

TOPSY-TURVY OIL, SPINS THE WORLD

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Many years ago, a Merrill Lynch institutional broker provided an annual chart adding to the list another significant reason or worry that investors cited for not being invested. Some of prior year worries were interest rate increases, Iraq war, rising inflation, and foreign sovereign debt. One could name a significant national/world concern, and thereby quickly pronounce it a wrong time to be invested. This annual chart also showed how remaining invested, despite a significant reason not to, created a significant increase in one's investment value. It was startling how much growth occurred for long-term investors. There is always a worry; a reason not to be invested. And it seems there are several big concerns in early 2011.

During February, two issues (probably more if we were detailed) created potential investor worry: Congress debating how to address the huge deficits, and OIL (via Egypt and now Libya). Two questions seem strategically important. Is the "bill coming due" (after "kicking the can down the street")? And, at what level do oil prices begin to erode consumer confidence and dampen economic growth? "Hope" (for the best) is not a solution or an investment strategy.

First, February proved to be a second successful month for investors, and also adds to an attractive start to 2011. The S&P 500 advanced over 3% in February, and over 5% for the first two months. That's despite the strategically crucial issues listed above. Bonds on the other hand, struggled amid worries of federal and state debt levels. For the first time in 2 years investors shifted money from bonds into stocks; and the allocation shift just began. Foreign stocks stumbled year-to-date because of North Africa geopolitical issues (also impacting oil). Foreign stock exposure impacted portfolio returns slightly, as underperforming foreign held back advances from domestic stocks. We do expect this pattern to reverse and normalize

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Style	February	YTD
Small Growth	+5.1%	+5.7%
Small Value	+4.7%	+5.1%
Mid Growth	+4.3%	+5.7%
Mid Value	+3.7%	+5.7%
Large Value	+3.4%	+5.7%
S&P 500	+3.4%	+5.9%
Large Growth	+3.3%	+5.2%
Foreign	+2.3%	+3.0%

Client Objectives (Stocks/Bonds)	February	YTD
20/80	+1.0%	+1.7%
35/65	+1.6%	+2.4%
50/50	+2.1%	+3.1%
65/35	+2.3%	+3.0%
80/20	+2.6%	+3.1%
95/5	+3.0%	+3.5%
S&P 500	+3.4%	+5.9%

Recent US economic data series remain solid. The economy shows continually accelerating growth progress with limited inflation (deflation risk is almost nonexistent). Unemployment is even improving. Inflation is not a US problem at the moment. Oil is inflating in emerging markets along with food prices, but not so in the US where rising oil prices is more like a tax (if it was inflationary, US interest rates would be rising). If not for recent oil spikes (rising 30% from roughly \$80/bbl to \$100/bbl), economic expansion would appear brighter. The US economic backdrop remains solid despite geopolitical contagion from Egypt to Libya, etc. creating an energy shock. In addition, events in Washington (and probably most states) bring up the impact of fiscal drag (the "bill coming due"). Economic growth seems again to be at a crossroad or transition – to the private sector (household + corporate), as government begins to formulate an exit strategy from stimulus via deficit reduction. We need the household/consumer to offset the drag of rising oil prices and the corporate sector to offset the drag of fiscal spending/stimulus cuts. Unemployment needs continued improvement to boost consumer confidence and companies need to spend their "too much cash".

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TOPSY TURVY OIL, SPINS THE WORLD -CONTINUED-

Historically, the US economy runs into trouble (a slow down) when energy prices and interest rates rise together (costs for energy and money that most everyone uses). Historically, when the sum of the two (oil + interest rates) exceed 10, the economy is at an elevated risk of slowdown. With gasoline pushing toward \$4 and 5% mortgage rates, we're currently working toward 9 ($4 + 5 = 9$). Or, from another perspective, when consumer expenditures for energy approach 8% of GDP, a meaningful decline in economic growth follows. Today we are approaching 6% of GDP with gasoline prices at \$3.30/gallon (\$101/barrel). If \$4/gallon gasoline is sustained (approximately \$130/bbl) it is anticipated that economic growth will begin to deteriorate. In emerging markets like China and India, food & energy represent 33% and 35% of consumer expenditures, respectively (compared to US at 14%). In essence, the US can handle higher energy and food prices easier than developing/emerging markets. But, prolonged oil shocks are dangerous for consumer confidence and thus the US economy and the world. At some point, rising prices (oil, food, etc.) sow seeds for its own reversal via demand destruction.

Aside from oil, if it alone were not enough, investors can also find reason not to invest because of deficit issues. Both oil and debt may prove to be a catalyst for investors to utilize near-term caution toward investing following a strong YTD start, and last 6 months advance. In the short-term, Congress must finance itself for FY2011 (started in October 2010) via continuing resolutions and approval of a final budget. Plus the current US debt ceiling will be broached in May/June and must be addressed (raise ceiling and/or reduce debt). And, Congress will start work on the 2012 federal budget. These are three major issues with huge debt ramifications. How will the "bill coming due" be addressed? Tax increases appear removed from the table (Bush tax rates were extended for two years, and high corporate tax rates are under consideration). So government spending appears under review (rightfully so).

What's an investor's investment alternative in a topsy-turvy world? Use money market funds which pay almost zero? High priced gold? Tough question! We continue to invest with much care, close attention to domestic and world events, and utilize a broadly diversified portfolio of no-load mutual funds. And, we manage risk via close monitoring of fund exposures relative to our tactical strategy. This approach has worked successfully through the years, when there were many significant reasons not to invest. We are not trying to elevate your worries, but provide perspective relative to the investment process. We expect current issues will resolve into something new in the future, while remembering that investing is a life time process. We welcome your thoughts and comments.

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