# The Waiting

*Oh baby don't it feel like heaven right now*

*Don't it feel like something from a dream*

*Yeah I've never known nothing quite like this*

*Don't it feel like tonight might never be again*

*We know better than to try and pretend*

*Baby, no one coulda ever told me 'bout this*

*I said yeah, yeah*

*The waiting is the hardest part.*

- *Tom Petty*

The famous rock and roller, Mr. Petty, once said about his 1981 hit, "It's about *waiting* for your dreams and not knowing if they will come true. I've always felt it was an optimistic song."

I suspect we all find ourselves anxiously *waiting* for something from time to time. Consumers and investors alike seem to be *waiting* for something good to happen but how (and when) the stars will align I am not sure they know. Maybe it's the Eurozone to either become more cohesive or disband…it's interesting to me that we're *waiting* until the year 2020 for *Greece to get their debt-to-GDP ratio to 120%* when they might be out of cash in October! Or, here at home in the US, perhaps we are *waiting* for the election to pass and to see if we fall off the "fiscal cliff." Maybe we are even *waiting* for the opportunity to stand around the coffeemaker once again while having our "mornin' joe" talking about how great stocks are performing; but whatever it is we are *waiting* for, I think we will be *waiting* a while longer.

Summary of the talking points in this newsletter…

- It is time for the US and Eurozone to make some tough choices.
- Returns for the next 12 months hinge mainly on how well Europe negotiates their debt problems.
- Re-thinking risk. There will eventually be NO low-risk investments.
- Investing when your short-term investment strategy is contrary to your long-term strategy.

**The Global** recovery hinges on Europe. The problem with Europe, as we have written in the past, is that they are not a cohesive union. Angela Merkel cannot decide if she will continue to support Greece's membership in the 17 member union, although resolution looks more likely today than it did two weeks ago. Meanwhile, Italy's Mario Monti recently blamed Spain for increased borrowing costs across the Eurozone. If Greece remains part of the Euro, they must be held to their promises – promises that ensured them $115 Billion in aid since last fall - and get their financial house in order. If Greece leaves the Euro it will be its citizens who pay most dearly but great harm also comes to the remaining countries because the all-for-one-and-one-for-all mentality will be unwound, and so too could the debts owed between nations.

Considering the web of indebtedness among EU countries, if one defaults there is risk of contagion. I suspect this is where most (including yours truly) miscalculated the economic impact of a country like Greece going-it-alone. Greece's GDP is in the $300 Billion range. This is a drop in the bucket of global GDP and losing this is not where the risk lies. As you can see from Diagram 1 below, Italy and Spain, two highly leveraged and economically unstable countries in Europe, owe their neighbors a lot of money. Spanish Prime Minister Mariano Rajoy forecasted a second year of recession partly due to the fact that they are drowning in interest payments. If a country the size of Spain failed to make good on their debts, it would be disastrous.

Diagram 1

| $ Owed To | Italy Owes | Spain Owes |
|---|---|---|
| Italy | N/A | $47 Billion |
| Spain | $31 Billion | N/A |
| Germany | $190 Billion | $238 Billion |
| France | $511 Billion | $220 Billion |
| UK | $77 Billion | $114 Billion |

While the president of the European Central Bank (ECB), Mario Draghi, recently said they will do "whatever it takes" to preserve the Euro as a single currency we cannot accept Draghi's words as gospel because the ECB is prohibited from financing governments directly. Given the challenge the ECB had keeping the $300 Billion Greek economy on stable ground, it would be impossible for them to backstop Spain or Italy should they follow in the footsteps of Greece.

If you've not seen it with your own eyes, I am sure you've heard a friend comment after a vacation to Europe about the laid-back lifestyle its people enjoy. Two hour lunches, shortened workdays and early retirement all are commonplace there. Accordingly, you might not be surprised to know that figures compiled by the Organization for Economic Cooperation and Development reported that in 2009 only one Frenchman in five, ages 60 to 64, was in the work force. In the US, 61% of men in the same age range were employed. In Japan, 75% are still employed in their early 60's.

Yes, countries like France have delayed the age for full retirement benefits much like we've done in the US with Social Security, but the cost of public debt and social programs are bankrupting these countries. What Europe needs most is fiscal responsibility. Like the US, most countries have spent far more than they take in revenue-wise. Still, most economists do not favor austerity – the belief is that spending cuts and tax increases will take the legs out from under the already unstable consumer. But if the government calls the bluff of its citizens – suggesting they might just do the unthinkable and "tighten the belt" – it could scare people into taking control of their own destiny rather than waiting for everything to be handed to them. In the meantime, the ECB should purchase Spanish and Italian bonds in an effort to keep their borrowing costs as low as possible. The ECB should also work with the International Monetary Fund (IMF) and Germany to build a more formidable rescue fund. Investment Implication: Chances are that the Eurozone will suffer a few more shocks before all is fixed. If so, there is a chance we could see more months like May, when things foreign stocks declined by double-digits. Months like these could provide good buying opportunities for investors. Remember, your growth opportunity is largely dependent on the price you paid for the asset. Since foreign stocks have been beaten down so much since the beginning of the year, generally speaking, they are "on sale" and offer some of the most compelling growth opportunities from this point forward.

**In the US** we seem to be equally tolerant to long term solutions to our problems. A recent commercial for Exxon noted the US is losing ground academically to other developed nations. In fact, our kids scored 17th best (out of 31 countries) in Science. The South Carolina Education Oversight Committee (EOC) has a solution: (in italics below and copied word-for-word. Really, I could not make this stuff up). *The EOC has established a 2020 Vision for South Carolina: By the year 2020, all students in South Carolina will graduate with the knowledge and skills necessary to compete successfully in the global economy, participate in a democratic society, and contribute positively as members of families and communities*.

What is it with 2020? Do we really have to *wait* for 2020 or can we endure a little pain to fix our problems today?!?

We are nearly 13 years removed from Y2K with the tech bubble clearly in the rearview mirror. Out the side window's we see the aftermath of a housing bubble that, when it burst, sent shrapnel into even the most vibrant neighborhoods taking the life right out of them. Dr. Bernanke was called to help the ailing market but is unable to prescribe the correct antidote despite zero-bound interest rates and the most massive bond purchase program on record. And if you think things could not get any worse, the Fed's actions to stabilize the housing market, *which could be argued are working*, has created yet another bubble which lays directly ahead - a bond bubble.

To frame the current bond bubble, it will be helpful to summarize the last two. Leading up to Y2K there was a great deal of spending in both the technological and manufacturing sectors. We realized after the turn-of-the-century that by spending so much in the 1990's we stole growth from 2000, thus creating a slowdown in the first quarter of that year.

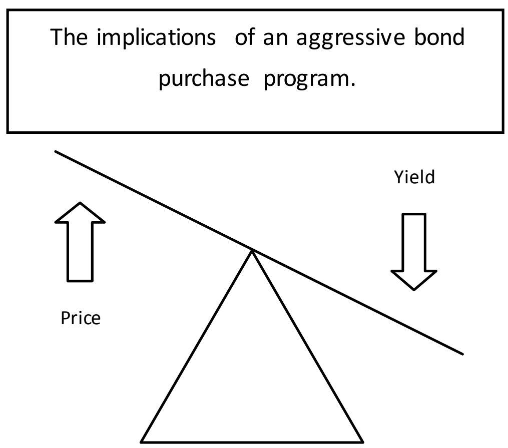
As was expected, the Federal Reserve, then led by Alan Greenspan, came to the rescue by slashing interest rates from 6 1/2% to 1%. The strategy was to make money cheap so that people would borrow it to buy cars, boats, build sunrooms and houses. And it worked! The economy thrived and along the way interest rates climbed from 1% back up into the 5% range.

But perhaps the plan worked too well because we found ourselves five years later in a position where we had bought so much "stuff" that we couldn't possibly pay for it all and a credit crisis ensued. Some investment banks disappeared overnight while others were absorbed by money-center banks. As credit dried up the housing market was damaged terribly.

The fact is that the housing bubble was really a housing bubble AND a stock bubble. However this time the one-two punch caused a very significant deterioration in investor and consumer confidence.

Once again, the Federal Reserve came to the rescue - this time under the guidance of Ben Bernanke – and interest rates were slashed all the way to zero! While Mr. Bernanke had the same high hopes that Greenspan had six years earlier, it didn't work quite as well this time. Most of the people who wanted loans couldn't get them; and the folks to whom the bank would lend money didn't have the confidence to take on debt. Therefore, money was not moving its way through the system. So, the Fed was forced to move on to the second tool in its tool chest - a bond purchase program known as quantitative easing, or QE. During 2008 -2011 the Federal Reserve purchased $2.3 trillion of bonds issued by the Treasury. The strategy can best be illustrated with the following diagram of a teeter totter. The Federal Reserve purchased trillions of dollars of bonds which drove prices up and the yield/rate down.

**Diagram 2**




Score another point for the Fed because they got what they wanted - to bring mortgage rates down further. In the last 12 months the 30 year note has dropped to 3.5%! (For those of you holding mortgages in the 5%+ range, this is a good time to look at re-financing as it might save you a few bucks). Recent data tell us housing is showing some very minor signs of improvement, but at what price?

If I were to ask the average person on the street to define "risk," I suspect that most people would say "having X amount of money today and something less than that tomorrow." This is called **principal risk**. Investors will normally hold low-volatility assets like cash and bonds in their portfolio to mitigate principal risk.

In the last year a lot of other risks have made headlines. One example - **reinvestment risk** is faced mostly by conservative investors - people who five years ago purchased a certificate of deposit from the bank for five percent only to renew at 0.75% now. At the same time, **credit risk** is hurting foreign governments, municipalities like Harrisburg, Pennsylvania, who last October filed for bankruptcy, and the US Government. Downgrades ultimately mean higher interest costs. Clearly the US is very highly leveraged. The reason it has not hurt us as badly as countries like Spain and Italy is because they are mired in seven percent interest rates while we pay a fraction of that on our debt. The interest expense on US Government Debt amounts to roughly $225 Billion/Yr. That is a lot in dollar-terms, but not too bad in percentage terms. Imagine how damaging it would be if we found ourselves in a Spain-like interest rate environment of seven percent per year. Our debt service would explode five-fold to nearly $1.2 trillion yearly, suffocating the US economy. The US will be downgraded again just like we were last fall making higher interest costs not only possible, but highly probable. Investment Implication: Regardless of US interest rates and our credit ratings, investors around the world will need to have some bond exposure in their accounts. Foreign (Australia) and Emerging Markets (China) bonds may offer opportunities when the prospects in the US are poor. Ten years ago we might have thought of investing in China as risky but not so much today….after all, they are the ones loaning money to us, not the other way around.

But the risk I suggest you should be most concerned about is **inflation risk**. If you listen to Ben Bernanke speak he will tell you that inflation is a benign 1.8% per year. We all know it's much higher than that as the Fed does not include food prices and energy prices in their calculations. It may take years but I see two catalysts for inflation. If the global economy expands we would expect money to flow through the system (i.e. you build a house and pay your general contractor, who pays his subs, who buy materials at home depot, etc.) causing inflation. Another likely scenario is for our politicians to address our debt by inflating our way out of it. Simply print money and use it to pay back our creditors. If we inflate our way out of debt we will make every dollar in circulation worth a little (maybe a lot) less. Investment Implication: Investments once thought of as safe, like cash, CD's, etc. will be worth less. The US is a NET importer (we import more goods than we export) so if our dollar drops by ten percent cash is effectively worth ten percent less, too. Thinking of your savings as having purchasing power of $100,000 today and $90,000 next month sheds a whole new light on the "safety" of cash. Certain assets, like inflation-positive bonds, floating rate bonds, stocks, real estate and commodities should outperform during an inflationary period.

Investors will rethink what risk means to them. Does it mean less in their account tomorrow? Or does it mean a lower standard of living because the cost of goods is rising faster than their income? Risk will be defined a little differently from one person to the next. **But I suggest to you purchasing power matters above all else. Financial planning is not about how much money you have - it's about how much purchasing power your money provides to you.** Our policy makers know that if they negatively affect your wallet by raising your taxes that you might vote them out of a job. But they are betting you won't notice if they let you keep your money while robbing you of its purchasing power. If our dollar loses 50% of its value that would have the same implication as you losing 50% of your principal so beware long-term inflation.

I often wonder how different the world might be today if it were not for the internet. While I benefit from many of the advances in technology, there are many aspects – the immediate access to information being one - that I believe causes us harm. We have become conditioned to *not waiting*. Not *waiting* for the news and not *waiting* for solutions to problems, to name a few. I firmly believe all of our clients have more money today as a result of the Fed's aggressive actions over the last four years, yet I am convinced constant government intervention adds to our long-term problems rather than solves them.

Why do the policy makers have to solve every single problem? Why not let companies and free markets work them out? Rather than having the recession drag out one more day than necessary, the Fed came to the rescue with QE and expanded the government balance sheet by trillions of dollars.

Since our elected officials continue to spend more than they bring in, we blew through our debt ceiling last fall and will likely do it again within six months – it'll be at $17 Trillion then. I recently heard a great analogy of how to deal with the debt ceiling.

> *Imagine you go on a one week vacation and return to your home, which has nine foot ceilings, to find that raw sewage has backed up eight feet into your home. Your choice is to:*
>
> *A.) Raise your ceilings*
>
> *B.) Pump out the waste.*

Seems like a pretty easy choice but Washington makes it more complicated than it needs to be. Whether it is QE or general deficits, who is willing to endure the pain to pay for it? Sitting with a client a month or so ago we talked about this topic and his analogy "I'd rather get hit with a stick today than a log tomorrow" resonated with me. As a country and as individuals we need to recognize our problem, determine a solution, acknowledge the pain we will endure and get started.

Have you noticed this is an election year? There's a lot of talk about issues like tax increases and spending cuts, issues that will likely decide the election. Romney will tell you the solution is to reduce spending while Obama believes it is raising taxes. I believe this problem is too big to solve from one angle. We need a *combination* of spending cuts and tax increases – we're too far down that road and the problem is simply too big. If Washington used our money wisely, we would not have this problem (and I might not have a problem paying more taxes, either). Please take time before November to understand the "issues" and vote for candidates whom you believe can best help turn our country around. Remember Ross Perot? We probably should have listened because we truly are on a Greece-like path and the end is not pretty.

Financial mismanagement is not only a government problem. A July article in the NY Times reported that the 500 companies in the Standard & Poor's index had pension plan obligations of $1.68 trillion and assets of just $1.32 trillion. The shortfall of $355 billion was the largest ever, S&P reported. Of the 500 companies, 338 have defined-benefit pension plans, <u>and only 18 are fully funded</u>. What makes the numbers even worse is that public corporations and institutions like the California Public Employee's Retirement System (CALPERS) are using irrelevant figures in their calculations. It is not uncommon, in this ultra-low interest rate environment, to find plans using growth assumptions of seven or eight percent.

Let's put this into perspective with a very simple example. You are the CFO for a pension fund and you need to generate an eight percent return for your employee's. You are cautious so you use the barbell approach – 50% in fixed and 50% in "risky" assets. The fixed portion (cash, money-markets, CD's and short-term bonds) pays three percent. That means you need to earn 13% on the risky assets to earn a total return of eight percent. We would never encourage someone to expect consistent 13% returns from stocks. So, you can be pretty confident that underfunded pensions using unattainable growth rates will find themselves far off their targets. Investment Implication: In a low yield environment institutions like CALPERS will be forced to over-weight stocks and similar investments. Remember, they need to earn eight percent just to break even. Stocks will have a <u>chance</u> to make a return of eight percent whereas a portfolio of bonds would not be expected to grow at those rates. If the institutions are buying stocks, the sheer volume of money flowing into the asset class should provide momentum and drive prices upward.

But before you can count on solid gains you need to be aware that investors could pay a penalty for pension miscalculations. These companies will take hits to earnings as they shore-up their plans. If earnings are less, you could argue stock prices should be less, too. Timing will be everything!

Or, as we have seen with many companies, like our hometown Nationwide Insurance, changes to the plans are being made that will result in less favorable benefits for those who have yet to retire. The most common change is to move away from a "pure" defined benefit plan to a cash balance plan or some hybrid of the two. This almost always results in a lower pension payment to the employee, putting more of the responsibility to prepare for retirement on their shoulders. **The best thing you can do for your children right now is to help them understand they will not have the benefits you had. They will need to save early and often, to be prepared for retirement.**

When I first began to work on this article a few weeks ago, the Standard & Poor's 500 Index was trading near its reaction high of 1422. This was a critical resistance level, and if passed through, could indicate the next move would be to higher highs. Corporate earnings have been strong for this quarter (hey, they should be – companies are not hiring or spending much) and there is momentum for most risky assets right now given that the central banks continue to talk about further stimulus.

We have felt for the last few months that the appropriate trading range for the S&P is about 1366 to 1422 and until one of those numbers is violated, we suspect we will continue to trade sideways. A lot of clients have asked in the last few months if we thought the S&P could travel to 1,500. I believe the better question is, "if the S&P were to hit 1,500, will it hold?" The last time the S&P was above 1,500 was the fourth quarter of 2007. Diagram three provides a few comparisons of 2007 and 2012 to help frame our discussion:

Diagram 3

| | 2007 | 2012 |
|---|---|---|
| Federal Funds Rate | 5.25% | 0% |
| Mortgage Rate (30 Year) | 6.30% | 3.5% |
| P/E Ratio of S&P 500 | 17.3 | 16.1 |
| Unemployment | 4.6% | 8.3% |
| National Debt | 9 Trillion | 16 Trillion + |

The first two data points are both good and bad. "Ben and the gang" admitted in their August 22 meeting minutes that they are ready to provide liquidity if the recovery falters and that is great; but recent attempts at priming the economy have been less effective and the Fed is running out of solutions. The fact that the 30 year mortgage is so low is great! We are seeing the results in home sales slowly, but surely. We hope this continues as the economic and psychological benefits are enormous. Number three - the S&P 500 price-to-earnings ratio is lower today than it was in 2007, but not by so much that we consider today's valuations a screaming buy.

The last two - unemployment and our national debt are working against us. Unemployment is nearly double the 2007 rate and history suggests the economy will not grow during times of elevated unemployment. Lastly, our debt at $16 Trillion, and counting, is terribly troublesome. What's more, the President's current budget projects it to increase to over $26 Trillion by the year 2022.

There will be no free lunches going forward for investors. Nearly every asset class will be subject to some form of risk requiring investors to remain tactical, with their investment portfolios. During periods of very low yield like today, future growth rates tend to be below average. Refer again to diagram 2 - low yield is a result of high prices. If prices are already high, what will be the catalyst to drive and support them at yet a new higher-high? Investment Implication: Even if stocks were the best performing investment, it does not necessarily you should expect to consistently earn double-digits, at least not from these valuations. The dividend yield for the S&P is at multi-decade lows today. We suggest that returns in the mid-single digit range are most likely.

How long will it take for the interest-rate teeter totter to swing the other way causing bond values to decline - nobody knows. I suspect as long as there's turmoil in the world (i.e. Europe and the fiscal cliff) the bond bubble will remain inflated as investors seek the real (or perceived) safety the asset class. Eventually investors will be tuned in to principal, reinvestment, credit and inflation risk and will realize all assets are "risky," leaving them with nowhere to go for truly safe investing. As of this writing, if you were to invest in the ten year Treasury note and hold it to maturity you would earn approximately 1.7% per year for total of 17%. Contrast this to an investor who invests into a stock-based investment with a dividend of 3.5% per year for a cumulative ten-year return of approximately 35%. That is the income component - we still need to factor in appreciation/depreciation of the asset. Looking forward, both the bond and stock could decline. The bond – already at multi-decade highs – is unlikely to appreciate but the stock could grow, depending on the earnings growth of the company(s) in which you've invested. Investment Implication: We've thought of some of the positions that we have taken in stocks since January - particularly the higher dividend paying stocks - as alternatives to bonds. Despite the President's current efforts to raise the tax on dividends beginning January 1st, companies with a proven history of paying dividends should outperform most other asset classes. Yes, some investors may consider selling a stock because the dividends they receive will be taxed at a higher rate but I am willing to bet the Warren Buffets of the world will not be among them and neither will we. Too many of these stocks are held in retirement accounts where the tax on dividends is immaterial. Further, I believe the "smart money" looks at taxes from a contrarian standpoint. If you're not paying taxes, you are not making money!

**Our near-term and long-term strategies are different.**

Long term you will need more exposure to stocks, real estate and commodities. But not just yet! We would be surprised if the equity markets can hold these lofty valuations so we're going be defensive in the near-term while we sort out the data. We will look for pullbacks as buying opportunities. Investment Implication: Over time you will develop a larger allocation to stocks and alternative assets than you have today. This will mean greater swings in portfolio valuation from one month to the next but at least with these assets you will have a chance to grow your money. It is highly possible that some bonds – many bonds – will be just as volatile but offer no growth opportunities. Those who remain focused on the long-term (and avoid over-reacting when markets decline) will be rewarded.

Since we often report to you in terms of asset allocation, here are some examples of what you might expect to see going forward:

| | | | |
|---|---|---|---|
| Cash | Reduce | US Large Company Stock | Long-Term Add. Possible Short-Term Reduction. |
| US High Quality Bond | Emphasize short-term and inflation-positive | US Small/Mid Company Stock | Reduce |
| US High Yield Bond | Add - Emphasize Floating Rate, the truest inflation hedge | Foreign Stock | Maintain / Add |
| Foreign Bond | Maintain | Emerging Market | Maintain |
| Emerging Market Bond | Maintain / Add | Alternative Assets | Add |

**This could take, months, quarters or even years to fully play out**. So, expect to hear from us at irregular intervals as we manage exposure to all asset classes. In general, you will remain diversified but your allocation will shift to assets that we believe will provide the best total return (income plus appreciation). Here we sit *waiting* for a catalyst…maybe even a few of them…to move the market acknowledging that Mr. Petty was right…..the waiting is the hardest part!

Matthew G. Kovalcik, CFP