VAUGHAN NELSON

INVESTMENT *perspective*

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During the quarter financial markets around the world, with the notable exceptions of the Japanese and Chinese domestic stock markets, continued to move higher almost exclusively due to central bank operations. As we discussed in our second quarter commentary, once the global economic growth slowdown approached stall speed, U.S. and European monetary authorities were forced to commit to open-ended, reflationary policies. In the Eurozone, the European Central Bank (ECB) announced further steps including Outright Monetary Transactions designed to support the euro and at least ease the financial crisis within the zone. Not to be outdone, the U.S. Federal Reserve announced an unlimited commitment to purchase $85 billion per month in securities including $40 billion per month in mortgage-backed securities. Despite the implications for inflation, the flight to safety remains strong with the yield on the bellwether 10-Year Treasury ending the period at 1.64%, exactly where it was at the end of June. While these actions have had a significant effect on asset prices, they have not yet led to an improvement in the economy. In order to sustain equity markets at current levels, it will be necessary to see near-term improvements in other leading economic indicators and that will depend on decisions made at businesses, large and small.

The current slowdown reflects in large measure a “crisis of confidence” throughout American businesses. Across multiple industries, management teams have routinely stated in conference calls that they were seeing a slowdown during the third quarter. As such, they and their customers have pared back inventories and remain reluctant to hire or invest in plant and equipment. They are losing confidence that public officials will adequately address both domestic and global structural issues. These issues include the potential U.S. fiscal cliff in early 2013, including tax increases; the outcome of the U.S. Presidential election; violence in the Middle East and the Iranian nuclear threat; and, the ongoing European financial crisis. Fortunately, the fourth quarter should produce some clarity on domestic policy questions thereby allowing firms to implement their respective strategies.

As we thought, the housing market continues to improve and has the potential to become a self-reinforcing cycle. Responding to that and the actions of central bankers, the equity markets have already discounted a trough in economic activity and corporate earnings in the third or fourth quarter of 2012. We anticipate a difficult third quarter for many firms with earnings finishing at or below previous estimates and muted fourth quarter guidance. Should a trough in economic activity and earnings occur in the fourth quarter, we estimate that the S&P 500 index has the potential to reach 1,600, or approximately 10% higher than current levels by the end of the first quarter of 2013. However, if economic fundamentals and earnings do not improve we would expect to see the S&P 500 index materially correct. This could be 5% to 10% or more depending on the nature of any further slowdown.

Compared to our historical positioning, our equity portfolios are more economically sensitive relative to their benchmarks at this point in the business cycle. This is the first slowdown in this era of the “new normal” and investors are finding it difficult to identify enduring trends that can be extrapolated into specific companies. As such, we have identified companies with sustainable cyclical growth that are materially undervalued and provide an opportunity for significant outperformance as the market ultimately recognizes that growth. And, as always, we are invested in companies that have competitive positions or secular opportunities that will allow their stocks to meet our targeted return objectives and outperform the market over time. Therefore, we are willing to accept a modestly higher level of cyclicality versus the risk of trying to time the market or maintaining exposure to less cyclical areas that appear overvalued.

In our fixed income portfolios, until the massive amount of global central bank accommodation begins to stimulate economic activity, we see little reason to alter our current, neutral duration positioning. Corporate credit quality and liquidity should remain at historically high levels and investor demand for yield should continue to support these issues. While we plan to remain overweight corporate bonds versus the benchmarks, we may shift some holdings into other maturities with slightly better valuations.