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## Vision is Foresight

### Perspective on recent market events

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Someone defined "Vision" as "foresight, with insight, based on hindsight." This thought may be helpful when considering what next to do in this nervous investment moment.

The global economic and financial saga continues. We expect there to be increasing differentiation in economic fundamentals across countries – largely based on the debt burden of various sovereigns. Some of the recent uncertainties affecting the markets include China tightening, the UK election, US primaries, the German election, the German short-selling ban, Greece riots, Thai protests, financial contagion in countries such as Greece, Portugal (maybe Spain and Italy), financial regulation and healthcare reform in the US, lawsuits against financial companies, the "flash crash", a failed terrorist attack in NYC, the Iceland volcano disruption of air travel, and the Gulf oil spill.

The capital markets are concerned that the world economies will again become synchronous, with the weakest bringing down the strongest; those with heavy debt and inability to grow hurting the financially strong and their growth prospects. Thus, the question is, can Europe spark another credit crisis and derail the US and global recovery underway?

What's important near-term is that it's tough to see recent events turn a "positive feedback loop" back to negative. It's hard to see recent events have large impacts on domestic GDP, employment, or wages in the US. It's been said that the US economy is like a behemoth battleship – once it's moving in one direction (currently up) it is very hard to change direction quickly. Exports from the US are roughly 10% of GDP, and only one-fifth of that is Europe related. Meanwhile, the domestic economy is benefiting from low mortgage rates and lower energy prices.

Instead, what's changing seems to be what investors are willing to pay for current and future growth. In other words, the uncertainty is flowing through to the market multiple (or Price/Earnings multiple, P/E) applied to earnings. As the economy rebounds and companies continue to recover sales and earnings growth, investors are saying they are not willing to pay higher prices (multiples of earnings). Thus, multiples are contracting as earnings rise. That does not mean stock prices will not rise; it means they will rise slower and not receive aid from multiple expansion. History also shares that multiples contract when government imposes new regulations, taxes and/or higher interest rates; and vice versa, when governments are less active with regulations, taxes and/or interest rates multiples expand. Thus, current events and prospects for greater government interaction are impacting what investors are willing to pay for recovering growth prospects. It is these "new" sources of uncertainty that are giving investors a tough time currently.

What are we considering doing; what are we thinking? We offer several summary thoughts:

1. The markets are showing oversold signals. We think the current "hiccup" is not the flu or a cold that will derail the recovery. Several areas of the market are offering attractive opportunities – foreign is oversold (sentiment is bad). And, we expect investors may rotate to focus on quality. If one is afraid or uncertain, risk is not a focus; but quality becomes the comfortable way to invest. Client portfolios are broadly diversified among funds of different styles and investment processes, largely touting a quality focus. Several market areas are attractive for additional and/or continued investing.
2. History shows that a 10% correction in the first 12 months or the second 12 months of a new bull market is not uncommon (occurring in 7 of the last 11 bull markets since 1941). We are in the 14<sup>th</sup> month since the bear market bottom (on March 9, 2009) and have not had such a correction.
3. Historical performance of stocks versus bonds, shows rolling 10-year returns skewed – bonds beating stocks by a lot over the past 10 years. In fact, stocks generated a negative 10 year return ending 2009. In two other instances where stocks had negative 10-year returns, the subsequent years experienced big reversions upward. Today, money flows from money market funds are 17 to 1 in favor of buying bonds (over stocks). Is consensus wrong in buying low yielding bonds?
4. We earlier mentioned the "positive feedback loop" and rebounding economic growth with small export trade to Europe. These trends do not reverse quickly.

Thus, our base case, or vision (see definition above) is that the new bull market remains underway with the recent hiccup largely past; investors will become more quality focused with their investment selections as they become less willing to pay high multiples. However, we remain vigilant in our watch of recent sovereign issues and the risk of contagion from a rolling credit event. Client portfolios are invested conservatively and quality focused, but with expectation for the continuation of this new bull market.

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