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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

Ho-Hum. Fiscal cliff? Big Deal. Sequester? Who cares. Deficits? National debt? Whatever.

Is it possible that a parade of one "crisis" after another is desensitizing us? Are we anesthetized by Federal Reserve money printing? The answer may be some of both. While not the most fun thing to consider, it is important to be aware of continuing and building risks. Complacency is not the best strategy for building and maintaining wealth.

The Markets

The broad-based stock market averages set all-time closing highs in March. One day after the last issue of *Outlook & Trends* mentioned the possible implications if the year-end Santa Claus rally failed, the jolly old fellow flew in and saved the day. Despite continued slow economic growth, corporate profits are hitting new highs, and as profits go, so goes the stock market. Low interest rates have made safer investments like bonds look less attractive in comparison. Bond return was just about flat during the past quarter.

The amount of Federal Reserve intervention should not be underestimated. They are essentially financing much of the government's debt, buying $85 billion *per month* of Treasury and mortgage bonds with previously non-existent money. Despite all the hue and cry about the sequester, the amount of expense reduction there is only $85 billion *for the year*. At some point the Fed must and will scale back its support. When the stock market senses that possibility, prices could be at risk, especially if the economy has not improved. That would not be a time for complacency.

The Economy

Despite the record levels of Federal Reserve monetary support, the economy continues to limp along. Fourth quarter GDP registered a growth rate of only 4/10%. Unemployment continues to fall slowly, while employment growth may have peaked out at a 2% annual rate, which is similar to the maximum rate during the 2003-2008 expansion.

Home sales continue to improve, and real estate prices are rising, up 10% across the country according to the National Association of Realtors. Mortgage rates have ticked up over the quarter though from 3.34% to 3.54% for a 30-year mortgage according to the Freddie Mac survey.

The economic story of the day comes from the threat of bank failures in Cyprus, which resulted in Cyprus planning to "tax" even "insured" deposits. Later they relented, deciding to focus on uninsured big depositors. This action is an indication that there are limits to the recent "too big to fail" mentality. Uninsured deposits could once again be at risk if a bank fails, rather than being guaranteed by taxpayers. Will the change in the perceived safety of deposits cause more problems down the road elsewhere? Possibly.

What is High? What is Low?

One of the fundamental problems that one encounters assessing risk is trying to identify when is a good time to invest in asset markets and when to be cautious. Regardless of whether the asset is stocks, bonds, real estate or any other, the perennial questions are "How high is high? How low is low?" As we have mentioned in these newsletters previously, if the investor is in the accumulation phase of life and has a long time before the funds are needed, history has shown that high and low are less important than simply participating as fully as possible. Historically, stocks have returned more than bonds over the long term (although not over the last 15 years), and investing consistently through dollar cost averaging has paid off handsomely and is likely to continue to do so.

On the other hand, for people who are close to, or are already in retirement, consideration of risk becomes a much more important issue. Volatility can matter, and stock and bond valuations at the beginning of retirement can make the difference between success and failure 30 years later. Financial planners typically rely on the "4% rule" to suggest a safe withdrawal rate during retirement. Michael Kitces' work shows that, if 4% of a balanced stock and bond portfolio is withdrawn in the first year, and the amount is adjusted for inflation each year thereafter, there was no time from 1871 to 1983 when the retirement funds would not have lasted 30 years. But the outcomes are highly variable, and much depends on market valuations at the beginning of retirement. A withdrawal rate of 10.5% worked for a person retiring in 1921, despite living through the Great Depression later. On the other hand, mutual fund company T. Rowe Price calculated that a person who retired during the highly overvalued market in 2000 would have only a 29% chance of making it for 30 years using the 4% rule. Parenthetically, today's conditions look closer to the times that just squeak by at 30 years than they do to either the 1921 or 2000 periods.

This may be a little misleading however. While it has been shown that it is not good to retire with a high valuation stock market, watching your portfolio value drop precipitously in a bear market just before retirement is obviously not so good either. It is a good idea to shift from an accumulating strategy to a more risk-aware protective strategy if valuations are high before retirement to preserve your savings. If you are able to do that successfully and reestablish your risk exposure after the next bear market, your probability of long-term financial success can improve.

So this again begs the question, "How high is high, and how low is low"? There is no absolute answer, but there is a lot of discussion about the right way to look at it. Generally, market valuation is measured by a Price / Earnings ratio. The higher the ratio, when compared to historical levels, the higher the valuation. People are rightly confused when one analyst asserts that the market is cheap, and another says it is overpriced. Can they both be right? Yes.

One method of measuring P/E ratios divides the current market price by current annual earnings. Sometimes analysts' consensus estimates of year-ahead earnings are used (the "forward P/E") instead of current earnings. This method can provide reasonable estimates of possible short-term gains and losses within a business cycle. Right now, the forward P/E is about 13.5. If the economy continues to grow, and the 2007 P/E of 15 were reached again, the S&P 500 would be about 10% higher. On the other hand, replicating the 2009 lows, which had a forward P/E of 10, but also had declining earnings, would send the S&P as much as 50% lower.

The second way to look at the P/E ratio is over a longer time period, using the current market price divided by 10-year average earnings (PE10 or Cyclically Adjusted PE). This method correlates very well with subsequent stock market returns over the next 10-15 years. Rather than answer how much gain or loss there might be over the current business cycle, it addresses the question of what can be expected over the next 10 to 15 years. That answer is currently an average annual gain of between about 3 and 6 percent, which is well below the historical average.

Taking the two methods together, it would not be unreasonable to conclude that there is the possibility of some continued shorter-term gains from here, and potentially larger losses in time, with business cycle length volatility oscillating around a slowly increasing trend. For those in or nearing retirement, this translates into planning on an expectation of a lower than average withdrawal rate and reducing risk for now.

In these unpredictable times, the key is to adapt, plan and manage risk. A good, well-executed plan is likely to be an investment worth far more than the cost. To learn more about our client goal-centered financial planning and investment management services, please call or e-mail. We invite you to visit www.linnardfinancial.com.

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