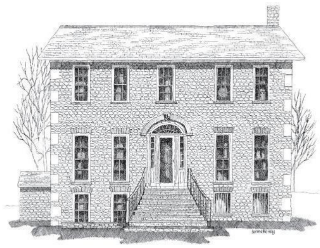

ON THE HORIZON...
NEWS, NOTES, AND COMMENTARY
FOR CLIENTS AND FRIENDS OF THE HORIZON GROUP

August 9, 2011

A DETAILED EXPLANATION…

…of what has happened in the financial markets the past few weeks and a discussion on what the future may hold is certainly in order. I've returned once again from an attempt at vacation to monitor the situation and provide interpretation for clients.

On a lighter note, it is a welcome break from a stinky situation. Sunday afternoon was Elizabeth's 12th birthday party at the cottage. I was setting up for the big day when I noticed raccoons had raided the garage and shredded the rotten garbage. Imagine my surprise when I bent over to scoop up the mess and found my face inches away from the business end of an agitated skunk. I won't share the gory details, but it ended with a dead skunk, buckets of bleach and Febreze, and a roaring campfire in 85 degree heat in a futile attempt to mask the smell enough for guests to eat. Let's just say when I jumped in the car to come home yesterday my cottage stunk as bad as the final market numbers scrolling across CNBC.

So what is happening? In a nutshell, we're dealing with the realization that governments around the world (especially Europe and the U.S.) have taken on far too much debt while continuing to run massive deficits. They do this by issuing bonds, what you hear commentators referring to as "sovereign debt". A slowing global economy reduces tax revenues and amplifies concerns about their repayment ability. Downgrades caused the existing bonds to drop in value, especially in Greece, Ireland, Spain, Portugal, and Italy. To make matters worse, most banks in Europe hold this government debt as a substantial part of their reserves used to pay depositors. When rumors started about a possible default, fearful customers made a run on Italian banks. Fearing a liquidity crisis that *has yet to materialize*, traders, banks, and brokerages started selling to raise cash. The result: oil down to $79 a barrel and a nearly 20% decline in global stock markets.

There is another factor playing a major role in this particular downturn – a severe lack of confidence that leaders worldwide have the altruism or intelligence needed to effectively deal with these critical issues. It is no coincidence the latest swoon occurred after watching the impotence of our Congress play out on television like a soap opera. Yesterday the President picked a poor time to give a rambling speech that just fanned the market selloff. Instead of whining about an inherited mess, blaming Standard & Poor's and Europe, and musing about tax increases, he could have seized the opportunity to lead and inspire. Calling this group in Washington clueless is an insult to clueless people.

This erosion of confidence has serious consequences. Skittish consumers slow their spending. Businesses hold off on hiring or expansion plans. This is not what we need at a time when the U.S. economy appears to be slowing once again. The other big fear of the market is that America will slide back into recession, a period of negative growth. Because we just emerged from one with a tepid recovery, it would be called a "double dip" recession. If this happens what would it mean for you, or more importantly, your investments? Could you see your portfolio drop back to the lows of March 2009?

It's important that you understand fundamentally how the stock market works, and the effect that the economy can have on stock prices. You must first accept that there are literally hundreds of variables that influence the direction of the market, and it is truly impossible to have confidence in any market forecast. There are simply too many forces at work to *know* what will happen on any given day or even in any given year. But there are some basic principles that once you understand them, can help you feel comfortable in turbulent times:

<u>Stocks are pieces of a living company</u>. When you or your mutual fund owns stock, you own a fractional share of a going concern, manufacturing a product or providing a service for a profit. It has employees and a management team that are innovating and adapting to market conditions. Hopefully after it makes payroll and fixed costs, it earns a profit due to forward thinking and good management. This profit is calculated as earnings per share. It can return some of the profit to you as a dividend, or keep it in reserve and use it to grow the business.

<u>Stocks trade at a multiple of earnings</u>. Motorola makes a number of products including cell phones. Over the past 12 months it reported that it made $ 3.64 per share. If the stock is selling for $40 per share, it is said to be trading at eleven times earnings, or have a price to earnings ratio (P/E) of 11. (40 / 3.64 = 11). For an individual stock, earnings are the predominant determinant of stock price. If Motorola's annual earnings jump to $5 per share and maintain an 11 multiple, the stock should jump to $55.

<u>Markets as a whole trade at multiples of earnings</u>. While individual stock prices are shaped by microeconomic forces such as product demand and company profit, macroeconomic issues like interest rates and the outlook for economic growth determine what investors are willing to pay for the stock market as a whole. According to Standard & Poor's, they estimate the 500 companies in the S&P 500 will earn $106 per share in the coming year. If you divide the close today of 1172 by 106, we sit at just over 11 times forward earnings. To put that in perspective, the 20 year average market multiple for the S&P 500 is 19.8 times earnings. At the lows of March 2009 the market dropped to just over 10 times earnings, and in the stock bubble of the late 90's investors were paying 30 times earnings and more!

Does this mean that the stock market can only fall a little bit more, about 13%, to a market multiple of 10? That would probably be the case if we were assured that earnings would remain at these levels. But this is where math blends with the art of reading the economic tea leaves to determine two important forecast inputs; how consumer behavior is impacting corporate profits, and investor's expectations for economic growth which will help determine the multiple they'll assign to those profits.

When I start talking about economics, the eyes of the average client glaze over. But statistics like housing starts, durable goods orders, jobless claims, productivity, inventories, trade deficits, money supply, consumer confidence, and a host of other reports are important clues for the direction of corporate profits and investor sentiment. In a robust economy with expectations for growth investors will pay higher prices for stocks. This is often referred to as a "multiple expansion". Conversely, when the economic readings signal a slowdown, market multiples contract – exactly what has been happening the past few months. It's always in a state of flux, and traders with differing interpretations and forecasts are buying and selling the same stock, at the same time.

Stocks have an intrinsic value. Companies own plants, patents, securities, and many have billions in cash on the books. Aside from their "book value", the present value of future earnings represents real value. That's why I'm never concerned about a stock portfolio or mutual fund losing *all* of its value. But markets can overreact and stocks can trade below intrinsic value at times – because investors get carried away with emotion. It's the old fear-hope-greed cycle that plays out on a regular basis. Right now, fear is the predominant emotion. Fear that we'll slide back into a recession. Fear that the debt crisis in Europe will spread. Fear that we won't have the political courage to straighten out our deficit and debt problems. Look through the fear. There is reason for hope.

In the meantime, remember this newsletter the next time the Dow drops 600 points in an hour – I can almost assure you it will happen again. Stay calm, ignore the hyped round-the-clock coverage and think for yourself. Will IBM lose contracts because of this? Will Hewlett Packard sell fewer computers? Will Johnson & Johnson lose shampoo sales worldwide? Will Quaker sell less cereal? If the answer is probably not, then earnings are OK. Next question – does this issue fundamentally change the market cycles that have been occurring regularly for the past hundred years? Probably not. Will this news change the multiple that investors are willing to pay for stocks? Probably. What should we do?

The good news is we've done it already. We've acknowledged we can't predict or time the market. We've implemented a diversified investment strategy based on a "bucket approach" that has conservative money insulated from market fluctuations and a growth pool that can be skimmed at higher multiples. We meet, review, and monitor your withdrawal rates. We review taxes, maximize brackets, review insurances, and check beneficiaries. At our best, we challenge you to make the most of your life and chase your dreams. Even if we knew the market was dropping on a multiple contraction we'd stay the course. These are normal cycles. Market recoveries and multiple expansions are part of the very same cycle. Rest assured we've done what we can do.

I won't sugarcoat that we are in a precarious position right now. I expect to see this extreme volatility in stocks, bonds, and the dollar continues for the foreseeable future. Yesterday's unprecedented Federal Reserve pledge to keep rates low for **two years** means they have serious concerns about our economy**.** We have structural problems that will take time and courage to meet with structural reforms. Everyone is underestimating the pain that will be caused by fixing these problems. Lost in the market turmoil is coverage of the riots sweeping across London and other cities in England. You'd have to watch international TV to hear that welfare cuts have sparked much of the violence and burning, and that recently laid off public employees are encouraging the mayhem. Right wing groups of vigilantes are taking to the streets to help overwhelmed police and shop keepers. It's not a stretch to think a similar reaction is in the cards for us in the future. I prefer to look through the fear and see hope. We're finally dealing with issues.

We'll get through our debt and budget situation. As Winston Churchill once quipped, "You can always count on Americans to do the right thing – after they've tried everything else!" Leadership will emerge, more than likely from the private sector. Regulations will be tamed, taxes and entitlements will be reformed, and businesses will flourish. I think we'll eventually see a value added tax that doesn't fan the flames of class warfare. Although ironic, I think the recently downgraded U.S. Treasury (and its printing presses) will rescue Europe from the debt crisis from behind the scenes. None of this will be quick, and none of this will be easy. But if we stay awake, aware, and are properly diversified against a variety of risks, we will survive and may even prosper.

As I mentioned in my last newsletter, I will be holding a special meeting this fall to explain some fundamental changes I'll be proposing for your portfolio in the coming year. Stay tuned for details. In the meantime, I'll work to keep you abreast of news you need to know. Please enjoy the last few weeks of summer!

Mark

News and Notes………..

The Rochester parking lot will be closed from 8/11 through 8/21 for repaving. The office will be open, please park on the lawn behind employee cars ….We now have a new server and backup system for all of our data. Special thanks to Amdex and our technical consultant, Mark Mose….Terry and I will be on from 7 to 9 Sunday morning, August 28th on 1180 WHAM ….Xerox employees can breathe a sigh of relief, thanks to the market panic it appears the August 15th annual PBGC rate reset for retirement calculations will show little increase as of now. I'm hosting workshops in our classroom on 9/28, 10/5, and 10/18 for those contemplating retirement ….Our annual Financial Fair will be held Saturday, January 28th at the RIT Inn & Conference Center ….We were honored to have frequent CNBC guest Dr. Bob Froelich drop into the office last month and give us his perspective. I rely on analysts like him and Pimco's Mohamed El-Erian when formulating my portfolio strategies and market outlook.