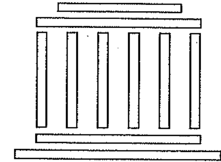
Investment Tally & Perspective



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2013 SECOND QUARTER INVESTMENT STRATEGY & OUTLOOK

Maestro Ben Bernanke – Conductor Extraordinaire

It has been more than four years since the financial crises and the stock market low on March 9, 2009. Since that time, economic data has been consistently positive, as real GDP has expanded for 15 consecutive quarters, and stocks and corporate profits have more than doubled from the bottoms reached during the darkest moments of 2008-2009. Yet clearly, global economies and financial markets are quite different in the post-2008 world. While significant progress has been made, there remains a pervasive mood of caution traceable to wealth destruction and turmoil during The Great Recession.

It is with this backdrop that the Fed and other central banks, as the financial conductors of monetary policy, continue to play nonstop music to get more activity on the dance floors. With new band leaders in Japan joining the chorus, the conductors are even more determined to change the score from the slow waltz of recent years, to a fast paced combination of the cha-cha, salsa and the twist.

"A Global Surplus of Savings" - Why The Fed Is Repressing Interest Rates

Eight years ago our economy was doing quite well, yet we found it necessary to borrow large amounts of foreign capital to fill the hole between the amounts of capital flowing into the U.S. versus the amount flowing out of the U.S. (our Current Account Deficit). At that time (March-April 2005), then Fed Governor Ben Bernanke made notable talks designed to educate the public on the causes and ramifications of being dependent on foreign borrowings. Without placing blame, Governor Bernanke explained that the dynamics of aging populations in the developed countries (U.S., Europe, Japan) combined with rapid growth in China, India and the emerging market countries, produced conditions that resulted in a "global surplus of savings". In addition to funding our external deficits, excess savings also served to put downward pressure on U.S. interest rates.

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Special points of interest:

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- *Investment Dichotomy and Dilemma - Pages 3 & 4*

Ronald E. Albert, CFP
Brittany A. Moran, CFP
Nina Walsh
Karen Jones Ariosta

40 Westminster St.
Suite 202
Providence, RI 02903

Phone: (401) 454-3040
Toll Free: (855) 768-3040
Fax: (401) 453-0678
Email: info@lccorp.com
Web:
www.lincolncapitalcorp.com

MAJOR INDUSTRIALIZED COUNTRIES

	2013 Est. GDP	Unemployment	Consumer Prices	Budget Balance (as % of GDP)	Int. Rate 10-Yr Gov't
Britain	0.8%	7.8%	2.7%	-7.8%	2.02%
Canada	1.9%	7.0%	1.7%	-3.2%	1.82%
France	0.1%	10.6%	1.6%	-3.5%	2.05%
Germany	0.7%	6.9%	2.0%	-0.3%	1.34%
Italy	-1.1%	11.7%	2.1%	-2.3%	4.58%
Japan	1.0%	4.2%	0.1%	-9.0%	0.55%
Spain	-1.6%	26.2%	2.3%	-6.6%	4.81%
Switzerland	1.1%	3.1%	0.2%	0.3%	0.76%
United States	2.0%	7.7%	1.8%	-5.4%	1.91%

Note: Interest rates in bold are Euro currency rates.

Data from The Economist, March 30, 2013

EQUITY INDEX RETURNS

Period Ending March 31, 2013			Average Annual Returns		
	First Qtr 2013	One Year	3 Year	5 Year	10 Year
S&P 500	10.61%	13.96%	12.67%	5.81%	8.53%
NASDAQ Composite	8.52%	7.14%	12.10%	8.59%	9.31%
Dow Jones Ind. Average	11.93%	13.37%	13.32%	6.50%	8.94%
Russell 2000	12.39%	16.30%	13.45%	8.24%	11.52%
MSCI EAFE (Foreign Index)	5.13%	11.25%	5.00%	-0.89%	9.69%

Data from Morningstar

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Currently, the global surplus of savings is still with us, as noted in the following excerpts from a recent report by BCA Research.

- The defining feature of the post-2008 world is still chronic excess saving. The world still saves too much and invests too little.
- It is not unusual to see a savings glut after a deep and chronic economic trauma. The 2008 Great Recession was akin to the Great Depression of the 1930s. During that episode, the gross savings rate soared to more than 24% of GDP, while the private investment rate dropped by 6%. This huge savings gap was the very reason behind a collapse in output, a sharp fall in prices and a soaring unemployment rate.
- There are many reasons behind the large and sustained savings gap, or glut, in the world. The pressure of deleveraging is one. In the 1990s and 2000s many developed nations saved very little, but built up enormous amounts of debt. The 2008 meltdown destroyed asset values, forcing debtors to reduce their leverage. This process prompted both businesses and consumers to save more and spend less. The devastating loss of wealth is another reason.
- The post-2008 savings surge could have driven the world economy into a downward spiral. Fortunately, the principal central banks around the world, the Fed in particular, have done everything possible to stop such a devastating outcome. <u>They have made savings as cheap and unworthy as possible to discourage savings and encourage spending.</u> In the meantime, central bankers have tried very hard to reflate asset values via QE programs that were aimed to shoring up household wealth and stopping the rise in savings rates. These efforts have produced some positive results.
- The global economic recovery will continue, but the strength of underlying growth will remain weak. This means that interest rates will stay low and competitive devaluation will continue to dominate the foreign exchange market.

The Investment Dichotomy

When stock prices rise, they are most often foretelling of better global growth and rising profitability in the months ahead. Stronger growth brings increasing demand for financing which normally results in rising interest rates. The opposite also applies – when economic activity is weak or declining, interest rates typically move lower, as investors seek the safety of bonds and the demand for financing declines.

In today's world, we have rising stock prices with interest rates near record low levels. Does this indicate stronger or weaker activity ahead? In the post-2008 world, there are alternative explanations. Low interest rates are primarily the result of the global surplus of savings and investors seeking principal security. For stocks, there is less uncertainty over government policies

following recent major elections and less fear of a breakdown in the financial system. These two factors combined with weaker competition from low yielding alternatives are prodding investors to pay up for stocks (a higher price multiple or P/E).

This is not to say that underlying growth for the world economy has changed much, despite higher stock prices. The savings glut remains in place. The euro zone is still in recession and Japan remains stagnant. The main points are stocks are rising on risk reduction, and bond yields are falling on the savings glut and confidence that the Fed will continue their accommodative policy.

Investor's Dilemma – How to Earn Returns Without Undue Risk?

Where can investors go to earn a decent return on their capital today? Lending money to the U.S. government (Treasuries) provides a return of 0.23% for two years, 1.7% for ten years, and 2.9% for thirty years. Prices for other types of bonds and income producing assets have all been bid higher, with yields lower, as the Fed represses interest rates to levels where individuals, pension funds, endowments and other investors are forced to take more and more risk in their quest for receiving a return on their capital.

Paltry interest rates make stocks look comparatively more attractive, a definite factor behind stock indices reaching historically high levels. The market rally since November has been quite notable for several reasons, including the fact that indices have risen over 103 days without a correction/pullback of 5% or more (markets typically decline by 5% or more every 2.5 to 3.5 months).

Before investors fully execute the "Great Rotation" (selling fixed income securities and moving proceeds into stocks), they may recall stock market movements each spring/summer in the past three years when stocks declined by the following amounts: in 2010 -16%, 2011 -19.4%, and 2012 -9.9%. While markets and most stocks recovered from each decline over time, going down 10% to 20% is not a pleasant experience.

The bottom line: While there are increasing signs that a meaningful equity correction is likely, the economic, financial, and political backdrop is less threatening today than during the equity market pullbacks in the past three years. Well managed companies with attractive valuations and growth prospects remain prime selections for income, growth, and growth of income. Yet two big unknowns lead us to temper near term expectations and brace for a bumpy ride: (1) What happens when the Fed removes the punch bowl (which markets will anticipate) and (2) how will U.S. leadership respond to a foreign event or attack, which is growing more likely in the near future?