THE FRIDAY BRIEF
A weekly discussion of events and their impact your investments

BEACON INVESTMENT MANAGEMENT

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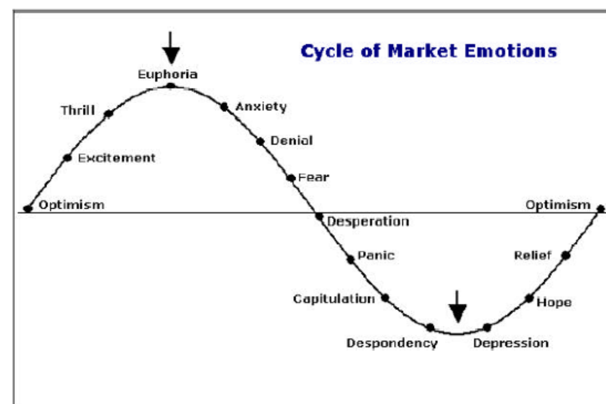
Are You Planning or Reacting?

During the lifetime of the "Greatest Generation" the market has fallen an average of 40% fourteen times, or once every 5.7 years. In fact the odds of an investor experiencing a loss in any one year are 1 in 3.9. The latest drop from May 19, 2008 to March 9, 2009 took us down nearly 53%. It's easy to see why so many former investors have been driven to the sidelines. Yet why do others remain steadfastly invested? In short they seek the 11.5% average annual return the market has provided for the past 40 years, along with the added benefit of ready liquidity. They understand the market, while seductively steady much of the time is prone to major emotional swings which require patience and fortitude to endure. Perhaps knowing that the average return a year after a market trough is 46% helps assuage the pain of declines, while understanding that 'irrational exuberance' will eventually lead to a hangover helps them remain on course while others fall prey to their emotions.

Doug Sandler of River Front Investment Group makes the interesting point regarding the possibility that the recent crash of '08 to '09 went too far down, just as the tech-driven bubble of the late 90's went too far up. He suggests the excessively high valuations seen in the 1997-2000 timeframe were an outlier, likely not reoccurring again for decades and therefore useless as a reference point or comparison for future investment decisions. If the recent crash driven by a financial meltdown of extraordinary characteristics then we should similarly discount the excessively cheap valuations that were reached on March 9th. In other words, the recent run-up of 50% might not suggest that a pullback is necessary if the recoil was simply back to a point of equilibrium in the market.

In last week's Brief we mentioned that the market has not demonstrated any excessive optimism. The market is climbing the proverbial "wall of worry" as investors fully discount the many legitimate and continuing concerns of unemployment, deficits, mortgage rate resets, and likely significant commercial real estate loan problems. For this reason, the market likely still has strong legs and will pull more investors off the sidelines. We are likely on the 'hope' or 'relief' part of the emotional market cycle depicted to the right.



Strategists are beginning to grow further apart in their views of what is ahead for the US economy. A growing number of economists such as James Glassman at JPMorgan say that significant pent-up demand is being built up by this extraordinary recession. He says that "whenever we have plunged off a cliff and fallen into a deep hole in the past, for a while the economy has a tendency to bounce back very quickly." He says that forecasts of 3% to 4%

growth in coming quarters may be too low given pent-up consumer demand. His views are becoming more popular.

On the other hand, Mohamed El-Erian of Pimco says that elevated unemployment and record wealth destruction will keep growth at 2% or less for years. Then there's David Tice, chief portfolio strategist of Federated Investors who says that US stocks are "dramatically overpriced" because the fallout from the financial crisis will continue to hurt consumer spending. He says "I'd love for prosperity to return, unfortunately I think you need to be realistic and it takes time to work off these excesses" created by the financial bubble.

Economic indicators continue down to mixed. The Fed came out on Wednesday and signaled that they would continue their unprecedented efforts to promote lending to sustain what they referred to an economy that is "leveling out." The official statement retained a pledge to keep interest rates near a record low for an "extended period." Bloomberg posits that the statement suggests the Fed will stretch into 2010 their bigger initiative to buy as much as $1.45 trillion of housing debt, currently due to end this year. Officials may as soon as today postpone the December expiration of their initiative to restart the market for asset- backed securities, analysts said. "The Fed knows its liquidity programs are essential to investor optimism, so it is not going to do anything to jeopardize the good mood" in financial markets, said Christopher Low, chief economist at FTN Financial in New York. "The Fed is always the last one to acknowledge that a recovery has begun because it cannot afford to be wrong."

Retail sales figures released earlier this week indicated that consumers remain dug in. The Commerce Department said purchases fell for the first time in three months, by 0.1%. The Labor Department report showed that 558,000 Americans, filed claims for unemployment insurance last week bringing the total job loss to 6.7 million in the recession that began in December 2007. Today's release of consumer sentiment by Reuters/University of Michigan suggests the consumer remains pessimistic as the index fell back nearly 3 points at mid-month to 63.2.

The housing market is starting to pull in the right direction to help the economy, with single-family housing starts and building permits up 32% and 26%, respectively, existing single-family home sales up 7%, and new home sales up 17%. Prices are still falling according to the S&P/Case-Shiller Home Price Index, but they are slowing. The combination of all of the above is helping to improve buyer confidence.

Industrial production in July helps the case that the recession is over, as it rebounded 0.5%, following a revised 0.4% decline in June. The July boost was due primarily to motor vehicle assemblies. Auto manufacturers are finally boosting production after GM and Chrysler emerged from bankruptcy. Nonetheless, manufacturing ex autos rose 0.2% after a declining 0.5% in June. Overall capacity utilization in July improved to 68.5%, rising from a revised record low of 68.1% in June.

Europe is showing signs of recovery as well as the region economy barely contracted in the second quarter. Germany and France unexpectedly returned to growth, suggesting Europe's

worst recession since World War II is coming to an end.

China, the engine pulling the global recovery train appears to remain up to the challenge, even as the government applies the brakes through domestic bank lending. But, they are not putting on the brakes financing their biggest customer, the United States. The Chinese continue to buy lots of US Treasuries, but according to Ed Yardeni, they are demanding more protection from potential inflation. The Treasury as a result will be offering more TIPS which force the government to pay interest at rates dependent upon the CPI.

Finally, it looks to be another excellent quarter for corporate earnings relative to analysts' estimates. Earnings surprised 8.7% during Q1 and 7.3% (both excluding Financials) during Q2. At the end of June, industry analysts estimated that the S&P 500 companies earned $13.90 per share during Q2. The actual number so far suggests $15.83. Yardeni suggests that dramatically increased productivity is responsible for the surprises. The fear of losing one's job likely compels workers to take on greater workloads than before.

The market and the economy remain emotionally charged. The former has recovered considerably more than the latter, but emotions are no less involved. The big question on the mind of those who went to cash and still hold more cash than they feel comfortable holding given the market's move are nervous that they have missed it. We suggest taking the long view as was suggested at the opening of this Brief. Historically the market generates average annual returns of 11.5%. A strong case can be made that the recent rally represents largely a snap back to a more 'normal' valuation and from here the market can continue growing, albeit less dramatically.

As we often suggest, market and investment performance should be considerably less important components of one's investment strategy than is typically the case. What truly matters is to develop a firm understanding of when and how one's savings and spending patterns occur over one's lifetime, stress-testing them against the uncertain timing of market risk. Only then can you have confidence that you will meet your most important goals. If beating the market is that goal, we wish you the best, as the statistical odds of accomplishing it are extremely low. But if your goals are more personal and unique to you and glossy colorful brochures of historical stock charts and happy couples walking on the beach fail to provide the confidence you require, Wealthcare awaits. Call us and in less than an hour we can help you replace worries and questions with confidence and a plan.

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