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The Good, The Bad, and The Ugly

(2012 Mid-Year Review)

Dear Clients and Friends,

I sincerely hope that your summer is going well and that you are able to break away from your work routine for at least a few days of family time. It is hard for me to believe that summer is nearly half over already! As we have now crossed the half-way point in 2012, I'd like to pass along a few thoughts on the state of the economy and financial markets.

First --- the Good: This week marks the beginning of earnings season, in which corporate America comes to Wall Street to report earnings for the second quarter and provide guidance for the rest of the year. In my view, markets are "bracing for the worst" in this reporting cycle, which I generally interpret as a near-term bullish sign. Wall Street has become quite adept at managing expectations by alerting the markets to possible bad news ahead of time. By the time earnings are released, expectations tend to be set below actual performance. Thus, we will likely look back on this earnings season and see that more than 70% of companies reported earnings that met or beat Wall Street's expectations. This should create an upward bias to the stock market as long as other factors don't steal attention away from these earnings reports.

Unfortunately, the bigger picture is that earnings margins are at or near historic highs for U.S. stocks. It would be dangerous to assume that these margins can persist indefinitely. Additionally, while earnings have been growing since 2009, the growth rate has been decelerating ---- and may actually be flat to slightly negative for the first time this quarter. In the end, as the stock market drifts higher, this process may end up feeling somewhat like winning the 11th place ribbon at the fifth grade track meet.

Second --- the Bad: Yields on 10-year Spanish sovereign debt are fluctuating between 6.5% and 7.0%. (Italian debt yields are not far behind at 5.50% to 6.0%.) This high interest rate makes it very difficult for the Spanish government to stay solvent as an ever-increasing portion of tax revenue must be used to pay interest on government debt. Earlier this week, Spain announced a $80 billion austerity plan --- a combination of tax increases and budget cuts. That number represents almost 6% of the Spanish economy. It would be similar to an $855 billion austerity plan for the U.S. economy. The sheer size of this plan is staggering. Initial reaction to this news was positive as Spanish yields dropped from 7% to 6.50%. But they are now climbing again and stand at 6.66% after only a couple of days! It is clear that the market either believes that these drastic measures are not enough or that they are not genuine. Either problem is a big one. And as we already know, Spain is not the only country in the Eurozone with problems…

And finally, the UGLY: In an effort to find a longer term perspective, please take a look at the chart below. It displays normalized price-to-earnings ratios (P/E) paid to own stocks

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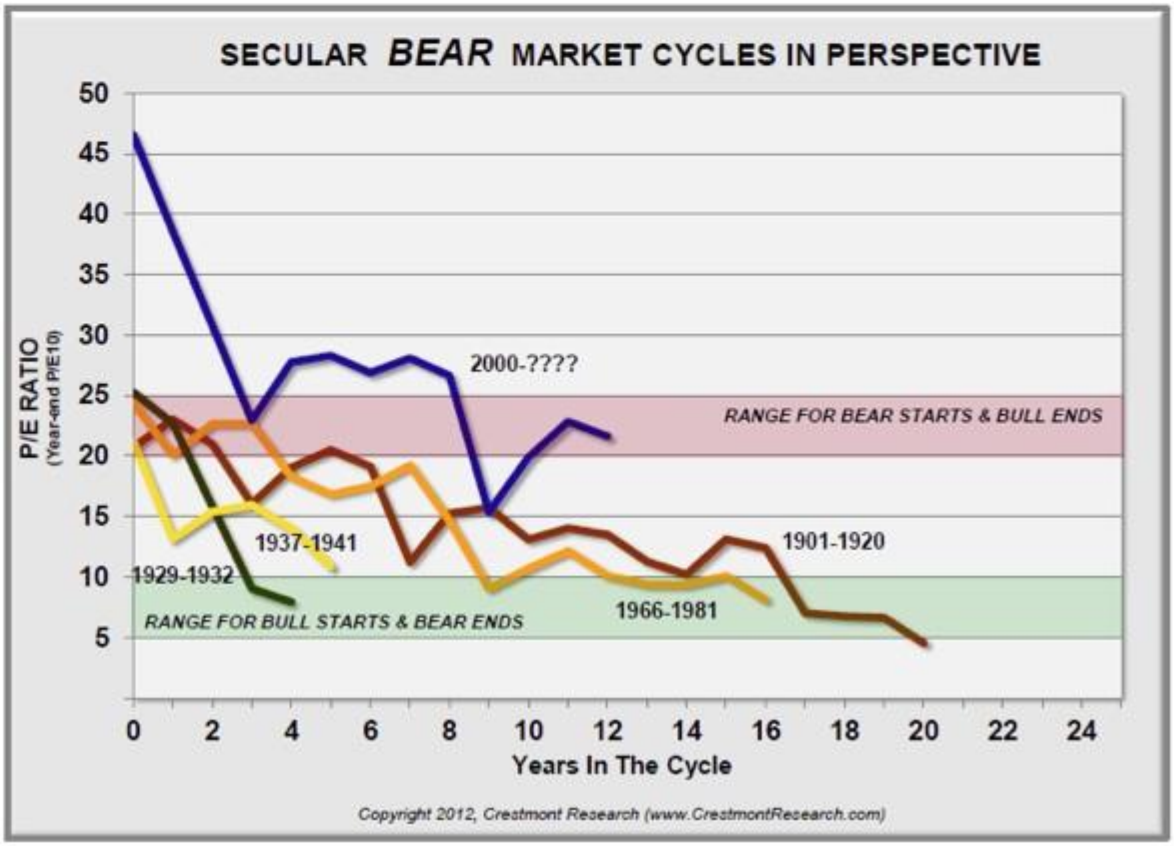
over the course of each secular bear market that our country has experienced since 1900. (Technical note: "normalizing " P/E ratios is an attempt to remove differences in data due to inflation and/or profit margin shifts from one year to the next.) As you might expect, P/E ratios trade down over time as the market finds an acceptable inflection point where stocks are cheap and a new bull market can begin.



It is sobering to realize that the current P/E ratio is actually still in the red zone where all other bear markets started. Given the current global economic and geo-political landscape, it appears that stock market returns are likely to be muted for some time to come.

Of course, this reinforces our current longer term asset allocation strategy of minimizing broad stock market risk. Instead, it is my view that the risk/return profile in alternative investments, specifically in certain hedge funds and potentially in private equity, are more compelling for the portion of your capital base dedicated to taking risk. As always, please feel free to email or call with comments or questions.

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