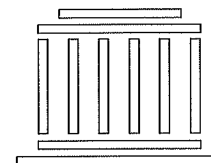
Investment Tally & Perspective



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During the first nine months of 2012, risky assets, including stocks, commodities and corporate bonds, increased sharply in the first quarter, declined in the second quarter, then experienced positive returns in the third quarter. Will this pattern of risk-on/risk-off continue, or will markets move significantly one way or the other? This issue of Tally & Perspective reviews issues related to stock market performance, past and projected, with economic and financial market data, and the current investment outlook.

The Stock Market—Recent Past and Reasons for Caution

During the first ten years of the new millennium (2000 to 2009), stocks produced a negative rate of return, with two severe bear markets. Then, after reaching the lowest level in March 2009, stocks more than doubled. Yet public participation throughout the most recent bull market has been very low. In fact, investors have been net sellers of stocks, transferring billions of dollars each month to bonds, all during this period.

With a decade of negative performance as background, disenchantment with stocks is quite understandable and we share numerous concerns, including the fiscal cliff, Europe's recession and China's slowdown, the increasing probability of an Israeli attack on Iran's nuclear facilities, earnings estimates that appear too high, and great uncertainty over the election ramifications (tax rates, regulations, the political will to deal with our major problems).

Yet, even with these headwinds, stocks rose over 15% from early June to the end of last week. Why? For decades, stock price movements were based on real fundamentals, mainly trends in economic activity, interest rates, and corporate profits. While still important, the role of these fundamental factors has diminished since the 2008 global financial crisis and continuing debt crisis. These events brought government intervention – monetary and fiscal – to unprecedented levels, with market movements determined more by the words and actions of the Fed, and other central banks, than by real economic factors.

Why New Highs in Stock Prices are Likely in Coming Years

The S&P 500 Stock Index first reached the 1,500 level twelve years ago, before declining nearly 50% the following three years. Then, in 2007, it reached a new high of 1,545, before suffering another major decline (-58%) the following two years. Recently trading at 1,450, the S&P is just 6.5% below the all-time high. Will it rise above 1,500 and remain elevated, or is this a prelude to another large drop?

MAJOR INDUSTRIALIZED COUNTRIES

	2012 Est. GDP	Unemployment	Estim. 2012 CPI	Budget Balance % of GDP 2012	Government Bond Rates
Britain	-0.2%	8.1%	2.6%	-8.4%	1.69%
Canada	2.0%	7.3%	1.8%	-3.4%	1.72%
France	0.1%	10.6%	2.2%	**-4.5%**	2.19%
Germany	0.8%	6.8%	2.0%	**-0.3%**	1.44%
Italy	-2.4%	10.7%	3.2%	**-2.8%**	5.11%
Japan	2.2%	4.2%	0.1%	-9.1%	0.77%
Spain	-1.7%	25.1%	2.4%	**-6.8%**	5.73%
Switzerland	1.0%	2.9%	-0.4%	0.3%	0.59%
United States	2.1%	8.1%	2.0%	-7.6%	1.62%

Note: Interest rates in bold are Euro currency rates.

Data from The Economist, October 6, 2012

EQUITY INDEX RETURNS

Period Ending September 30, 2012	2012				Average Annual Returns			
	1st Q 12	2nd Q 12	3rd Q 12	YTD	1 Year	3 Year	5 Year	10 Year
S&P 500	12.66%	-2.84%	6.35%	16.44%	30.20%	13.20%	1.05%	8.01%
NASDAQ Composite	18.67%	-5.06%	6.50%	20.65%	30.53%	14.81%	3.89%	10.29%
Dow Jones Ind. Avg.	8.91%	-1.90%	5.02%	12.19%	26.52%	14.45%	2.16%	8.60%
Russell 2000	12.06%	-3.83%	5.25%	14.23%	31.91%	12.99%	2.21%	10.17%
MSCI EAFE (Foreign Index)	10.86%	-7.13%	6.92%	10.08%	13.75%	2.12%	-5.24%	8.20%

Data from Morningstar.

INVESTMENT STRATEGY & OUTLOOK

October 11, 2012

The Economy

- The U.S. economy continues to expand at "stall speed" with high unemployment
- Uncertainties – the election, fiscal cliff, tax policy, Mid-East - make businesses cautious
- Budget deficits and excessive debt are growth suppressants around the globe
- The U.S. "fiscal cliff" may well cause a recession, if not resolved or revised
- Much of Europe is in recession with continuation into 2013 likely
- Economic indicators are mixed with tepid growth expectations, at best

The Fed and Monetary Policy

- Central banks are primarily concerned with deflation and recession risks spreading
- The Fed has launched an open-ended bond buying program (QE3) targeting mortgages
- The Fed expects short term rates to remain suppressed into 2015
- The aggressive policy response is being coordinated and supported by other central banks
- Fed strategy is to inflate stock and real estate values to spur consumer and business spending
- Highly simulative monetary policies are setting the stage for future inflation

Bonds and Interest Rates

- The 10-year Treasury yield has risen from the recent low below 1.4% to levels near 1.75%
- Mortgage rates remain near record low levels in modern times
- Cash producing assets have increased in price as investors desperately seek income
- Longer term, it's an open question whether interest rates will normalize (rise), or whether the "global savings glut" noted by Ben Bernanke in 2005 will keep interest rates suppressed

Equities

- The S&P 500 and Dow Industrials indices have risen past or near their highs earlier this year
- The stock price rise is fueled more from "money printing" than rising earnings
- Stock market positives include bearish positioning, low expected returns from bonds, a healthy corporate sector, stabilizing US real estate, easy money policies
- Tremendous uncertainty is negatively impacting economic activity, with major concerns being the U.S. 'fiscal cliff" and upcoming elections, the European debt crisis and recession, slowing economic activity in China, and the future direction of inflation and interest rates

Summary Outlook

- The global process of deleveraging and addressing un-funded liabilities is well underway
- The end result will be stronger balance sheets for consumers, businesses and governments
- In a world of zero and negative interest rates, solid growth companies will become more highly valued; following near term volatility, stocks will likely move significantly higher in coming years

While the future is truly unknown, the case for expecting new all-time highs in coming years is quite reasonable. Stock prices are determined by many factors, with corporate profits being the primary data point, and corporate profits are related to overall economic activity (GDP). The connections between economic activity, corporate profits, and stock prices are illustrated in the following table.

	GDP ($trillions)	S&P Earnings	S&P High
2000	$11.2	$52.13	1,520
2007	$13.2	$82.54	1,545
2012E	$13.7	$101.7	1,475

While the uncertainty level is high and we won't pretend to know how everything develops, we maintain a positive view on equity investments in the coming years. The major economic issues of budget deficits and excessive debt (mainly unfunded pension and healthcare liabilities) are being painfully dealt with, and will gradually be resolved. At the same time, growing populations and affluence in the emerging countries, which lack the legacy debt of the developed countries and have younger demographics, will continue to spur global growth in coming years, resulting in increased corporate profits for companies that provide goods and services.

In sum, we expect sharp moves in both directions in the months ahead. Looking beyond the near term, we are cautiously optimistic, as the auto and housing sectors are improving, balance sheets are being restructured, and trillions of dollars recently injected into the global economies will eventually lead to higher economic activity. While it may also lead to other major problems (inflation, dollar weakness, etc.), for clients with a time horizon measured in years, we suggest a balanced and diversified investment strategy, with stocks being a primary asset for income and growth of capital.