Lassus Wherley ...a view from the top

Building Better Futures

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One More Time...............

We decided to send out one more issue before we make the changes to the VFT we discussed in Issue 43. People seem to be as worried now as the market goes up as they were when the market was going down. Obviously, we are never happy when we have a lot of uncertainty surrounding what is happening in the world, and some recent events have increased stress levels for everyone.

Last time we saw these levels in the US financial markets was in 2007 prior to the downward slide we experienced in 2008 and 2009. It makes sense that many of us are looking back and making the comparison.........and worrying about a repeat.

Although we aren't worried about a repeat of 2008-2009, we do expect continued volatility with everything that is going on in the world. The reality is that the US stock market has much to recommend it these days. We are cautious on a short-term basis because there is risk in the global markets but we remain positive in terms of the long-term outlook.

Gaining Perspective

The S&P 500 posted a total return of 16% in 2012 and has returned close to 10% so far this year, through March 15, 2013. The move upward in US stocks has been based on a growing realization that our economy is indeed healing, thanks in large part to a very supportive Federal Reserve which has kept the Fed funds rate near 0%, has been actively buying both US Treasuries and mortgages each month, and has made very clear that these policies will continue for the foreseeable future.

The combination of the healing economy and the easy monetary policy being conducted by the Federal Reserve, as well as several other central banks, has so far more than compensated for the continued state of political dysfunction which has been in place. In recent months, it has become clear that investors are ignoring politics on both sides of the pond, at least for now.

This may change after the events that transpired in Cyprus last weekend, but we will wait to see how things evolve. The situation remains fluid and there are likely to be a lot of twists and turns in the story before this latest European crisis is resolved.

Since the news broke about Cyprus, the worry has been that this will cause rates to rise on the debt of other weaker countries in the Eurozone periphery, such as Italy and Spain. So far, the impact has been limited. Spanish bonds have fallen, but not dramatically. Neither have there been runs on the banks in these countries.

We take Mario Draghi at his word that the ECB will do "whatever it takes" to save the euro. This financial backstop has been crucial in calming both European debt and equity markets since the summer of 2012. As we mentioned in last month's issue, "the European debt situation was never really

resolved; it just went away for awhile, and it is back."

At some point, however, some event is likely to give stocks a reason to take a breather. Whether it is problems with banks in Cyprus or something else, we believe the market could correct (decline by 10%) and still recover as the trend for US stocks remains up. A correction is actually healthy in that it allows the market to consolidate its gains and form a firmer base from which to rally.

To anyone who is concerned about markets acting like they did in 2008, we think it is important to point out that the global financial system is much healthier now. This is largely because central banks worldwide are constantly assessing the health of the global financial system. The Federal Reserve, the European Central Bank, and the Bank of England have also been conducting very easy monetary policies to ensure that the global financial system continues to heal. Central bankers are being much more vigilant these days in monitoring for potential issues such as the Lehman bankruptcy.

Another big difference between 2008 and the present is that US banks have been recapitalized and are in much stronger shape than they were prior to the financial crisis. In releasing the results of its "stress tests" of US banks, the Federal Reserve recently noted that both the quality and quantity of bank capital have increased over the past four years and that this should help enable the nation's largest banks to continue to lend, even if an economic slowdown were to occur.

Corporations and households have also reduced the debt on their balance sheets dramatically. Companies in the S&P 500 are expected to pay at least $300 billion in dividends in 2013, according to S&P Dow Jones Indices, on top of the $282 billion paid last year. Corporations in the US have also recently announced plans to buy back a record $117 billion in stock. These shareholder-friendly actions on the part of corporations have been one of the reasons why money has begun to flow back into stocks.

Consumers in the US are carrying less debt and many consumers are living within their means while still continuing to spend. The recently released February retail sales number set a new record of $42.1 billion, largely boosted by auto sales.

Finally, corporations are making money. S&P 500 earnings grew by 7.7% in the fourth quarter of 2012, which is much higher than had been expected at the start of earnings season.

While stocks are not as cheap as they once were, valuations do not look extended at this point. Although we would not be unhappy to see a bit of a downturn so that we could buy into equity funds at lower prices, we continue to allocate funds to all underweighted asset classes at these levels. The S&P 500 is trading at price/earnings (p/e) multiple of about 13.7 times the next 12 months' expected earnings, which is below its historical average. We would expect the p/e multiple on the S&P 500 to drift higher over time as long as we remain in the current slow-growth/low-inflation environment.

The S&P 500 is yielding 2.2% which is higher than the 2.0% yield on the 10-year US Treasury. We have said for some time that we felt that stocks represented better value than bonds, and we remain of that opinion for long-term investors. We have already seen interest rates start to rise in anticipation of the improving economy. We could see them rise to the 2.25% level on the 10-year US Treasury over the course of 2013. At this point, rising rates represent much more of a headwind for bonds than they do for stocks.

There remains plenty of uncertainty in the world - including our budget issues and the sovereign debt situation in Europe. It is for this reason that we continue to utilize a risk management strategy that we have developed over the years. This strategy enables our portfolios to participate on the upside when stock markets are rising but also provides some protection when markets are going down.

We continue to maintain cash where needed, invest in hedge strategies funds which play an active role in the defensive portion of the portfolio, and utilize active equity funds where we believe they can assist in managing the risk level of the portfolio.

This strategy has worked well. We are able to keep equity asset classes invested at target levels while benefiting from less volatility. While portfolios may slightly underperform in very strong, risk-on markets, we are content with the degree to which portfolios have been participating in up markets.

We believe that we have already taken action to protect portfolios in advance of "another downturn." If you have any questions concerning your specific portfolio and the potential risk level, please contact us and we would be happy to review it with you.

As always, we would ask that you let us know in advance of any above average cash need which you anticipate having. This enables us to raise cash in advance of the need and at what may be a more opportune time.

The bottom line - given the current strong fundamentals – we expect slow but steady economic growth, reasonable valuations, low interest rates and inflation, and good earnings. Given our confidence about the long-term outlook we would look upon any downturn in stocks as an opportunity to invest at lower levels.

Stay warm and have a happy Spring!

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