Lassus Wherley ...a view from the top

Building Better Futures

Issue 40: October 23, 2012

Don't Forget to Vote!

Who Knew…..

Who knew we could get such a convincing run up in the stock markets in September which is typically our flakiest month. For a while I was calling the latest stock market rally the "wishful thinking rally." It certainly felt like we were pushing the market up based on everyone being really tired of it going down. The other part of this thinking was that we were waiting for the other shoe to drop on Europe and it didn't. So we kept on wishing. We will discuss more of the specifics later in this newsletter, but the reality is Europe and the US have gotten really good at kicking the cans or problems down the road. The questions at this point are when are we going to actually solve some of these problems and ………..what will be the cost of solving them. Unfortunately, we haven't figured out the answers to these questions quite yet. Until we do figure it out, we remain a little cautious in our outlook for both the US and European economies and markets.

The election is another one of those interesting happenings that is so important for determining the future of the US. Whether you are a D or an R or a combination of the two like many of us, there are critical questions that won't be answered until long after the election. If you look strictly at the performance during specific years, the stock markets have done very well during Democratic administrations, including the current one. Of course, if you are a Republican, you might make the case that the positive markets were driven by actions taken by previous Republican administrations. The reality is that you can't really give any administration credit for specific market action. First, there are too many variables and the leaders have very little control over most of them. Second, it is in many ways the luck of the draw in terms of what happens during specific administrations. So………….in answer to the many questions about what will happen depending on who is our next president……..it depends on what happens in the rest of the world and in small business and in corporate America and ……………………

You get the general idea. President Obama has moved pretty much to the Bill Clinton centrist position so his focus will probably be on the economy, but there is no way to really know what that would mean. Governor Romney is basically a moderate who has campaigned up until recently to attract the conservative vote. More recently he has moved more to the center to attract some of the independents. The bottom line is there is no way of predicting what either one of them will do since the world changes very quickly, and I'm not sure they even know what they will do if elected or re-elected.

We also have to deal with a dysfunctional Congress along the way. I'm not convinced that Governor Romney could work with the Democrats any more effectively than President Obama has worked with the Republicans. That means we would once again get very little positive out of Congress regardless of who wins the election. Of course, there is always a chance that we will elect new leaders in the House and/or the Senate who will be more focused on negotiating to find solutions.

It will probably remain a close race to the finish based on recent polls. So…………..if you believe strongly that one candidate or the other is much better for the future of the US, make sure you not only vote but encourage those around you to vote. **It is our country and our responsibility to vote.**

Don't Fight the Fed

Stock markets worldwide have been reacting to the very easy monetary policy being conducted by central banks worldwide. The strength and duration of this year's "stealth" rally have been surprising to many. This rally has looked like a classic case of stocks climbing a wall of worry. With all of the issues surrounding debt problems in Europe, slowing economic growth in China and the potential for our economy to fall off a fiscal cliff, what matters most for the markets is the fact that central banks worldwide are conducting a very easy monetary policy.

The old saw, "Don't Fight the Fed" explains better than any long-winded explanation exactly what caused this summer of 2012 to be such a positive one without the gut-wrenching volatility and declines we experienced in the summers of 2010 and 2011. Only this time the axiom should be ***"Don't Fight the Fed, or the European Central Bank, or the Bank of Japan, or the People's Bank of China or the Bank of England."*** Actions and statements of all of these central banks are causing risk assets to rally. For example, stocks moved up this summer in anticipation of further easing on the part of the Fed and then continued their climb when QE 3 was announced in mid-September.

So, where do we go from here? It is safe to say that many investors remain skeptical of this rally and yet ………… it continues. We believe stocks are not yet priced for perfection and that markets can continue to move ahead supported by very low interest rates, low inflation, plenty of liquidity and a slow-growing global economy.

Given that cash is returning essentially nothing, and is, in fact losing money in real terms, selling stocks and going to cash is not really an attractive option for investors. In fact, there remains over $10 trillion in investable cash sitting in money market funds, savings accounts and CD's as of September 30, 2012. We view this as a potential source of support for equity prices as investors appear to be growing tired of getting negative real returns on this money.

Bonds are not really a good alternative either. Yields are at secular lows, with the 10-year US Treasury yielding 1.65% as of the end of the third quarter 2012, down from 15.84% at the start of the bond rally in 1981. Rates are now so low that bond **returns** going forward will be much lower than they have been over the past 31 years when rates were pretty steadily declining. This bull market in bonds has gone on so long, in fact, that many investors do not realize that it is possible to lose money in bonds. We aren't expecting a huge run up in interest rates over the next few years, and still believe that bonds play a role in portfolios in terms of maintaining balance.

As an indication that nothing breeds complacency like a very long bull market, recent mutual fund flow data show that individual investors have not adjusted their asset allocation for the reality that rates are at secular lows or close to them. Many investors continue to take money out of US stock mutual funds and direct these dollars into bond funds. We, on the other hand, are content to let the allocation to fixed income funds become somewhat underweight versus target as we continue to see more potential in equities.

We are also monitoring our fixed income allocation to make sure that our bond portfolio is diverse enough to include not just US Treasuries but also corporates, mortgages, some high yield and some emerging markets debt. These types of bonds are less sensitive to rising interest rates than straight Treasuries. We are also keeping the duration (sensitivity to interest rates) of our bond portfolio relatively short.

The valuation of US stocks remains reasonable. As of the 3rd quarter end, the S&P 500 is trading at about 13 times forward earnings. This p/e compares to a 20-year average of 16.4 times. Stocks were priced much higher at recent market highs. At the peak in March 2000, the market traded at 25.6 times earnings. At the most recent peak, in October 2007, the market traded at 15.2 times. The dividend yield on the S&P 500 is now 2.1%, or about twice what it was at the 2000 peak. So far, the current rally has lasted only 43 months compared to the average for bull runs in the post-WW II period of 68 months. The 113% rise off the March 2009 low compares to an average bull market rise of 176% in post-WW II rallies. We think this could indicate we still have room to go.

One of the reasons that pundits say the market rally will soon be over is that they believe earnings are about to collapse. We believe earnings are likely to be growing more slowly going forward since margins have stopped rising. This does not mean that earnings are set to collapse. Margins have gone flat in earlier periods, such as the late 1990's and 2004 - 2007, but the stock market continued to move up. Basically, as long as the economy continues to grow, earnings can muddle through. We are expecting to see earnings grow by low- to mid-single digits or in line with revenues in the near term.

The bottom line is that while there were many issues that could have held markets back this year, in fact, they did not. The overwhelming reason was the strong tailwinds provided by easy monetary policies. We look for a continuation of a current slowly growing US economy in spite of the weakness in Europe and China. We begin to be more hopeful as well that wisdom will prevail in Washington and that the fiscal cliff will be avoided.

It is sometimes better to ignore the financial press and those strategists who are really more interested in pointing out the things that we should be worried about (and making headlines) than in pointing out that maybe things aren't so bad. Right now is really one of those times. Things are not perfect, but they are really not all that bad, either. Maybe that is the message that the financial market is trying to give us.

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: *What is QE 3?* **Answer:** QE 3 (the third round of quantitative easing) is the name given to the package of extraordinary measures which the Federal Open Market Committee (FOMC) announced in mid-September. The FOMC said that they will be buying $40 billion of agency mortgage-backed securities from financial institutions each month <u>on an open-ended basis</u>. They also indicated that these purchases could be extended and additional assets could be purchased if the job market does not improve. Operation Twist, under which the Fed has been selling short-term Treasuries in order to buy long-term Treasuries, will continue and be expanded from $45 billion a month to $85 billion. Finally, the Federal Reserve expects to keep short-term interest rates near zero until mid 2015. Fed Chairman Ben Bernanke is a student of the Great Depression and is convinced that the Federal Reserve should use every tool in its arsenal in order to support the economy and try to get unemployment down. He believes that while this extremely easy monetary policy may cause inflation down the road, it is crucial not to let the economy fall into deflation.

The Federal Reserve has held short-term rates near zero since December 2008. While this policy was widely seen as necessary immediately after the financial crisis, the wisdom of effectively announcing that rates will be kept this low for the foreseeable future is now being brought into question. Some find that telling consumers and businesses that rates are not going up any time soon essentially takes away any incentive they may have to go forward and borrow now to buy, or build or invest.

Question: *How is the third-quarter earnings season going so far?* **Answer:** As of October 19th, of the 115 companies that have reported earnings, 59% have beaten estimates, 27% have missed and 14% have met estimates. This is in line with long-term averages. This was expected to be a down quarter for earnings, and it is still too early to say whether or not this will hold true. Most companies are still beating expectations for earnings (the bottom line), but more have been missing for revenues (the top line). This is a trend which began in the second quarter and we continue to monitor.

On the plus side this quarter, several banks have reported good earnings. On the other hand, several technology companies have printed disappointing third-quarter reports. This past week, earnings for large, traditional tech companies such as IBM and Intel came in below expectations as did earnings from the poster child of new tech, Google. More than a few companies have mentioned being hurt by the strong dollar, as well as weakness in Europe and China and uncertainty in the United States. Global economic growth remains sub-par, and it is not surprising that this would impact earnings and revenues. Earnings are expected to be up on a year-over-year basis for both the fourth quarter of 2012 as well as for calendar year 2013.

Earnings season is far from over, and we will get more clarity on the health of the economy as we hear more companies discuss their outlook.

Question: *The market took a dive on Friday, October 19th. That was kind of scary. Is this the beginning of another down trend?* **Answer:** Following Friday's swoon, the S&P 500 is trading at 13 times a conservative estimate of calendar year 2013 operating earnings of $110. This price/earnings multiple remains below long-term averages. We believe stocks will be supported by the very easy monetary policies of global central banks. Tremendous cash balances will also provide fodder for new purchases of stocks by those investors who regret not having participated in the market rally over the past year. Finally, given very low interest rates, stocks continue to appear more attractive than bonds.

If volatility increases over the next few weeks, it might help to remind ourselves of the following points. We have had a long rally with very low volatility for some time. We have all enjoyed watching the market move upwards without those abrupt downturns we have experienced too often over the past few years. We know, however, that markets need to reset themselves from time to time in order to build a stronger base.

We have taken steps over the years to manage the overall volatility of portfolios. This includes utilizing hedge strategy funds and adding other investments that we believe will assist in managing the overall risk of a portfolio. We also ask, as always, that you let us know well in advance of any cash need which you anticipate.

Question: *What is happening in Europe?* **Answer:** Investors have been able to take a break from focusing on the European debt situation this summer and into fall. This began with Mario Draghi's famous comment that the European Central Bank (ECB) "is ready to do whatever it takes to preserve the euro, and believe me, it will be enough." The ECB has, in fact, made real progress in stabilizing the sovereign debt market with their announcement of an open-ended bond-buying program. The ECB's program, called Outright Monetary Transactions (OMTs), has effectively eased tensions in the Eurozone and brought yields down significantly on both Spanish and Italian debt, as have his comments that indicate the OMTs will continue.

Countries on the periphery remain in recession and are still carrying heavy debt loads. Spain and Greece have unemployment rates of about 25% and much higher rates for younger workers. Spanish Prime Minister Mariano Rajoy has been working with the leaders of the European Union to come up with a budget that satisfies them so that Spain can get the bailout which the country needs. Rajoy's task is to cut enough to get the bailout but not so much that the Spanish people have to endure too much more austerity.

This is the pattern in Europe for now. Bailouts must be requested by the governments, and the governments must agree to accept a certain degree of austerity in return. Spain is expected to formally request the bailout later this month.

So………….. while we have seen progress on the monetary issues and some sense of a structure that will enable beleaguered countries such as Spain to formally request a bailout (with conditions), governments continue to struggle with recessions and austerity simultaneously. Investors will probably still be on a roller coaster ride of ups and downs regarding the European situation for some time to come as the weaker countries attempt to bring down debt and grow.

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As always, the world of finance and investment is never dull and boring. Sometimes boring would be a really good thing, but until that day comes, we will continue to focus on ways to balance the risk and return.

Stay warm and enjoy the holiday season!

Diahann

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