Lassus Wherley
Building Better Futures
...a View from the Top

Issue 47, September 13, 2013

Back to School and.....

September is always an interesting month of the year. It is typically very volatile and many times has been the worst month of the year for the financial markets. We always like to believe this time is different and maybe it is …..or maybe not.

Here are our thoughts around the increased volatility, answers to some of the great questions we have received, and some things to watch out for with technology and email.

It seems like back to school is almost equivalent to back to volatility. And here we go again—as we get closer to September—the markets always seem to find a reason for increased gyrations on a day-to-day basis.

And now that September is here, we are still looking at markets that are attempting to come to grips with the beginning of the end of quantitative easing. The US economy has already shaken off a lot of uncertainty and is continuing to grow at a slow but steady pace.

The questions surrounding how and when the Federal Reserve will taper has resulted in a lot more ups and downs in both bond and stock markets. Adding to the stress is the uncertainty surrounding just who will replace Ben Bernanke as the head of the Fed.

Given the many moving parts, we don't expect boring bond or equity markets anytime soon. We do expect continued volatility for quite some time to come. The uncertainty around Syria and what action may be taken has added more to the factors driving volatility. Hopefully, the current suggested peaceful solution will prevent further violence.

With all the doom and gloom, you would expect more negative days in September. This week was off to a good start with a strong rally in stocks, and we have been pleasantly surprised by recent strength in the equity markets. Given taper talk, Syria and the fast-approaching debt ceiling, the current rally seems to once again be climbing a wall of worry.

We expect to see continuing volatility driven by many of the issues

currently being discussed. As we have seen in the past, September is always an interesting month, and it would be a nice change if it turned out to be a positive one. We are keeping our fingers crossed but not holding our breath.

> ***Bogus Tech Support Calls***
>
> *There is a scam that is currently active where someone calls claiming to be from Microsoft. If you receive an unsolicited call from* ***anyone*** *offering to "fix" your computer (especially if they claim to be from Microsoft or a Microsoft Partner) hang up immediately—it is a scam.*

Protecting Your Assets From Wire Fraud

Did you know that over 90% of wire fraud attempts are from scammers using someone else's email account to commit fraud? Anyone who has experienced an email account intrusion or "hacking" knows how frustrating it can be to deal with the aftermath – from telling friends in milder cases that you did not send the flurry of bogus emails they received to regaining access to a blocked account. In the most serious cases, a compromised email account can lead not only to identity theft, but also the theft of your money.

There have been an alarming and increasing number of reports involving investor funds being stolen by fraudsters. The trend is revealing hacked email accounts being used to facilitate wire transfers. These frauds tend to follow a typical pattern. For example, in some of the instances the perpetrators appear to have obtained the investor's brokerage information by accessing the investor's email account and searching contact lists or emails in the "sent" folder. The fraudster then typically sends an email to the investor's financial advisor with instructions to wire funds to a third-party account. The scammers have become very sophisticated, making it nearly impossible for anyone to detect if the email is legitimate or not.

While it may sound like something that happens to others, we have had firsthand experience with this scam. We have seen email accounts hacked and have received emails that appear to come directly from the client. When we called the client to discuss the request, they had no knowledge of the email – nor did they have a copy of the email in their "sent" account. Because this problem has become so widespread we will not process a wire request to transfer funds to a third party without speaking directly with the client. **We will place a call each and every time to verify the transfer instructions prior to implementation.** It is critical that we speak directly with you and verbally obtain authorization. While these extra steps may seem onerous, they exist to protect you and your assets.

If your email account gets hacked, or if for any reason you think that your personal financial information has been stolen, immediately contact us and other financial institutions you use, including credit card issuers, to notify them of the problem. You should also notify credit bureaus to put a fraud alert on your file. Check all your accounts for unauthorized transactions, especially withdrawals or wire transfers to an account that is not yours. One of the best defenses against hacking is having a subscription to antivirus software that is installed, active and kept up-to-date. By working together, we can protect against this type of fraud.

Questions

In this issue we had so many questions that we decided to focus on them.

Question: The value of my bond fund holdings has continued to go down. What is going on with bonds and bond funds? Answer: In June, we saw a perfect storm towards month-end as markets reacted negatively when Federal Reserve Chairman Ben Bernanke indicated that the Fed was considering moderating its level of bond purchases. Money flowed out of both bond and stock funds in June as investors worried about how the economy would react if the Fed cut back on stimulus. In the month of June, the S&P 500 posted a return of -1.34% while the Barclays US Aggregate Bond Index suffered an even greater drop, with a return of -1.55%.

Since then, investors have been watching economic data closely for clues as to when the Fed might start to cut back on bond purchases. Ben Bernanke has said on more than one occasion that the Fed's decision will be "data dependent" and recently, data has indicated that the economy is strong enough to handle a reduction in bond buying on the part of the Fed.

The S&P 500 returned 5.09% in July as stock investors took comfort in the Fed's post-meeting statement which pointed to modest growth, rising mortgage rates and low inflation as reasons to maintain their current policy. Bond investors were also somewhat reassured, and the broad-based Barclays US Aggregate Bond Index posted a positive return of 0.14% in July.

In contrast, in August, both stock and bond investors became more convinced that the Fed could start to taper its monthly bond purchases by $10 - $20 billion as early as this month. Initial jobless claims for the week ended August 10th came in at 320,000, which was the lowest data point for this series in almost 6 years. This economic data point has been followed by several more that indicate that the US economy continues to recover, making an early start to Fed tapering more likely. In August, the S&P 500 returned -2.90% while the Barclays US Bond Index did better on a relative basis with a return of -0.51% as stock investors discounted the Fed announcement of tapering as soon as the September 17th- 18th FOMC meeting and as bond investors began to think that a Fed tapering in September was largely discounted at current levels.

Bonds and stocks will continue to price in this eventual reduction in stimulus on the part of the Fed, while also dealing with the possibility of US military action in Syria, the question of who will head the Fed after Bernanke steps down, and the need to raise the US debt ceiling this fall. The yield on the 10-year US Treasury has already risen from

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. We really enjoy doing the research on some of the tough ones.

Some argue that most of the threat from a Fed reduction in bond purchases is already reflected in current prices. Others would say that the real (inflation-adjusted) yield on the 10 year US Treasury of 1.3% needs to approach its long-term average of 2.55%.

1.63% in early May to close to 3%.

Some argue that most of the threat from a Fed reduction in bond purchases is already reflected in current prices. Others would say that the real (inflation-adjusted) yield on the 10-year US Treasury of 1.3% needs to approach its long-term average of 2.55%. Since none of us know just how strong the economy is, we can't predict how much higher yields can go. What is as important as how high yields go is how quickly they move up.

We do know that a well-balanced portfolio is more important than ever in times of volatility. While US stocks have performed much better than bonds this year, bonds still have an important role to play in our portfolios. We hold an allocation to bond funds both for the income which they produce and because they serve as an anchor in our portfolios when stock market volatility returns. Bond investments have proven to be much less volatile than stocks over time. While our portfolios may be somewhat underweight in bonds versus their target allocation right now, we continue to nibble at short-duration bond funds in order to take advantage of these higher yields.

We have made several moves over the past few months to strengthen the ability of our bond portfolios to hold up well if rates continue to rise. For example, we have shortened the overall duration of our bond portfolios (sensitivity to a change in interest rates) by increasing the weighting in short-term versus intermediate-term bond funds. We have reduced our overall exposure to US Treasuries and mortgage-backed securities. We have also added a fund which can take advantage of the opportunities that arise in the bond market and can hedge by either going short and/or holding cash.

Question: How do you expect rising interest rates to impact the equity markets? Answer: On a basic level, when rates rise, bonds become cheaper and become more competitive to stocks. For some time, we have felt that stocks represented a better value than bonds since yields on bonds were quite low, while stocks remained reasonably valued compared to historical valuation measures. At this point, we find that international stocks represent better value than US stocks, and they are both relatively more attractive than bonds.

Whether stocks are hurt or not by rising interest rates depends on how low rates are when they begin to rise. Historical data show that when the yield on the US 10-year Treasury is below 5%, rising rates are generally associated with rising stock prices. When rates are low and rising, they tend to be rising because the economy is improving, and in this scenario, stocks benefit from rising earnings and confidence. This is the situation in which we find ourselves today. On the other hand, when rates are above 5% and rising, they are

When rates are low and rising, they tend to be rising because the economy is improving and in this scenario, stocks benefit from rising earnings and confidence. This is the situation in which we find ourselves today.

often rising because inflation is a threat, and in this case, stocks tend to lose ground when rates rise.

While US stocks may no longer be as cheap as they were at the beginning of the year, they are still reasonably valued, especially compared to historical averages. The S&P 500 Index is currently selling at about 14 times estimated earnings over the next 12 months. So, investors are currently willing to pay a multiple of earnings of 14 times while the average multiple at which stocks have sold since 1985 is 15 times. Earnings are key to how the stock market fares going forward. Earnings grew by just over 2% in the second quarter. Earnings growth could pick up in the second half of the year if the economy continues to improve.

Stocks may continue to trade in a choppy fashion in the coming weeks as investors recalibrate their portfolios for less help from the Fed. From our point of view, the improving US economy and reasonable valuations on stocks should support equity prices as we approach the seasonally strong year end.

Question: You always talk about the Macro versus Micro factors in the economy. What's happening with the Macro today? Answer: The fiscal situation in the US is improving. The Federal budget is on track for its narrowest deficit in 5 years, buoyed by higher tax receipts and the slowly improving economy. The Congressional Budget Office estimates the deficit for the current fiscal year ending September 30, 2013 at $642 billion, down from $1.087 trillion.

Q2 2013 saw a large part of the impact from the federal budget sequester and the tax increases. We expect that growth will accelerate over the next few quarters as this fiscal tightening begins to ease.

Consumer confidence suggests consumer spending may be picking up. This is supported by recent indications that the availability of credit is improving.

Pent-up demand in both autos and housing remains a positive force for economic growth. The average age of cars on the road in the US has recently hit a record 11.4, up from 9.7 years in 2003. Cars are built better and last longer than they used to, but it is still hard to push them much past 11 years of life on the road. Vehicle sales rose in August to a 16.1 million annual rate for the best report since 2007.

One of the prime drivers of housing demand is the rate of new household formation. Household formation has been depressed in recent years by the weak economy and job market. We all know of two and three generations living under one roof. We are seeing signs, however, that as the job market continues to improve, the rate of household formation will follow, as long as further rate increases do not cause mortgage rates to move up too high.

Another bright spot is manufactur-

ing. The Institute for Supply Management (ISM) Manufacturing Index for August came in at 55.7 compared to expectations of 53.8 going into the report and 55.4 seen in the July report. This index is based on surveys of more than 300 manufacturing firms by the institute. A reading in the index above 50 indicates that manufacturing is growing, while a reading below 50 indicates contraction. This was the second strong report on manufacturing in a row. It was interesting to note the strength in new export orders, which would indicate that economies overseas are picking up as well.

We have been seeing good news on the macro front out of Europe for the past few weeks. Data released in mid August showed that economic growth was positive in the eurozone in the first quarter. This report signaled the end of a recession which had lasted almost two years. On September 5th, the European Central Bank raised its forecast for the eurozone economy for the year. We are watching events closely in Europe as markets will soon have to deal with the taper in the US as well as the appointment of a new Fed Chairman, the elections in Germany and the ruling by the German Constitutional court on the OMT (Outright Monetary Transactions or bond buying scheme of the European Central Bank).

We have been seeing good news on the macro front out of Europe for the past few weeks. Data released in mid August showed that economic growth was positive in the eurozone in the first quarter. This report signaled the end of a recession which had lasted almost two years.

All year, stock markets have been reacting negatively to evidence of slowing economic growth in China, with commodity exporters in the emerging markets such as Brazil being particularly impacted. China's gross domestic product slowed to 7.5% in Q2 2013 on a year-over-year basis.

Recently, we have seen some evidence of strengthening in China. We have also seen positive data on capital investment, retail sales and industrial production.

The bottom line is that the global macro picture still looks positive for stocks as global growth looks to improve in the third and fourth quarters, and we do not expect rates to rise so far, or so fast, that they will derail this expansion.

Question: What is going on with the emerging markets? Answer: Until very recently, investors had been pulling money out of both emerging market stocks and bonds as the economic outlook looked so much better in the US and Europe. Emerging markets have been hit hard by the volatility created as markets attempt to reconcile less monetary stimulus from the US with slowing growth in the global economy. Rising yields on US debt have increased concerns about growth in many emerging market economies and have negatively impacted currencies of those countries that are most reliant on foreign capital.

For long-term investors, we continue to see diversification and total return benefits from investing in both emerging market equities and debt. We choose to invest in emerg-

ing market debt through an actively managed fund that focuses on investing in securities of countries with strong fundamentals and has proven less volatile than its benchmark index over time.

A third reason for the volatility in emerging markets, in addition to uncertainty around tapering and slowing growth in China, has been the recent move in Japan to ease its monetary policy. This has brought flows into its bond, stock and currency markets and siphoned money out of the emerging markets. Finally, recent political disturbances in Egypt, Turkey and Brazil have also led investors to reduce their exposure to emerging markets.

Given their young populations and low levels of per-capita GDP, the emerging markets should grow at a stronger pace than the developed world over the medium to long term. We find valuations on both emerging market equity and debt to be getting more attractive for long-term investors as prices are now reflecting more of the concerns regarding rising US rates and slowing emerging market growth.

As always, please keep us posted on any upcoming cash needs you may have. This helps us make sure you have cash when you need it.

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

Have a wonderful Fall!

Diahann

Investment Committee:

Diahann W. Lassus, CFP®, CPA, PFS, Chair

Anne L. Kehl, Investment Officer

Lisa McKnight, CFP®, Financial Planner

Chadderdon W. O'Brien, CFP®, FRM, Financial Planner

J. Charles Pawlik, CFP®, Financial Planner

Deborah J. Rivosa, CFP®, CFA, Chief Compliance Officer

Betty S. Thomas, Investment Analyst

Compliance Disclosure

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Lassus Wherley & Associates, P.C. ["LWA"]), or any non-investment-related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from LWA. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. LWA is not a law firm and no portion of the newsletter content should be construed as legal advice. A copy of LWA's current written disclosure statement discussing our advisory services and fees is available upon request.