Lassus Wherley ...a view from the top

Building Better Futures

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Here We Go ……….

A Little Excitement in Europe…..

We were getting ready to send out this issue of the View from the Top when we decided that there was so much uncertainty around the elections in Europe, especially France and Greece, that we would hold off on finalizing this issue until after the weekend votes were in. Most of the analysis and news we had included in this issue haven't changed, so we just added more on the latest developments and concerns.

The issues around the EU and the new governments are many, and most are not going to increase the confidence of the financial markets. I attended a JP Morgan Investment Symposium last week that included many well-known and very bright speakers. Some of them believe as we do that Europe will figure it out but it will take time. One speaker, Peter Zeihan from Stratfor, believes that the EU will break, which is certainly pretty scary on the surface when you think about the impact on the financial markets in the short-term. However, even this speaker, who definitely got our attention (approximately 100 attendees in the room) believes that a breakup of the EU would have a long-term positive impact on some countries, including the US. He thinks that there will be a significant flight to quality that will include capital flowing to the US.

The reality is that the next few weeks and months are going to be difficult ones for the EU, and the challenges these countries face will probably create significant volatility in the markets over the short-term. We will continue to monitor actions and reactions to these events as they take place to determine what tactical changes, if any, are required in investment portfolios. So ………… let's talk about the good news so far this year.

A Great Start for 2012….

We hope that you have enjoyed a beautiful spring holiday season with your family and friends. The markets had a very healthy first quarter and lifted a few spirits along the way.

Much has been made of the fact that this was the best first quarter for the US stock market since 1998. We have seen gains across all major asset classes. Stocks rallied globally for three reasons. A lot of bad news had been discounted in share prices by the end of last year. From August through December 2011, investors were very concerned with the possibility of a default by one or more countries in Europe and a breakup of the euro.

The LTRO (Long-Term Refinancing Operation) of the European Central Bank (ECB) that we discussed earlier in VFT Issue #37 reduced these concerns. Under LTRO, European banks were able to borrow from the ECB at the low rate of 1%. The banks then used these funds to buy their own sovereign debt, thereby supporting the European sovereign bond market. About €500 worth of these loans were made in December and again in late February. The agreement reached by creditors on a new round of official lending for Greece also eased nerves about Europe for a while.

Increasing signs of a turnaround in the US economy boosted stocks as the quarter progressed. Week after week, economic reports showed improvement in the US jobs market and manufacturing as well as rising consumer confidence, although we have seen a little weakness in the employment numbers recently.

Finally, investors bought stocks as central banks globally provided liquidity to the financial system and support to the recovery. Central banks in the US, the Eurozone, Japan, and the UK have been providing easy money, and the Chinese and Indian central banks are now in the process of easing as well. All of the liquidity provided by the central banks has served to keep interest rates on cash very low and to push investors into higher risk assets in order to get returns.

While markets may correct over the next few months based on fears of slowing economic growth, we do expect positive returns from equities for the year 2012. The global economy is expected to grow by about 3.7% (Real GDP) this year with slow growth of about 2.5% from the US and stronger growth of about 6% from the emerging markets. While some countries in Europe are sliding into recession, this should not overwhelm the growth from the US and the developing world.

A heightened sense of political uncertainty has returned to Europe this week with Sarkozy's loss and the recent resignation of the Dutch Prime Minister after the Dutch budget talks collapsed. Add to this the fact that Spanish 10-year bond yields have been approaching 6% and economic data that indicate the contraction in Eurozone economic activity continues. It is no surprise that European stocks are selling off, and this will probably continue in the short-term. The elections in Europe are seen as a chance for the people to vote on how they see austerity. And it is increasingly clear that they don't like it at all.

Somewhat mitigating the bad news out of Europe is the fact that the International Monetary Fund (IMF) was able to get pledges of at least $430 billion in extra funds to fight any future financial crisis in Europe. Pledges from developing nations are increasing, but it is likely that China and Russia will want to approve just how the funds they contribute are used.

Renewed worries about slower economic growth may create increased volatility in the stock market during the next few months. It is important to remember, however, that corrections provide us with the opportunity to invest at lower prices. The market has sold off pretty dramatically the past two years in late spring on concerns that the economic recovery was stalling out. We think that any sell-off this year will be much less dramatic for the following reasons:

The US economy still has room to grow. We expect that continued improvements from two of the most cyclical sectors of the economy, autos and housing, will add to growth in GDP over the next several months. Both autos and housing are still well below where they would normally be in an economic recovery which is almost three years old. Auto sales have been quite strong lately as consumers have been buying smaller, more fuel-efficient vehicles and trading in their old cars. We expect this to continue as the average light vehicle in the US is over 11 years old and consumer confidence is rising.

Home sales (both new and existing) are still well below average levels in a recovery. With prices and interest rates low, and affordability increasing, consumers who are able to obtain financing are likely to increasingly make the decision to buy rather than to continue to rent. As home prices have been dropping, rents have been increasing, and it is now more expensive to rent than to buy in many areas.

In addition to a slowly improving economy, stocks should also be supported by the huge cash balances sitting in individual investors' accounts. In spite of the rally off the bottom, investors are still very conservatively positioned. Money in mutual funds has continued to flow out of US stocks and into bonds since 2007. Investors remain very skeptical about the rally in stocks. We expect that this will gradually change as interest rates on cash remain low.

Finally, stocks look reasonably valued relative to long-term averages, particularly with the current low levels of interest rates and inflation. The S&P is currently selling at about 13 times expected earnings for this year. At two prior peaks, the S&P 500 was selling at much higher multiples of earnings. For example, the S&P was selling at 25.6 times earnings at the peak in March 2000 and at 15.2 times at the October 2007 peak.

A big thank you to our clients who continue to challenge us with great questions. Please let us know if you have any questions you would like to share with others.

Question: *How will the election impact the stock market this year? Is there reason to worry?* **Answer:** At this point, polls are indicating that President Obama will be re-elected, but it is too early to know what the final outcome will be of either the Presidential election or in the races for seats in Congress.

The 2013 budgets proposed by President Obama and Rep. Ryan made headlines last month as they clearly illustrated the differences between the two parties on spending, including on Medicare and Medicaid, and on taxes. The budget debate in Congress framed the issues which will be faced at year-end when Congress and the President will grapple with finding a way to avoid having the economy fall off a "fiscal cliff" come December 31, 2012.

Without congressional action before year-end, several changes in taxation and spending cuts are scheduled to occur: 1) the payroll-tax holiday will end, increasing taxes for workers by as much as 2% of wages; 2) tax rates on dividends will revert to ordinary income levels, and the rate on long-term capital gains will increase from the current 15% to a 20% rate; 3) the new 3.8% Medicare tax on unearned income will take effect; and 4) several across-the-board cuts in domestic and defense spending will be triggered.

How this issue is handled could have a dramatic impact on both the economy and the stock market. If all of these changes occur at year-end, the economy would suffer a shock from an abrupt reduction in demand. This is the worst possible outcome and one that is not wished for by either Congress or the White House. Rather than having the economy fall off a "fiscal cliff," we need Congress and the President to find a way to gradually reduce the deficit, or what is known as a "fiscal glide path" rather than a "fiscal cliff."

The bottom line is that whether President Obama wins a second term or Mitt Romney wins the election, the impact of not dealing with the expiration of the Bush tax cuts this year would have a major impact on the economy. The results of the election does typically have some impact on the stock market but it is far too early to make a prediction about the end result.

Question: *I noticed that you sold some of my holdings in Hussmann Strategic Growth Fund. What is your thinking about the fund?* **Answer:** We made the decision to reduce the allocation to hedge strategies as markets have begun to normalize after the extremely volatile year that we experienced last year. We believe that, even if we have another summer swoon, 2012 is set up to be a decent year for the stock market with slow growth and continued low inflation.

Volatility has remained contained so far this year as measured by the CBOE Volatility Index or VIX ($19.16). While we would expect the VIX to rise if stocks continue to correct, the fact that there is plenty of cash in the financial system greatly reduces the chances that there could be a financial meltdown due to the European sovereign debt crisis.

This is one of the prime reasons why markets have seemed more normal this year. Another is the fact that investors have been able to focus more on the fundamental outlook for the stocks in which they are investing rather than on the macroeconomic headline risks. While this may change over the next few months, we believe the global economy will grow this year at a decent pace.

We decided to implement this change by reducing positions in Hussmann Strategic Growth (HSGFX). This was based on two reasons: (1) we have gradually lost confidence in the hedging strategy which is being used by fund manager John Hussmann, and (2) we believe that the remaining funds we employ in the hedge strategies asset class will be very effective in meeting our objectives.

Hedge strategies funds are expected to protect against stock market declines while still capturing a reasonable level of gains when markets do well. This mandate requires funds to be flexible and active in order to protect against market downturns, as well as to take advantage of opportunities for growth when they are present.

We have reduced the target allocation in the hedge strategies asset class in most models and allocated these dollars to other equity asset classes including US Large Cap and Emerging Markets. We believe that these asset classes remain attractive for long-term investors with the outlook for slow but steady growth in the US and much higher rates of secular long-term economic growth in the developing world. You will see this change implemented as we rebalance portfolios over the next few months.

Question: *How do you build exposure to emerging markets into portfolios?* **Answer:** Our primary method for investing in emerging markets is through mutual funds that are specifically targeted at those areas. We also recognize that some other funds that invest in the international arena include emerging market investment at different times in the investment cycle. We take that into consideration when making decisions about the percentage allocation.

We invest in emerging markets' stocks through an emerging markets' core equity fund and in dollar-denominated debt of emerging markets through an emerging markets' bond fund. We have been increasing the weighting to emerging markets' stocks this year as we expect that countries in the developing world will continue to grow at levels well above Europe and the US and we find current valuations to be attractive. Emerging Markets' share of global GDP was 12% in 2011. This share is expected to almost double by 2050, and we would like our portfolios to participate in this growth.

As these economies develop, we expect that the volatility we have seen in recent years will decline. We will continue to increase our investment in this asset class as opportunities present themselves over time.

Our investment in dollar-denominated debt or bonds of emerging markets enables us to benefit from the higher yield (distribution yield of 5.34% as of March 31, 2012) and healthier finances of countries such as Brazil, Russia and Mexico. We have chosen to invest in the dollar-denominated fund so as to minimize the currency risk of this investment. The fund we use is managed with a quality bias and invests in Emerging Market higher quality credits with strong fundamentals as well as in debt of select corporate credits.

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Interesting News

Social Security Statements are now available online at www.socialsecurity.gov. It is actually pretty easy to set up your account, and the information is current concerning estimated benefits and earnings. I was able to establish my account in just a few minutes. The other good news is they have added some really nice features online.

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Stay cool and enjoy your Summer!

Diahann

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