



Paul R. Ried Financial Group, LLC

Security for your future

A MESSAGE FROM YOUR FINANCIAL TEAM

Second Quarter 2010

April 27, 2010

Dear Clients,

The market has continued to maintain its momentum and post gains year-to-date, with the market up approximately 7% (as measured by the S&P 500). The market has managed to take most negative news in stride and focus more intently on those economic numbers which are, refreshingly, no longer pointing in the wrong direction.

The Economy

The most refreshing news economically was the BLS employment report for March which estimated that 167,000 jobs were added. This has, in part, helped stabilize and boost other economic indicators, including retail sales. While about 48,000 of those jobs were temporary census workers, even without the census jobs the March report still puts the economy roughly in the range needed to stabilize the unemployment rate. Generally speaking, 100,000-125,000 jobs are needed monthly to keep pace with the growing population and prevent a further long-term rise in the unemployment rate.

The employment numbers are likely to look much better over the rest of this quarter. However, it is important not to take the numbers at face value. These numbers are very rough estimates and likely to consist overwhelmingly of temporary census workers. As mentioned in our last letter, over 900,000 census workers plan to be hired this quarter. While this will represent a real injection of money into the economy, these jobs are temporary and taken at face value can skew the real underlying economic fundamentals.

Speaking of the underlying fundamentals, economic numbers do indeed show solid stabilization, and even growth. However, the degree of the artificial stimulus it has taken to see these numbers should not be forgotten. Even now, we do not know what the situation would look like without the ongoing stimulus measures, including support provided by extended unemployment benefits and increases in other social safety nets. In fact, unemployment compensation has been extended to provide in some cases up to 99 weeks of benefits.

Debt

Government spending always appears as the easy way out and a favorite of politicians looking for short-term "wins". After all, who doesn't like money? Banks in trouble? Give them money to stabilize them. Consumers won't buy houses because they are too expensive? Give them money as an incentive. People out of work longer? Give them money in the form of longer unemployment benefits. Angry public sector unions? Give them more money, too.

It is easy to say we must keep pumping stimulus into the economy or risk stalling the recovery. However, in doing so, the result could be spending our way into the next crises. The reality is that you cannot continually spend what you do not have without eventual consequences. As Jeffrey Lacker of the Federal Reserve Bank of Richmond recently put it "The government's debt cannot grow indefinitely at a rate much faster than the economy itself grows, so ultimately, something has got to change — either taxes are raised, spending is reduced, or the real value of the debt is eroded through an increase in inflation".

Federal Reserve Chairman Ben Bernanke was even more straight forward as he put it "The arithmetic is, unfortunately, quite clear." and went on to put it quite well "unless we as a nation demonstrate a strong commitment to fiscal responsibility, in the longer run we will have neither financial stability nor healthy economic growth".

While the problems are certainly present in the US, they are mirrored by a growing list of developed countries, and even further advanced in others such as Greece. Even though government debt worldwide is getting a lot of attention, it is possible that it is still not adequately understood. Additionally, the seemingly slow moving nature of the issues involved can cause complacency.

Earnings and Valuations

There is no doubt that companies' reported earnings have been rebounding with a corresponding rise in stock prices. The market has rallied over 75% since it's absolute low reached last March. However, since the law of percentages requires much larger gains to make up for losses, the S&P 500 still remains more than 20% below its peak reached in October 2007.

The reported earnings have definitely been encouraging. However, after such large swings in the market it is always good to take a step back and look at the larger picture instead of being wrapped up in the day-to-day news. After all, news about "the market" means very little if not put into a larger context.

With any financial asset, the long-term return you receive will ultimately be effected by the price you paid to own it. In the case of stocks, future earnings (and what you pay for those) is ultimately what will determine your long-term returns. In fact, earnings are what are used to pay dividends and to grow the value of the business.

Therefore, the most popular way to broadly value the market is by using the Price-to-Earnings ratio or P/E. However, earnings can be very volatile year-to-year and it is the long-term earnings that ultimately matter. Over the long-term, earnings tend to grow in a much more predictable range. It is with this in mind that economist Benjamin Graham is largely credited with developing the P/E10 in 1934. This takes the average inflation adjusted earnings of the last ten years, divided by the price.

While the P/E10 does not say much about short-term returns, there is a very strong relationship between the starting P/E10 and the following 10-year returns of stocks. In fact, a recent study by Plexus Asset Management went back to 1871, using data compiled from Yale economist Robert Shiller. It looked at starting P/E10 ratios and subsequent real returns (returns above the inflation rate) in the following 10-year periods. The results were then put into 5 groups from the cheapest to the most expensive. The results show that there is a significant correlation between the price paid and the future returns.

In fact, the average 10-year real return of the cheapest 20% of markets was just over 11% per year. In stark contrast, the average return for the most expensive 20% of markets was only 2.8% after inflation. It should be noted that while there were wide variations within the groups, the trends were clear. For example, the real returns varied from 9.5% to 20% per year for the cheapest group and ranged from -5.9% to 7.5% per year for the most expensive group. As can be seen, even the ranges were greatly influenced by the starting valuations.

So where are we now?

The current valuation of the S&P 500, using the P/E10 ratio, is just over 21. This puts the market in the ranks of the top 20% most expensive markets. In contrast, when the market bottomed last March at a P/E10 just over 11, it ranked among 40% of the cheapest markets. The long term average P/E10 ratio is about 16.

While stocks are currently priced for lower than historical returns, bonds are in a similar situation. With bonds, what you see is essentially what you get. If a 10-year bond is yielding 4% (close to what US Treasuries currently pay), an investor receives a return of principal and the stated interest at maturity, barring a default (although there may be significant price volatility along the way). Looking back over the last 100 years, the average 10-year Treasury rate has been 5.0%. Although most investors are used to even higher returns from Treasury bonds as the average 10-year Treasury over the last 30 years has paid about 7.2%.

The Conclusion

Economic data has indeed been encouraging. Stabilization of the jobs data may be the most refreshing news, as productive jobs drive the economy. While major government intervention around the world has helped stabilize economies, valid questions still remain whether the intervention really has solved the underlying problems or simply moved them, mainly to the governments themselves.

Eventually, governments will have tough choices to make. Those choices could include spending cuts and tax increases which could slow economic growth. Or they could decide to continue spending. For those countries with the ability to print their own currency, that could result in inflation and rising interest rates. For those without that ability, it could potentially result in default and the consequences associated with that.

The outcomes are ultimately determined by unpredictable decisions of governments. Since those decisions can cause very different outcomes it is increasingly important not to rely too heavily on one view or the other. The importance of diversification increases with uncertainty and the current environment provides plenty of uncertainty.

We continue to actively evaluate long term economic and market fundamentals, as well as diligently monitor individual fund management and performance. Our goal, as always, is to maintain a portfolio which will help you meet your long term goals and objectives. We are here to serve you and encourage your calls and e-mails.

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