September 2012
Market Commentary

New Book Published

My staff chided me for failing to mention the recent release of my latest book by McGraw-Hill. The book titled *Wise Money: Using the Endowment Investment Approach to Minimize Volatility and Increase Control* went on sale in late July and is available through booksellers across the U.S. The book explains how individual investors can mimic the portfolios used by large endowments and institutions. These institutions generally achieved excellent returns over that past several decades in spite of the struggles of the stock market while far too many individuals suffered terribly, particularly since the turn of the century. My next book, *How to Keep and Grow Your Retirement Assets,* reaches book stores in first quarter of 2013. It is a complete rewrite of the book I published about a decade ago.

Price to Earnings Ratios

The lack of disasters or highly publicized bad news has driven the market to near the heights reached in late March and early April of this year. Market increases have elevated the price to earnings ratio (PE ratio) to about its historical average, and it currently sits about 10 – 15 percent higher than a year ago, depending on which index is measured.

With the general market PE ratio near its average, a quick appraisal suggests that stocks are no longer the bargain they've been for the past couple years. Continued weak economic growth probably provides more confirmation of the same. While stocks can always go either direction, if you've been waiting for U.S. equities to rise before making changes to your portfolio, now is probably a good time to act. Stocks could always continue up, but the uncertainty of the upcoming elections and ongoing European issues could quickly send share values down. Relatively average PE ratios, a much stronger banking system, and corporate cash troves exceeding $3 trillion make a repeat of 2008 and 2009 highly unlikely, but some of the cushion against unfavorable news has been removed.

Elections

For the remainder of the year, elections will likely serve as the primary driver of the U.S. stock market. While elections always seem to affect equity values, this fall's choices are likely to influence investor sentiment more than normal given numerous challenges in Washington and the vastly expanded role of government. Even so, it appears highly unlikely that elections will produce a clear mandate. Most likely, next January's president will face a split Congress holding highly polarized ideological views. Progress in any direction will be slow and painful.

Normally, government inaction is highly welcomed by the business and investment community. Almost all historical market growth occurs when Congress is out of session. Yet, the tremendous fiscal cliff the U.S. faces at the end of 2012, including an expiring tax code, debt ceiling breach, and sequestration, reverses the normal dynamic. Government inaction results in automatic changes that are mostly viewed as destructive. The unpredictability of the elections combine with uniquely contentious circumstances to create a highly combustible situation. Anyone concerned about only the short term may be best advised to sit on the sidelines for a while.

Recent Market Drivers

In addition to a lack of highly public bad news, the market has been cheered by stronger signs that the housing market really is improving. U.S. home prices jumped the most since fourth quarter of 2005 according to the Federal Housing Finance Agency. Prices were up 3% from the same quarter a year earlier. As of third quarter 2011, residential housing was providing only about 2.2 percent of total economic activity versus its normal level of 4.5 percent. Essentially, about 2.3 percent of the economy is missing. If housing simply returns to normal levels, economic growth could appear strong rather than weak. Progress in the sector hints at better economic growth numbers in the future.

Commodities and shipping, strong indicators of manufacturing and trade strength, remain mildly reassuring. Before hurricane Isaac, a rebound in crude oil prices reflected rising demand which is likely to continue until the end of the year. Industrial metal prices appear to have hit bottom, and some metals such as copper and steel have already started an upward climb.

Freight volume continues to grow slowly as well. Tepid increases mimic the overall slow, but steady growth of the economy. Still, forward progress continues. Some ports are making capital improvements in anticipation of the completion of the new Panama Canal which will accommodate mega cargo ships. The opening of the canal should spur U.S. growth through greater efficiency of cargo distribution from the Far East to the East Coast. West Coast longshoreman unions will be hurt by decreased volume and influence, but nearly everyone else in the country should benefit.

Job gains also continue, although July's 172,000 net gain barely exceeds levels required to absorb population growth. Consumer spending also rose to its highest level in five months lifting hopes for improved economic activity. Again, signs are positive, but not terribly.

Financial Markets

In a sign of muted confidence, the spread between high-yield corporate bonds and Treasuries has narrowed since October 2011. The current difference of around 6 percentage points historically indicates the economy and markets will grow slowly. When the spread rises to 8 points, an economic contraction usually follows, while a gap of five percentage points or lower typically occurs when the economy is expanding at a healthy pace.

Overall

August's relative lack of volatility may have comforted investors weary of rapid price changes, but the month's calm will likely dissipate during the election season. Price movement of all assets with risk, including stocks, could go either way given tremendous uncertainty in so many areas in and out of the U.S. There's enough good news to encourage bullish investors, particularly if looking longer term. But anyone focused on only the short-term can also find plenty of reasons to worry. Hold on. The next 6 months should be very interesting.

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