Market Commentary

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3rd Quarter 2011

Extreme market moves during August and September pushed investor sentiment toward panic levels often seen at major market bottoms. It's not clear that we got all the way there. If not, we suspect we will, and sooner rather than later. In either case, we think stocks turn up in the fourth quarter of 2011 or the first quarter of 2012.

A Loss of Confidence

Back in July we suggested that the market would be "shaky" going forward. Little did we know. A confluence of events in early August hit investors' confidence hard, prompting a wholesale flight from risk assets, including stocks around the globe, commodities, even gold.

Foremost among those events, the debt-ceiling debate in Congress demonstrated how deeply dysfunctional our federal government has become. Ratings agency Standard & Poors ratified this assessment by downgrading long-term US debt from its traditional AAA rating to AA+.

Second, the sovereign-debt crisis in Europe showed the same to be true of governments across the water. European Central Bank (ECB) leaders and finance ministers from countries throughout the Eurozone dithered and squabbled about how to contain the effects of a potential default by Greece on its bonds. Fear of a Greek default also raised the specter of Lehman-like troubles among European banks that hold Greek bonds.

Finally, revisions to US economic data showed the 2008-2009 recession to have been deeper than we thought and the recovery from it shallower. Together, these events cast fresh doubt on the already tepid economic recovery in the US.

The response from the US stock market was swift. In the third quarter of 2011 the S&P 500 fell 14%, its worst quarterly performance since the fall of 2008. Along the way markets swung dramatically up and down, often in the same day. It felt like some eXtreme roller-coaster ride, only minus the fun.

By September 30 the S&P 500 was down 8.7% so far in 2011 and down 17% from the high it made for the year in late April.

While the market's fall from the April high remained in the "correction" category (less than a 20% decline), it felt a whole lot worse.

The Religion of Austerity

As we've discussed for some time, the developed economies of the US, Europe, and the UK are operating under a "New Normal" paradigm where consumer spending is restrained and consumer saving rises as the private sector pays down debt and repairs its balance sheet. This restrained spending has resulted in what economists call an inadequate level of aggregate demand in the developed economies.

If people aren't buying enough stuff to raise the general level of demand in an economy, employers feel no need to hire new workers. Since no new workers are hired, aggregate demand stays weak, unemployment stays high, and a negative feedback loop is created that reinforces weakness in the economy. This is the reality of the private sector today throughout the developed world.

In 2008 as the US was entering recession and aggregate demand was falling off a cliff, Congress agreed on nearly $800 billion in new federal spending to offset the anticipated shortfall in demand. While the recession that unfolded was deep, non-partisan analyses show that federal spending clearly prevented a much deeper decline.

Today, with Congress drunk on the Tea Party's punch, there is little political will to increase federal spending to offset the continued weakness in aggregate demand. To the contrary, the Republican-controlled House of Representatives is hell-bent on cutting spending in order to reduce the federal budget deficit.

continues on reverse

Major Market Performance 3rd Quarter 2011

	3rd Quarter 2011% chg.	YTD 2011 % chg.
DJIA	-11.49	-3.90
S&P 500 (large cap)	-13.87	-8.68
S&P 1000 (small/mid cap)	-19.86	-13.26
S&P 1500 (all cap)	-14.61	-9.23
NASDAQ	-12.91	-8.95
Barclays State G.O. Municipal Bond	3.28	8.31
Barclays Gov/Credit Intermediate Bonds	2.39	4.92

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Nothing could be more wrongheaded. The same policy mistake is being made throughout Europe and the UK. A new religion of Austerity has converted fiscal policy throughout the developed world and focused it on reducing spending.

The Paradox of Thrift

Cutting federal spending now would only deepen the shortfall in aggregate demand. It would put more people out of work as employers reduce headcount to meet a lower level of demand. Federal revenues would fall as payroll and income taxes decline with rising unemployment. All of which would likely produce a worsening rather than an improving federal budget deficit.

In short, Congress is set to demonstrate what Keynes called the paradox of thrift: if everyone at the same time tries to save more by spending less, overall savings will fall due to the resulting weakness in the general economy. We're already seeing this all across Europe from Greece to the UK: Austerity measures that slash spending are hurting rather than helping overall economies and budget deficits.

Market Discipline

The punishment meted out by stock markets around the globe may well prove the necessary antidote to this fiscal folly. Stock markets are in essence vast economic prediction machines. In August and September they were predicting a return to recession in Europe and quite possibly the US with a resulting sharper-than-desired slowdown in China.

This message from the markets brought a level of fear and pain to bear that moved us closer to three related objectives: First, forcing European leaders to address decisively and collectively their sovereign debt problems and related banking system risks. Second, shifting the focus of fiscal policy in developed countries away from ill-conceived near-term austerity and toward a more stimulative approach to aggregate demand. The International Monetary Fund (IMF), typically a staunch proponent of austerity, urged just such a shift in early October.

Finally, the extreme market moves during August and September pushed investor sentiment toward panic levels often seen at major market bottoms. It's not clear that we got all the way there. If not, we suspect we will, and sooner rather than later.

A Question of Timing

As Greece is on schedule to default in the fourth quarter, Europe's sovereign debt problems must be addressed soon. Very soon. The problems resulting from misguided fiscal policies throughout the developed world are also rapidly pushing these economies toward recession. If corrective action is to be taken, it too will need to be soon.

Continued dithering or denial on either front would likely incite more panic selling. That, in turn, could incentivize the necessary corrective policy actions. Financial crisis tends to focus politicians' minds in a way that the ongoing economic suffering of millions appears not to.

From a cyclical perspective, we've argued that in a slow- to no-growth economy, inflation plays an unusually large role. As we've posed the problem of developed economies in terms of a shortfall in aggregate demand, we can think of inflation as an aggravating or ameliorating factor in this regard.

When inflation rises, it effectively dampens aggregate demand by shrinking the buying power of consumers. This is what happened in the US in the first half of 2011, with a resulting slowdown in overall economic activity. With the global economy slowing, inflation has likely peaked and is headed down. This will boost aggregate demand by increasing the buying power of consumers. This in turn should lift the overall economy.

As changes in inflation tend to pass through to consumption with a lag, we expect the beneficial effects of falling inflation to register in the US in the fourth quarter of 2011 or the first quarter of 2012. As improving prospects for the economy tend to be heralded first by the stock market, we think cyclical factors call for an upturn in stocks within the next six months.

So, from both the political-policy and economic-cycle perspectives, we think stocks turn up sometime in the fourth quarter of 2011 or the first quarter of 2012.

What We're Doing

We are maintaining the defensive posture we first assumed in early August, with an underweight in equities and an overweight in bonds and cash. From a sector perspective, we are overweight defensive names, particularly consumer staples, and underweight cyclicals, most importantly financial services. Should we see signs of improving weather in coming weeks, we're prepared to shift portfolios away from this defensive posture.

Farnum Brown
Chief Investment Strategist

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Social Advocacy Highlights

Corporate Political Spending

In 2011, shareholders expressed their discomfort with corporate political spending more strongly than ever before. In the spring, our proposal at **Halliburton** (HAL) seeking greater transparency and oversight at the energy services company received 46% support. The same proposal at **State Street** (STT) enjoyed 44% support.

These votes were a fitting cap to a proxy season that started early last August, when Trillium was part of a shareholder group that responded promptly to the revelation that a number of Minnesota-based companies had given substantial contributions, via a business front group, to a gubernatorial candidate with extreme anti-gay views. As protestors demonstrated at its stores, **Target Corporation** (TGT) became the focus of a nationwide boycott that received generous media attention during a slow news month. Within days of the initial revelations, Trillium filed shareholder resolutions at Target, **Pentair** (PNR), **Best Buy** (BBY) and **3M** (MMM) calling for a review of existing political donations policies and tighter oversight of the reputation and other risks incurring from them.

With the exception of 3M (where our resolution received 31% support), the resolutions were eventually withdrawn at all of the companies after they demonstrated that they had reviewed and improved their oversight of political contributions and the procedures in place for vetting potential recipients. A multiyear national shareholder campaign coordinated by the Center for Political Accountability has resulted in the adoption of best practices in political disclosure by more than 85 companies, of which 50 are in the S&P 100.

LGBT Workplace Policies

In 2010, we worked with the Equity Foundation to file a shareholder proposal at **Gardner Denver** (GDI), asking the manufacturer to recognize sexual orientation and gender identity expression in its nondiscrimination policy; it garnered the support of 49% of shareholder votes. To our surprise, it was necessary to re-file the proposal in 2011; the resubmission was successful in spurring the company to adopt our policy recommendation and we subsequently withdrew the proposal. In contrast, **Lowes Corporation** (LOW) responded very positively and quickly to our request, and now its 200,000 employees are protected by an up-to-date policy that includes gender expression.

Internet Privacy and Freedom of Expression

CenturyLink (CTL), the nation's third largest telecommunications company, finally owned up to its responsibilities regarding Internet privacy and freedom of expression. Trillium's well-supported 2009 and 2010 shareholders proposals (both received about 30% of the vote) had asked the company to report on how it would avoid violating Internet users' privacy, after it was revealed to be in business with an online advertising company that secretly monitored Internet users' browsing activities. In exchange for the withdrawal of our resolution this year, CenturyLink agreed to incorporate privacy and freedom of expression responsibilities into its governing documents.

Environmental Advocacy

Concerned with the environmental risks associated with the controversial practice of hydraulic fracturing, Trillium filed a shareholder proposal at energy company **Anadarko Corporation** (APC), which has a large interest in the Marcellus Shale. Following a productive dialogue, we withdrew a shareholder proposal when the company agreed to expand and improve its public reporting on its management of these risks. There is still more to be done and we will continue to advocate at Anadarko and other companies for increased transparency and the safest practices.

Dialogue with **Costco** (COST), the membership warehouse retailer, produced another constructive outcome. The company produced and shared with Trillium a substantially improved seafood sustainability policy. Costco will discontinue selling twelve wild species identified as "at great risk" by the Marine Stewardship Council, up from seven. Costco is also partnering with non-governmental organizations to come into compliance with best practice standards for shrimp and salmon aquaculture.

We were also able to withdraw a shareholder proposal we filed with food distribution company **Sysco Corporation** (SYY) after the company agreed to participate in the Carbon Disclosure Project and to fully develop its sustainability strategy to include areas such as water scarcity and sustainable agriculture.

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