August (96k to 142k) and July (141k to 181k) with a net gain of 86k jobs.

Year-to-date, the economy has added 143k jobs a month on average, falling slightly relative to the growth rate of 153k set in 2011. Employment experts generally believe that the economy must add at least 150k jobs a month just to keep up with population growth. Needless to say, the number required to bring down the unemployment rate consistently is a significantly higher number.

The employment crisis continues despite the recent gains: 12.1 million people remain unemployed (down from 12.5 million the previous month) with the highest rates of unemployment among teenagers (23.7%) and minorities. Long-term unemployment, those without a job for six months or more, remained basically unchanged at 4.8 million (previously 5.0 million). A broader measure of unemployment (called the U-6 measure), that includes the marginally attached and workers employed part-time for economic reasons (representing 8.6 million people) was flat at 14.7%.

The decline in the unemployment rate to 7.8% (the lowest such rate since President Obama took office in January, 2009) was a surprise. Despite the conspiracy theorists' suggestion that this was the Administration's way of manipulating the figures, we find this hard to believe. The Bureau of Labor statistics (the agency responsible for compiling the jobs data) is populated by career economists and irrespective of their political leanings, we suspect such a manipulation would be seen as outright fraud.

Be that as it may, the household survey (the survey that is used to compute the unemployment rate) has had balky seasonals for a few months now. Indeed, during the months of July and August the household survey had job ***losses*** of -195k and -119k compared to the gains of 181k and 142k as pegged by the establishment survey (showing a cumulative difference in jobs created of 637k jobs over the two month period). The same household survey showed the number of employed as having ***increased by 873,000*** jobs in September alone, thus dropping the unemployment rate by three-tenths! Go figure.

Economic growth slowed to a crawl in the US during the second quarter: The Bureau of Economic Analysis of the Department of Commerce released their third and final estimate of 2Q GDP at 1.3% (q/q, saar), previously 1.7%. Downward revisions were widespread with only a handful of sectors bucking the trend: consumer nondurables, government purchases, and equipment/software investment. Taken as a whole, the report showed an anemic economy growing at stall speed. If politicians decide to let the economy roll off the so called ***"fiscal cliff"*** and allow budget cuts from the sequestration process to occur, a recession could well ensue.

The battle for the White House has been well and truly joined with Governor Romney's performance in the first Presidential Debate. No question, Governor Romney benefited from being on the same stage with President Obama during a nationally televised event. Nonetheless, he made his points both effectively and respectfully. President Obama on the other hand came across as "not wanting to be there" and quite disconnected from the proceedings. It is interesting to note that spin doctors from both parties (and campaigns) suggested that their candidate had acquitted himself well.

An incumbent does have a record that he needs to be able to defend: A jobless recovery characterized by weak growth and passing unpopular legislation like Obamacare and Dodd-Frank (many of whose rules have yet to be written and promulgated) make it a hard record to defend. In addition, as pointed out by Governor Romney, the

President has chosen to "not just pick winners and losers, but pick losers" when it comes to green energy subsidies (a favorite high horse of ours!)

Television attack advertisements – the kind that cast aspersions on an opponent's character (more than just on his policies) – have become all the rage in this contest. Despite the millions of dollars in attack ads that the President's campaign has spent trying to define Governor Romney for the voters, both candidates appear to be in a dead heat currently. In our opinion, it will probably come down to the pivotal state-by-state, precinct-by-precinct contests in Florida, Ohio, Pennsylvania and perhaps another state or two (Virginia, Michigan, North Carolina, to name a few more!).

Over the course of the next couple of weeks we do have a Vice Presidential debate (Oct 11th) and two more Presidential ones (Oct 16th and Oct 22nd). We expect President Obama to come out swinging in these contests and much as the first one managed to change a few people's minds, we suspect subsequent ones could do the same. Political pundits often imply that the debates do not do much to change voter's minds – as many of them have made-up their mind long before the debates actually take place. This time however, we do believe that the independent voter (clearly a species that is bordering on extinction) is likely to take his cue from the debates!

Farther afield, the European fiscal crises continue: Catalonia (a prosperous region in Spain) is agitating for self-determination, particularly at a difficult time for Spanish leaders. While the European Central bank has promised to "do what it takes" to ensure the survival of the single currency, the ECB cannot act unilaterally. The Spanish government needs to ***"ask for help"*** and then agree to the terms and conditions of the bailout – which the Prime Minister of Spain Mariano Rajoy is wary of doing. These "on again, off again" talks amongst the powers that be in Europe have the effect of undermining investor confidence over time.

Minutes of the FOMC meeting from mid-September and subsequent speeches by Fed Chairman Bernanke as well as other regional Fed Presidents (Dudley in New York, Evans in Chicago and Kocherlakota in Minneapolis) suggest that the activist Fed believes that their unusual stance of trying to help the economy might continue indefinitely until such time as the economy displays genuine improvement. In other words, a little inflation (and more of it if you will), please! We interpret this ***"Fed speak"*** as being quite negative for markets – especially given the discretionary nature of policy and the "trust us, we know what we are doing" implication from the Federal Reserve.

Next week also kicks off the Third quarter's earnings season in the US: Many analysts believe that this could be the first quarter with ***negative earnings growth*** since early 2009. While corporate chieftains have gotten pretty adept at lowering (and managing) expectations ahead of actual earnings releases, it is nonetheless hard to shrug off the serious loss of momentum in corporate earnings at the aggregate level. While corporate earnings as a percent of GDP (in aggregate) are at historical highs, it is probably well nigh impossible to sustain these levels.

Furthermore, expectations for the remaining two quarters of earnings as well as for the entire year have been steadily ratcheted down over the past few months. Specifically, consensus bottoms-up earnings expectations for the entire year 2012 have come down from a high of $115 to currently around $104 per share for the S&P500. In addition, those for the Third and Fourth quarter have seen comparable downward adjustments.

More alarming than the loss of momentum in earnings growth is, expectations for 2013 and beyond remain quite elevated: Indeed, the consensus earnings expectations for next year is at $115 per share which implies a year-on-year gain of around 11%. Given a difficult macro-economic environment (with growth slowing and little in the way of inflation or pricing power), it is hard to imagine how these numbers can come to fruition. We are on the look-out for ***earnings disappointment*** and a concomitant decline in markets going forward.

In summary, we continue to position your portfolios with some near term caution, but optimism about the longer term. Politics is indeed front and center for now, but we expect fundamentals to come to the fore soon. While our worries about policy uncertainties remain over the near term, we do feel reasonably positive about the longer term prospects for financial markets. Indeed, our abiding faith in a fully diversified portfolio - that has a balanced approach to both risk and return - as the main way to attain favorable investment outcomes over the long haul remains steadfast.

This report was prepared by

Suresh Raghavan, CFA and Clark Blackman III
MBR Financial, Inc.
2000 West Loop South, Suite 1510
Houston, TX 77027

www.mbrfinancial.com

For further information please contact us at
Voice: 832.667.8787
Fax: 281.974.2108
Email: contactus@mbrfinancial.com

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