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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

This is the 50th quarterly issue of *Outlook & Trends*! We hope that you have found it informative and helpful to see the financial world a bit differently on occasion. Following our fiduciary philosophy, our intent has been to provide you with useful information that need not reflect the financial industry's conventional message. Over the years much has changed, but much has remained the same. One constant has been the empowering value of understanding your financial options, planning for your future, and having the capacity to execute your plan with confidence.

The Economy

GDP rebounded in the second quarter, with the economy growing at a 4.6% rate during the period. Combining the latest data with the first quarter's gave an annual growth rate of 1.7%, which is still lower that the average of the last fours years. Consumer confidence continues to trend upward as we move farther away from the "Great Recession".

The National Association of Realtors reports that existing home sales dropped over the last year, while the inventory of homes for sale has increased. Apparently the post-recession rush to purchase homes at low mortgage rates has waned, though long-term rates are not significantly different than a year ago. Despite this, average home prices have continued to increase in all regions except the Northeast.

The government is finally reducing the federal budget deficit. The Congressional Budget Office estimates that the deficit will be $506 billion this year. While this is still a lot of money, it is a long way from 2009's imbalance of 1.4 trillion. The deficit has decreased steadily on a path from the high point that was set to bail out failing companies and fund "shovel-ready" projects, through the sequester reductions, and finally from rising tax receipts today.

Likewise, the Federal Reserve's "Quantatative Easing" money printing policy is winding down and will conclude this month, with the unemployment rate below the target of 6.5%. Injecting liquidity into the economy was clearly a prescription for freeing up the seized credit markets of 2008, and likely also provided psychological support for the eventual turnaround. Whether the policy had a positive effect on economic growth since then may be debated for years to come. There is not much disagreement, however, whether the Fed's intervention affected the financial markets. Low interest rates have benefited corporate borrowers and reduced the government's deficit at the expense of savers and bond investors. Low interest rates and excess government spending repaired corporate balance sheets and increased corporate profits. This, in addition to investors' quest to improve measly bond returns by adding greater risk with stocks and junk bonds, has driven stock market values ever higher. Hence the disconnect between "Wall Street and Main Street" that has increased income disparity by inflating financial asset prices, while growth in the prices of assets used for production, like labor wages and commodities have remained subdued.

The Markets

Once again the markets are beginning to diverge. Large company stocks, which make up the Dow Jones Averages and the S&P 500, are an easy place to recycle Fed-induced excess money. They hit new highs during the quarter, then dropped back a bit of late. This was not unusual for September, which is historically the weakest month of the year. Most other areas have lagged, however. While S&P 500 is about 1% below its peak, small-cap stocks and developed country international stocks are 7% below their peaks set in early July. Emerging market stocks have dropped 10% in the last few weeks, and gold has also lost 10% since July. If you are maintaining a well-diversified stock portfolio, the results you have seen of late have not matched the reports on the nightly news. Though just as September is often weak, the November - January period is often strong. We will have to wait to see if the end to the Fed's QE policy and the drying up of the excess money supply reverses the prevailing trend.

Valuation

In the past, we discussed how long-term market valuations differ from cyclical value measures. Long-term values have been high for some time and growing higher as the S&P 500 continues to climb. Long-term valuation measures, like the Nobel Laureate Robert Schiller's 10-year cyclical adjusted PE, correlate well with expected returns 10 to 15 years later. Another measure, the Q ratio developed by another Nobel winner, James Tobin, which tracks Schiller's valuation measure fairly closely, is higher than any peak for the last 100 years other than in 2000, when the Fed was also pumping in money to inoculate the economy from Year 2000 computer problems.

The shorter–term forward earnings P/E ratio, which is useful for trading within a cyclical market, stands at 15.1, equal to the 2007 peak, but well below the 2000 "irrational exuberance" level of 24. This measure divides the current S&P price by its per share earnings estimate of $131 over the next 12 months. That estimate is 17% higher than the $112 actually earned in the last 12 months. The expected 17% gain contrasts sharply with a Fed estimated growth environment of less than 3% (5% if you include inflation). A downside earnings revision, which would increase the forward P/E, is particularly possible at a time when the Fed is also scaling back monetary support.

Why has *Outlook & Trends* mentioned valuation often over the last several years? Because it is important. We have heard the financial industry's logic suggesting that entering at a peak does not produce substantially different returns over the long run than entering at a bottom. The logic goes if you invested at the market peak in 1973, your return would only average about 1.4% less per year than starting at the bottom in 1974. This is not much in the overall scheme of things. But $1,000 invested at the bottom would be worth $96,000 today, while $1,000 invested at the top would be $59,000. This 62% difference could clearly affect the quality of someone's retirement.

A person planning their retirement should be looking at their savings and considering the likely return that they will receive, in order to visualize and plan their future expenses over a 20 - 30 year period. No one can say with any certainty what the value of the Dow Jones average will be in twenty years. We can say with good certainty that it will have some distinct value on October 1, 2034, which will not be known until then. That value will be the same, whether today's number is high, low or in between. What will change then is the return that today's investor will receive when moving toward that fixed value. If the Dow were 30,000 in twenty years, it would represent a 75% gain from today (before dividends). However, if the stock market were at a "normal" long-term valuation, the 20-year gain would be 184% from that point. If stocks continue to rise back to the year 2000 record valuation levels, that return would total 13% from there. Long-term returns are not constant. Current valuation is important.

If a person planning retirement builds their budget based on a normal 184% return, but does not recognize that they are basing their plan on a retirement savings number that is overvalued, their return and their subsequent life style may turn out to be less than planned. It is important for you to consider long-term valuation in your planning.

In these unpredictable times, the key is to think ahead, adapt, plan and manage risk. A good, well-executed plan and strategy is likely to be worth far more than the cost. *LFM&P* helps clients to create, adjust and manage their individual plans and investments considering return, risk, diversification, and time. 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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