Financial Counselors

Ethics, Education & Experience™

December 30, 2011

D3 Business Update:

Many of the mutual funds we invested in during the year paid out long term and short term capital gains, as well as large dividend payments. We estimated the capital gains distributions and attempted to offset them by harvesting losses in other portfolio positions. We also invested excess cash that we knew of from these various distributions to rebalance your portfolios to target asset allocations.

Starting in mid-January, after we reconcile all of your accounts, we will generate your portfolio performance reports. We anticipate loading those up on your client portal by January 31st and plan on reviewing them with you in February.

D3 Investment Insight:

As we said last month, "The economic numbers being reported by the U.S. government continue to show slow and slightly accelerating growth in the U.S. economy." The ISM manufacturing index and pending home sales announced yesterday were both better than what economists had been expecting. All indications are that retail sales will be significantly higher for December when compared to last year. The four week moving average of reported jobless claims is at a 3 ½ year low. Slow and steady growth for the U.S. economy appears to be the watchword.

Although the headlines from Europe continue to generate market volatility, it is less than the previous two months. The European Central Bank is acting as a backstop to make sure government bond deals get done at reasonable rates.

At the end of this newsletter we included an article from Boris Schlossberg summarizing 2011. We will be providing more detailed information regarding asset class performance in January.

D3 Investment Outlook:

We may be moving to a 1950s investment environment where stock dividends are higher than government bond interest rates. For this reason we continue to emphasize investing in dividend paying U.S. equities (hence the big dividend payouts in your accounts this month)

Regarding interest rates; the Federal Reserve Bank (Fed) has hinted that they may keep interest rates low until 2014 (previously they had stated 2013). It is clear that the Fed wants the U.S. economy to avoid deflation pressures and grow out of this deleveraging cycle. It is also clear that the Fed will risk some inflation in favor of these policies.

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D3 Investment Strategy:

Most of our efforts this past month were focused on tax minimization, rebalancing and replacing underperforming assets. We will continue replacing underperforming assets in January. We will also revise our asset allocation models and will share those changes with you. We will also share with you how different asset class investment performed during 2011.

If volatility in the bond market continues to subside, we will resurrect our move form short duration bond funds, to longer duration funds.

Don't hesitate to contact us if your goals, needs or risk tolerance changes.

Lastly…..

As always, thank you for your business and happy New Year. .

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2011 S&P 500 Review

By Boris Schlossberg, Director of Currency Research, GFT | GFT Forex – Mon, Dec 26, 2011 8:47 PM EST

Looking Back

At the time of this writing (early December 2011), the S&P 500 is pretty much back to where it was at the start of the year. Yet, it has held up better than many other global indices. For comparison, the UK's FTSE100 is down around 7%; German DAX has fallen14% while the Japanese Nikkei and China's Shanghai Composite are down 15% and 18% respectively. It is interesting to contrast the S&P's performance with that of three other major U.S. indices: both the Dow Jones Industrial Average and the NASDAQ 100 are around 4% higher for the year. However, the broad-based Russell 2000, where the average market capitalization of its constituents is considerably smaller than other U.S. indices (at around $1.25 billion), has fallen over 6%. It would seem that investors are more interested in owning diversified multinational corporations than smaller, more domestically focused companies.

The S&P began the year in robust fashion. It rallied to an intra-day high of 1,376 in early May, its highest level since the summer of 2008. However, it began to struggle over the next few months before slumping around 20% in the two weeks between the end of July and early August. The sell-off was triggered by a downgrade to the U.S. sovereign credit rating. Policymakers struggled to agree on ways to deal with a possible breach of the U.S.s debt ceiling, which is a limit set by Congress on the amount that the U.S. Treasury can borrow. Without an agreement on tax increases, spending cuts, or raising the ceiling, the prospect of the U.S. defaulting on its debt became a much-discussed topic. There was a last-minute deal agreed by U.S. policymakers to raise the debt ceiling and reduce future government spending. However, the rancorous nature of the debate and the shabby compromise that resulted eventually led ratings agency Standard & Poor's to downgrade the U.S.'s AAA rating.

Current Assessment

Growth is slowing across Europe and China. Yet many investors believe that the prospects for the U.S. economy are improving. They seem convinced that better-than-expected economic data (most recently in consumer confidence, employment, and housing) demonstrates that the U.S. can now decouple from the rest of the world in the same way that many believed that China would just a few years ago.

Yet at 8.6%, U.S. unemployment is still far too high. Data on the housing market is mixed, and while many analysts insist that this is a prelude to an upturn, excessive inventory and record numbers of households swamped by negative equity suggest that further deterioration is equally likely. Employment linked to real estate, construction, and related retail, together with housing equity withdrawal, provided a boost to U.S. growth between 2000 and 2007. Without a significant improvement in housing, it is unlikely that unemployment will fall much further. Consequently, U.S. consumers are unlikely to contribute to demand in the way that they once did.

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Corporate Earnings

Last year's quarterly earnings reports consistently surprised to the upside and we have generally seen over 70% of S&P 500 companies beat analysts' estimates over the last 12 months. To a great extent, this positive dynamic was due to analysts' cutting their expectations. A similar pattern holds true as we head into 2012, and fourth-quarter earnings growth has been revised down to 13.6% from 19% at the end of September 2011. Corporate guidance has also been tempered lower with more than 80 negative preannouncements on earnings per share for S&P 500 companies from September to the beginning of December. This is the highest number of negative pre-announcements since the fourth quarter in 2008 and it includes giants such as DuPont, Texas Instruments, and Intel.

Earnings can be enhanced by cost-cutting, and that has certainly been a recurring factor since the financial crisis started over three years ago. However, there is a limit to how much companies can cut, and corporations may now be reaching their limits, especially in terms of staffing levels. The severe cost-cutting of the past three years indicates severe structural problems. After all, if this were a normal cyclical recession, GDP growth would be running at more than twice its current levels, and unemployment would have fallen rapidly. Yet monthly Non-Farm Payrolls have averaged a gain of 108,000 over the past 15 months. Such tepid growth is not even enough to accommodate fresh entrants into the U.S. labor market, let alone make in-roads on the six million-odd Americans who have lost their jobs since the start of the financial crisis. The unemployment rate dropped sharply in November to 8.6% from 9%, although analysts have pointed out that this has much to do with a drop in the Labor Participation Rate. This is where job seekers become so discouraged that they give up actively seeking employment. When this happens, then they are no longer counted as being unemployed and so drop out of the calculation. The Labor Participation Rate dropped to 64% in November, its lowest level since 1983 – hardly representative of a healthy economy.

Another argument in support of equities is the large amounts of cash that many corporations hold on their balance sheets. It is said that all that a company has to do is start spending its cash pile on worthwhile acquisitions, or organic expansion, and its earnings multiple will leap. Yet, companies don't like holding cash as a rule, and if they aren't spending it, it is because they can see nothing worth buying or they are fearful of the future.

The Federal Reserve

The U.S. Federal Reserve has a dual mandate: to ensure price stability (through keeping inflation under control) while maximizing employment. It has undertaken a succession of interventions since the global financial crisis took hold in 2008. The central bank's balance sheet now stands at an unprecedented $2.8 trillion (up from around $500 billion prior to the financial crisis). Two years ago, the talk was of when the U.S. Federal Reserve would begin to reduce its balance sheet. Since then, the original $1.75 trillion program of asset purchases has been augmented by "QE lite", QE2 and "Operation Twist". In addition, the Fed has committed to keep rates low until mid-2013.

The Fed finds itself in a difficult position. Equities in particular have benefited from its liquidity provisions, and it is the hope of further intervention that has helped to keep the stock market buoyant. But if U.S. economic data continues to improve, it may be difficult for the Fed to justify further interventions.

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The upcoming presidential election may also cause problems for the Fed. The central bank is desperate to be seen as independent, yet a number of Republican candidates have suggested that the Fed is becoming increasingly politicized. Any further Federal Reserve stimulus in an election year could be spun as an attempt to boost President Obama's chances of re-election.

Looking Forward

The uncomfortable fact is that for the past thirty years or so, much of the economic expansion in the developed world has been built on credit and borrowing, either unsecured or using stocks, bonds, and property as collateral. Deleveraging is a prerequisite of a return to solid growth; this is made all the more painful by European austerity. So far, the U.S. and the UK have managed to temper the effects of deleveraging through loose monetary policy and quantitative easing. But central bank intervention brings diminishing returns, and at some stage, this has to be unwound. Will central banks decide that inflating away their obligations is their only viable option?

Markets anticipate further central bank stimulus in 2012. Hopes have risen following the coordinated central bank action on November 30th which saw a cut on U.S. dollar swaps, just after the People's Bank of China cut its Required Reserve Ratio for banks by 50-basis points. There is a growing consensus that the U.S. Federal Reserve will target any future asset purchase program at the mortgage market in a bid to depress mortgage rates further and help embattled homeowners. This should help to underpin the S&P.

Since last August, the S&P 500 has been notable for sharp, daily price movements as investors have struggled to come to terms with the escalating European debt crisis. Faced with only unpalatable choices, Europe's policymakers have repeatedly put off making difficult decisions. In addition, there are fundamental disagreements between Germany and France over the role of the ECB and the creation of Eurozone bonds. The last "make-or-break" EU summit in early December did little to assuage the ratings agencies, which have now warned about the possibility of future downgrades to the credit ratings of Europe's banks and/or sovereign debt. With the U.S. presidential election in prospect, and further wrangling over tax cuts and spending, will the U.S. be able to decouple from the rest of the global economy, allowing the S&P index to build on recent gains? Or has the U.S. already done so, in which case, we can expect other global indices to outperform the U.S. over the next year?

- David Morrison contributed to this article