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BALANCE IN A CHANGING WORLD
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# THIRD QUARTER 2012 INVESTMENT ADVISORY REPORT

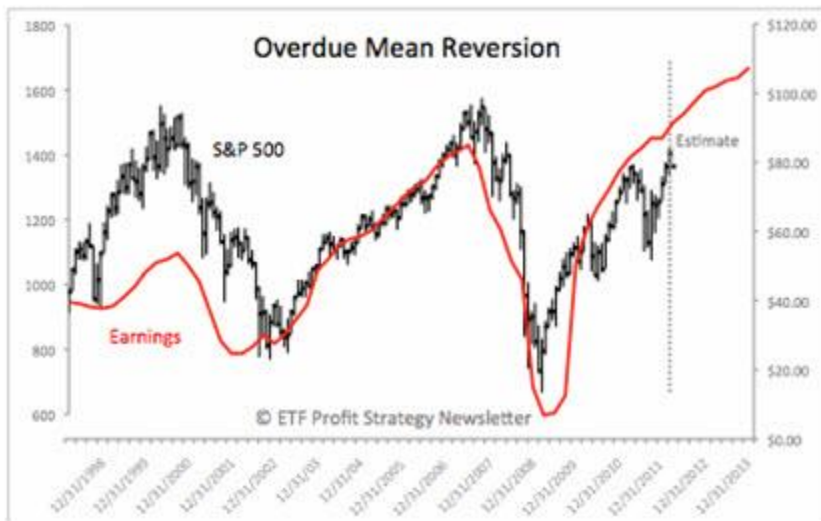
*"This Time It's Different"*

The Markets put in a decent performance for the Third Quarter. According to data compiled by T. Rowe Price (see table 1. Below) the Dow Jones Industrial Average gained 5.02% for the quarter and the S&P 500 index rose by 6.35%. Bonds also did well, as did International and Emerging markets.

Earnings, although cooling off from their record growth, have remained solid. However, as noted in a recent blog on the NASDAQ.com website: "All major market tops coincided with record earnings". They then reference the chart below:

## "Will Bad Earnings Sink the Market?"

"Today, forward Q4 earnings estimates for the S&P 500 is (sic) now at a high of $112.26, surpassing the July 13th peak of $111.88, and a new record high for the S&P 500 earnings estimate. (Source: Thomson Reuters)"




http://community.nasdaq.com/news/2012-10/will-bad-earnings-sink-the-market.aspx?storyid=180607

The writers question whether earnings have peaked, or whether economic growth will drive stock prices higher thus justifying the higher earnings estimates. They're skeptical about the growth story. They compare U.S. domestic economic growth in 2007 (at the market's peak) with growth today, citing some of the following statistics:



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- The unemployment rate today is still 75% higher than it was in 2007
- U.S. national debt has jumped 86% from $8.6 trillion in January 2007 to more than $16 trillion
- The U.S. post office defaulted on a $5.6 billion payment for future retiree health care benefits
- 46 million Americans are on food stamps (up 170% since 2000).

And this is supported by other data from the Fed, for example, such as the Industrial Production Index which was reported at 97.0 in September, vs. 100 in 2007[1]. Gross Domestic Product was measured at 105.125 for Q III 2007[2], virtually unchanged from estimates of 106.141 for Q III of this year[3].

The bloggers point out that: "The world's central banks (in particular the Fed and ECB) have bid up stock prices to near all-time highs. Yet, even without the threat of sovereign debt defaults, stocks crumbled 50%+ from their 2007 highs (during the 2008 crash – and, in all fairness, it's not clear that global financial institutions defaulting en masse would be any less severe than sovereign defaults; *ed. note*)". They then ask, rhetorically; "Where will stocks end up this time? What happens when countries start defaulting on their debt?" Their conclusion is; "The bottom line is that the downside potential is now larger than at any other time since the Great Depression. While the long-term outlook is grim, it needs to be balanced with a short-term positive bias of Presidential election years and the Fed's monetary stimulus."

So, about that stimulus…According to a recent article in the Wall Street Journal entitled "Central Banks Flex Muscles", the Journal states that; "Massive injections of stimulus into financial markets by the world's largest central banks are creating a domino effect around the globe, prompting governments from Brazil to Turkey to take steps to keep easy money from flooding in and driving up their currencies…The Bank of Japan Wednesday became the latest central bank to ease monetary policy. That follows bold pledges by the world's two biggest central banks to launch open-ended programs to bolster their economies."[4]

What if the stimulus actually works? What if the flood of liquidity provides the salve that enables our wounded financial system to heal, as organic global economic growth once again sprouts and flourishes? Of late, I reflect often on the words of Sir John Templeton, who once famously said something to the effect that "the four most dangerous words in investing are 'This time it's different'". Monetary policy is a time tested tool for dealing with classic economic business cycles. Central Bank easing has been a potent driver of nominal growth – hence the old Wall Street saw "don't fight the Fed" – and deciding that this time is any

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[1] http://www.federalreserve.gov/releases/g17/Current/default.htm
[2] http://www.bea.gov/iTable/iTable.cfm?reqid=9&step=3&isuri=1&903=3
[3] http://www.conference-board.org/data/usforecast.cfm
[4]http://online.wsj.com/article/SB10000872396390444165804578006723461538666.html#project%3DEASE0912%26articleTabs%3Darticle



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different is a decision made at your own (investment) peril. However, the relevant question really is "different, relative to what". This current cycle is clearly much more than a classic economic boom/bust cycle – it's also a financial, deleveraging cycle, and, dare I say it… *that's very significantly* *different!* It's not at all clear how this eventually plays out, or if fighting deleveraging with more leverage, actually works.

In future letters, I plan to focus more on issues concerning capital allocation, or more specifically, the unintended consequences of capital misallocation. At this point, I can only watch in amazement how the Fed has taken the world of risk that I've navigated for over thirty years and turned it on its head. Cash and government bonds, the formerly "riskless" assets are now **fraught with risk**. And, even if earnings *have* peaked, a stock's price is ultimately a function of the *multiple* that the market is willing to place on those earnings. Clearly, stock multiples are nowhere near the elevated levels of the last dot.com bubble in the late 90's. I fully understand how, as a result of the Fed's zero interest rate policy, the relative returns on equities look ever more attractive, and hence multiple expansions can take stocks ever higher. However, by the metric of "classic economic cycles", this bull market – assuming a trough back in March 2009 – at 43 months old, is an aging bull. We have an imminent US election along with a "fiscal cliff" to traverse, a power transition in China, a yet to be resolved European crisis, along with tensions flaring daily in the Middle-East. Given the risk/rewards as we see them, we are maintaining our allocations. Our balanced accounts remain basically 50% in equities, 25% in fixed income, and 25% in alternative investments. We remain overweight cash in the former and latter pools. The Alternative sleeve is still underweight commodities and long the US dollar; however we are monitoring this position most closely. If the dollar appears to begin resuming its long term secular decline, we will exit the position and aggressively add to commodities and gold.

We hope you are enjoying the fall colors, the looming turkeys and pumpkin pies, and the time spent with family. We suspect that by the end of the current quarter, things will be as "clear" as they are currently, but we remain vigilant for opportunities that will present themselves. In the meanwhile, our primary rule, that permeates every fiber of our investment philosophy, is to "first do no harm" – i.e. to never impair capital. We do not believe that another 2008 is looming, but nor are we convinced that this is a propitious time to take large bets on any asset class. Embracing caution is always most difficult at market peaks, as is the timing of those peaks. However, we will continue to remain true to the discipline that has served so well over this past decade – and, "that will be no different this time"

Best regards,

Jason Waxler



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Table 1.

| | Total Return[1] | |
|---|---|---|
| **Index[2]** | **Third Quarter 2012** | **Year-to-Date** |
| DJIA | 5.02% | 12.19% |
| S&P 500 | 6.35 | 16.44 |
| Nasdaq Composite | 6.17 | 19.62 |
| S&P MidCap 400 | 5.44 | 13.77 |
| Russell 2000 | 5.25 | 14.23 |

| **Index[1]** | **Third Quarter 2012** | **Year-to-Date** |
|---|---|---|
| Barclays Capital U.S. Aggregate Bond Index | 1.58% | 3.99% |
| Credit Suisse High Yield Index | 4.27 | 11.22 |
| Barclays Capital Municipal Bond Index | 2.32 | 6.06 |
| Barclays Capital Global Aggregate Ex-U.S. Dollar Government Bond Index | 4.37 | 5.18 |
| J.P. Morgan Emerging Markets Index Plus | 6.94 | 14.33 |

| **MSCI Index[1]** | **Third Quarter 2012** | **Year-to-Date** |
|---|---|---|
| EAFE (Europe, Australasia, Far East) | 6.98% | 10.59% |
| All Country World ex-U.S. | 7.49 | 10.86 |
| Europe | 8.76 | 12.02 |
| Japan | -0.77 | 2.43 |
| All Country Asia Ex-Japan | 9.42 | 16.09 |
| EM (Emerging Markets) | 7.89 | 12.33 |

| **MSCI Index[1]** | **Third Quarter 2012** | **Year-to-Date** |
|---|---|---|
| Emerging Markets (EM) | 7.89% | 12.33% |
| EM—Asia | 8.86 | 14.46 |
| EM—Europe, Middle East, and Africa (EMEA) | 8.54 | 15.58 |
| EM—Latin America | 4.71 | 4.34 |

http://individual.troweprice.com/public/Retail/Planning-&-Research/T.-Rowe-Price-Insights/Market-Analysis/Quarterly-Wrap-Ups



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