Paul R. Ried Financial Group, LLC
Security for your future

A MESSAGE FROM YOUR FINANCIAL TEAM
First Quarter 2011
February 22, 2011

Dear Clients,

We wrapped up a fairly solid year in 2010 with the market (as measured by the S&P 500) up about 15%. Essentially all of that gain came after Ben Bernanke hinted at the likelihood of additional stimulus in his speech in August. That stimulus plan was enacted in November, followed in December by the extension of the Bush tax cuts, the extension of the emergency unemployment benefits and the addition of a temporary 2% payroll tax cut. That has kept the momentum going into the new year with the S&P 500 up about 6% year-to-date.

Delay Tactics

The markets have taken well to our government's decisions to delay tough choices. The danger is that this is more than simply "kicking the can down the road" as these decisions have generally been characterized. In that case, when you get back to the "can" it's basically in the same condition (albeit slightly dented). A better analogy for this is rolling a snowball down the street. Indeed, the issues become bigger and at an increasing rate.

Nevertheless, the extension of the tax cuts and unemployment benefits is a welcome relief to companies reliant on U.S. consumer spending. While many will be happy to see a little boost in their check from the 2% payroll tax cut, unfortunately, they are likely to see the benefits quickly disappear at the gas pump.

Inflation in Necessities

Gas prices, which are about 20% higher than this time last year, are not the only thing back on the rise. Raw materials of all sorts have increased dramatically. In the last 12 months, copper is up over 35%, wheat over 20%, cattle over 20%, corn over 90%, cotton over 150%, and heating oil is up over 30%. The majority of those gains have come in just the last six months. One of the few things down is natural gas (by about 20%).

Although food inflation has added to civil unrest internationally, the effects from most of the increases in raw materials are yet to be fully felt by end consumers. However, these cost increases are hitting producers who must decide how much of these costs to pass on to the end consumer in the form of higher prices or how much they will have to absorb in the form of lower profits.

While these cost increases will have an effect on real-life budgets, inflation as measured by the consumer price index (CPI) is likely to stay relatively low. This is due to housing making up 41% of the U.S. CPI (with owner's equivalent rent making up the majority). In fact, the housing component makes up roughly the same share of CPI as food, clothing, transportation and health care combined.

However, the recent price increases of raw materials should not necessarily be extrapolated into the future. This is especially true of renewable resources such as cotton since the rapid price increases should result in farmers planting at an increasing rate.

Interest Rates

There has been a lot of talk about interest rates recently. Despite all the volatility, 10-year treasury rates at 3.5% stand almost exactly where they were this time last year. Last April, 10-year treasury rates reached 4% before falling as low as 2.4% in October. Rates then quickly rose for the remainder of the year. Despite the whirlwind in rates, most bond categories finished the year with healthy gains.

Rates started falling last April mainly due to concerns about a renewed slowdown in the economy and then continued down after news of the Federal Reserve's plan to buy Treasuries. However, actual implementation of the plan didn't prevent rates from rising back up as talk of inflation renewed the public's awareness of what can result when governments worldwide spend money whether they have it or not, and Central Banks choose to assist in funding that spending.

Valuations

Concerns about interest rates and recent strong returns from the equity markets are making many investors wonder if they should increase their allocation to stocks. There is a danger here of exchanging one risk for another, possibly greater risk.

While company earnings have been on the rise, so too have valuations. Using the "P/E10" ratio economist Benjamin Graham is largely credited with developing in 1934 (which takes the average inflation adjusted earnings of the last ten years, divided by price), the S&P 500 is currently in the ranks of the top 10% of most expensive markets using data going back to 1871. The long-term average "P/E10" ratio is about 16. The current ratio is just over 24. The last time we discussed valuations back in April of last year, the ratio was just over 21, putting it in the top 20% of most expensive markets.

There is a strong relationship between the "P/E10" ratio and subsequent 10-year returns. However, the ratio does not say as much about short-term or sometimes even medium-term returns. An expensive market can continue to get more expensive.

The "P/E10" ratio on the S&P 500 was above 24 from 2003-2007. After the ratio reached 24 in mid-2003, the market continued to increase about 75% until it peaked in 2007. However, all of that gain was lost before the market bottomed in 2009 at a more attractive valuation ratio below 12.

Similar high valuations were seen in 1928-1930 and prior to the 2000 tech wreck. High valuations have a bad habit of eventually ruining the market's fun.

In Conclusion

It is well understood that investing involves risks. These range from interest rate risk to market risk to inflation risk, just to name a few. However, it should be equally understood that not investing has its own risks. Specifically, this involves the risk of inflation and of outliving your nest egg.

In our ongoing monitoring of the economy and the markets, and in the writing of this letter, it is not our intent to dwell on the risks, but it is important to be aware of them. In doing so, it has been our goal to properly take these into account in the structure and design of your portfolios. This is with the understanding that all risks cannot be eliminated but the aim is to balance them for a smoother journey.

As always, don't hesitate to contact us with any questions or concerns. We are here to serve you and encourage your calls and e-mails.

Sincerely, Your Financial Team

Paul R. Ried, MBA, CFP®
Senior Financial Advisor*
Regional Director*

Timothy R. Kimmel, CFP®
Senior Financial Advisor*
Registered Representative*

Adam Jordan
Director, Investment Research and Management
Registered Principal*

Lucy Beppu, CFP®
Senior Account Manager
Registered Representative*

Prepared By:
Adam Jordan
Director, Investment Research and Management
Registered Principal*