TW Advisors

1st Quarter 2011

# Will the FED Keep Fueling the Markets?

The stock market got off to a great start in 2011 continuing its steady advance since August 2010. However, equities quickly gave back all its gains as political turmoil in the Arab world pushed oil above $100 a barrel and the tragic events in Japan unfolded. The market rallied back the last two weeks of the quarter to finish 5.9% higher. Volatility, which is usually a red flag for investors, has returned to the markets.

While we are thrilled with the rally, which we believe has been engineered by the Fed; we now perceive an increase in risks relative to the return potential of the stock market. There is no doubt the economy is improving and corporate profits are at record highs, but these conditions are a result of massive fiscal and monetary stimulus that cannot continue forever. Despite an all-clear message from the stock market, many of the economy's long-term problems have yet to be solved: system-wide debt is still too high, contagion risk is great due to concentration of poor quality assets at the banks, our tax structure is a mess, and most importantly there is no political will (or quite frankly public will) to reform our entitlement programs. Consider that a report issued by an 18-member bipartisan commission on fiscal responsibility projected tax revenues in 2025 will only be sufficient to finance interest payments and entitlement programs, **with no room for anything else.** So far, capital markets have not reacted much to the dismal long-term outlook, but investors should not get complacent. Our advice is to be very **skeptical of anyone arguing our economy has entered a self-sustaining advance.**

**We are fast approaching the time when the Fed will end QE2 which we believe is the primary driver for the recent stock market advance.** It is no coincidence that when the **Fed stopped QE1 last year the stock market corrected by 17%.** The current psychology of stock investors is more a fear of missing out on gains than of seeing declines in their portfolios. When the psychology changes to "fear of losses", the market will be vulnerable.

Overall valuation is worrisome for the market with the clear exception of former stock market darlings like drug and technology companies. Some commentators argue the stock market is cheap based on current earnings expectations. However, corporate profit margins are elevated and will likely revert to their averages once the stimulus ends. Most valuation measures that average earnings over a full economic cycle, like Prof. Shiller's popular CAPE (cyclically adjusted price earnings ratio) are near record highs. None of this applies, however, to many former growth stocks. As you know, we own many companies with strong balance sheets, high dividend yields, and reasonable growth prospects that are trading below 10x earnings. These companies are trading at significant discounts to even electric utility stocks (which is irrational) and at such attractive valuations, could do well even if the market corrects.

While the future is always uncertain, we believe the right portfolio can help navigate the expected choppy waters.

**Jim Tillar , CFA and Steve Wenstrup**

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