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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

Events today may be compared to the question of whether the light we see at the end of the economic tunnel is a safe exit, or the proverbial on-coming train. Our leaders have tried to move forward by applying normal remedies, albeit in abnormal size, with little success. Will there be a new solution coming? Will the cure be worse than the disease? Are they even capable of solving the problem, or are they merely actors in a drama written by events and human nature? We should be prepared to adapt to whatever the future brings. To that end, as always, this *Outlook & Trends* will attempt to provide information and perspective that you may use to plan for your financial success.

The Economy

Whoops! As the President said, we have been hitting bumps in the economic road. The growth rate slowed again to 1.9% according to GDP data for the first quarter. The Federal Reserve hoped that their policy of flooding the markets with money by buying bonds (known as QE2) would lift asset prices and build confidence enough to propel the economy to an "escape velocity", where it could grow on its own. The policy project has now expired. It did lift stock prices for a while. Although Fed chairman Bernanke dismisses the idea, it probably was also a factor in the run-up of gasoline and food prices. But alas, growth seems to be slowing again, and unemployment remains stubbornly high. That may be because there are structural problems that money will not cure. It may simply take time to work out the excesses in housing and consumer and government debt. It may take time for businesses to understand and adjust to a new regulatory environment before they choose to invest in growth again. It may take time for the population to choose an acceptable spot in the continuum between capitalism and the welfare state.

For now, we probably do not need to tell you, people are not showing the enthusiasm that reflects a healthy growing economy. Consumer confidence dropped off again to a level that is still better than 2009, but is consistent with the lows of most recessionary periods. Consumer debt is flat compared to last year. The employment growth rate is less than 1%, while unemployment remains stubbornly high at 9.1%.

According to Case-Shiller, Washington DC boasts the strongest real estate market in the country. This may be a clue to the root of our broader economic issues. Homeowners in the East can celebrate an annual increase of 3.8% in prices of existing homes. Those in the West no doubt continue to be dismayed by a drop of 9.3%. Unfortunately, as the market has begun to stabilize, the number of homes offered for sale has also increased, keeping pressure on prices. A piece of good news is that the 30-year mortgage rate continues to drop to new lows.

The Markets

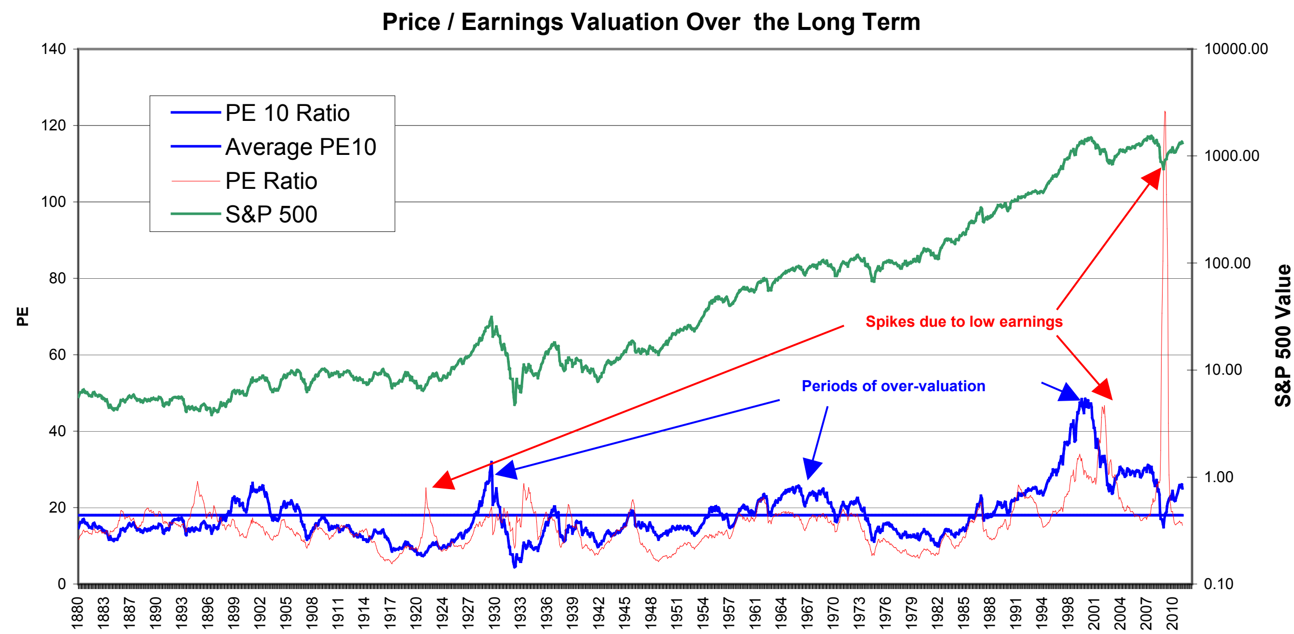
The stock market closed the quarter a bit lower than where it began, while bonds rallied. Drug and medically related sectors are showing strength. These sectors, along with the also strong utilities, are considered defensive and tend to do well in the latter part of an economic expansion. Commodities are pulling back within an apparent up-trend, after a strong rise in the second half of last year. Prices of these globally traded materials tend to move in the opposite direction to the dollar, as do foreign equities. Despite government assurances of a strong dollar policy, the dollar has reached the lowest point since before 1973.

Adding to the confusion is the renewed instability in Europe, as the credit card of the Greek welfare state is maxed-out. The concern is that a Greek debt failure will create a chain of financial failures similar to the Lehman Brothers collapse in the US several years ago. It is not clear yet whether this situation will slowly fade in our memory as a crisis averted, or blow up into a major debacle for investors in Europe (and the United States).

Valuation & Price/Earnings (P/E) Ratios

Do the ebbing confidence levels and widespread concern about the economy and Europe warn us to be cautious, or do they suggest that we take a contrarian view, assuming that the bad news is known? Trying to base an investment or retirement approach on the contradictory statements of the political pundits can give a person a case of vertigo.

Since equity values are generally related to the future earnings of companies, investors often look to the ratio of a company's stock price and its earnings to answer the question of how low a price is possible, or how high a price is too high. Analysts use their crystal balls, and calculate "forward P/E Ratios" based on estimates of future earnings. These calculations can drive stock prices up or down over the short term, but are typically proven very wrong at economic turning points. Longer-term investors often use the "trailing P/E Ratio", which is calculated using reported earnings. This gives a better sense of how the market is valued at a snapshot in time, rather than trying to be predictive. The problem with the "trailing" P/E ratio is that it gives spurious answers when earnings are low, typically during recessions. You can see this effect in the red line spikes in the graph. Another way to construct a PE ratio is to normalize it using a ten-year average of earnings (known as the PE 10). This does not work very well for companies that have not been in business for a long time, but does provide a good sense of long-term market valuations. The PE10 for the S&P 500 is shown in blue, constructed by using data provided by Robert Shiller. The cyclical variations had been quite consistent until the mid-1990s, when you can see the market became very over-priced, reflecting the credit and life-style expectations bubble that we are still working off today. Even though the current valuation (25) is only 1/2 of the peak in 2000 (48), it is roughly equal to the market tops in 1900 and 1965, and 38% higher than the long-term average (18). This suggests that we still have a ways to go before sustained multiyear progress is likely. Even with good government policy, it still may take time to get the good feelings back.



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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