

TFC Market Update November 1, 2010

Elections (Politics & Policy), QE2, Investor Confidence, and Future Return Expectations

Your vote counts! Without knowing the mid-term election results as this is written, herewith are a few thoughts on the months ahead for individual investors.

Priced into today's stock market valuations appears to be the assumption that post-November 2nd, the U.S. political playing field will be leveled somewhat. Implied also is that a more balanced and business-friendly economic environment will follow. This is, as well, the third year in the four-year Presidential term stock market cycle; historically a strong year for equities as the party in power anticipates the next national election (i.e., 2012) and tries to set the fiscal table for a banner economic election year.

Equity markets around the world today are selling at roughly 13-14 times 2011 estimated corporate earnings, by most past standards a reasonable valuation; even suggesting an opportunity for a price-earnings multiple upgrade, should investor confidence modestly turn more positive. Going into 2011, investors will probably begin to look forward to further corporate earnings improvement in 2012.

But, of course, one is tempted to say it is different this time. The effect of the accumulated baggage of incessant consumer borrowing encumbering personal balance sheets, continued accommodative central-bank-mandated short-term interest rates, the fiscal gap opening up as government entitlement program markers come due, and the unfunded private and public pension future liability black hole, all conspire to severely constrain the usually robust economic recovery typical of the past U.S. economic rebounds. The policy choices to remedy the situation are reasonably obvious. The question is whether the political will exists to make the difficult decisions. Against the current moderate inflation backdrop, any resolution of these issues continues to be postponed. As most voters attempt to reorganize their own personal financial lives, pressure on the Federal government to follow suit will mount.

QE2 (Washington's Version, Not the Cunard Liner)

Meanwhile, the Federal Reserve Bank (Fed) proposes to add further liquidity to our banking system through a second round of *quantitative easing* (i.e., buying from U.S. banks up to another \$1 trillion of underwater home mortgages). Termed QE2, this should be understood for what it is—printing money. The net result will be to further debase the dollar, reducing the purchasing power value of the U.S. Treasury debt held by China, Japan (holdings in excess of 50% of our Federal government debt), and other dollar-denominated fixed income securities. While today inflationary expectations remain contained, the Fed and Congress can continue to try to inflate our way out of our accumulating fiscal and trade balance deficits, paying off such obligations in dollars of declining purchasing power. But finding a chair when the music stops sometime in the future will be the challenge. When our trading partners no longer wish to accept dollars in payment for our imports, Congress would be forced to act.

Wall Street vs. Main Street

Meanwhile, institutional “sell-side” financial engineers continue to create investment products aimed at gathering assets to generate additional fee income. But the institutions flogging these synthetic instruments may not be able to deliver on the risk characteristics and return promises implied. *Target funds* are the flavor-of-the-month. Hedge funds (despite the lackluster results of the average fund the past few years) continue to attract disproportionate inflows. Securities structured to reduce volatility remain in demand.

In the pension world, investment committees continue to reduce equity exposure, building up long duration bond positions to match future liabilities while reaching for yield with higher income-generating obligations. Consultants, professional and institutional money managers, as well as individual investor behavior seems mired in concerns of the recent past.

Ignored in this frenzy to avoid risk is the case for owning domestic and international stocks. For nearly three years investors have been net sellers of equities reinvesting the proceeds in bonds and other alternatives. Bonds have experienced a 30-year bull market, outperforming stocks since 1981. Ten-year U.S. Treasuries, today yielding 2.65%, are selling at 40 times cash flow; stocks by contrast on average sell at an earnings yield of 6.74%. Although the economic and fiscal policy issues facing those in power seem formidable, the remedial actions do not seem completely beyond reach. The case for investment in global equities continues to seem compelling. It can be less expensive (through passive vehicles), income yields in many cases exceed bonds, and many corporate balance sheets are in better order than the U.S. Treasury.

The Retirement Challenge: Is An Inflation-Adjusted Annuity Attainable?

For most individual investors, the rationale behind accepting portfolio risk is to ultimately accumulate enough retirement financial resources to guarantee a purchasing power-adjusted continuation of their lifestyle. The traumatic events of the last few years and our equities markets’ recent “lost decade” (during which the S&P 500 Index produced a negative return of -0.97% per year), have caused many to revise their retirement plans. Whether working longer, downsizing retirement budgets, or generally lowering expectations, capital preservation is the mantra of the “new normal” moment.

Not wishing in any way to diminish concerns about the shoals ahead which must be navigated, the understandable tendency for investors to become overly risk-averse needs to be recognized. The inclination also to chase recent past returns in currently popular asset classes is a pervasive bias often driving investor thinking. Although not fashionable currently, reasonably valued global equity funds continue to attract our attention and research efforts. From current levels, a total return approximating 6-7% annually for stocks would seem a reasonable expectation. In today’s 2% inflationary environment, despite the expectation of greater price volatility, an equity emphasis in portfolios would seem to still offer a better chance of maintaining purchasing power throughout retirement than most of today’s alternatives.

Please feel free to let me know if you have any comments or questions.

Best,



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