Economic Update (Q1 2012 Recap)

COROMANDEL WEALTH MANAGEMENT

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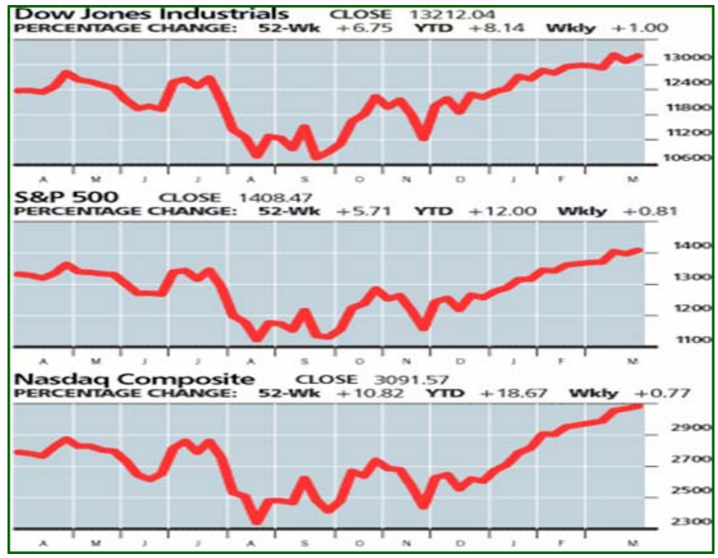
Wow – what a great first quarter for the stock market. The Dow Jones Industrial Average increased 8.1%, its highest level since 2007. The S&P 500 jumped 12% and the NASDAQ climbed 18.7%, marking the end of one of the more unexpected first quarter stock market performances in a long time. This was the biggest first quarter percentage gain since 1991.

The U.S. gains came amid a global rally. Stock markets from Tokyo to Frankfurt all posted their strongest quarterly gains in several years. The world-wide embrace of stocks surprised some investors who entered the year with many of the same concerns that dominated 2011. Many worried that Europe's debt troubles would keep flying up and that the U.S. and Chinese economies would stumble. Instead, the U.S. economy was pleased that Greece's debt restructuring was completed with relative calm.

There have been a number of reasons why the market did so well, one of which was a general lack of bad news. The Greek debt problem, for example, was temporarily moved out of the way and there was a basic improvement in the U.S. economy, according to Christopher Zook, the chief investment officer at CAZ Investment. (Source: Barron's, April 2, 2012, pg M2) Stimulus from Central Banks in the U.S. and Europe helped push investors into riskier assets such as small-capitalization stocks and "junk" bonds. Corporate earnings are growing nicely and the job picture is slowly but steadily improving.

Many large U.S. companies have emerged from the deepest recession since World War II more productive, more profitable, flush with cash and less burdened by debt. Deep cost cutting during the downturn and caution during the recovery, coupled with reduced interest rates on new debt, put many companies on firmer financial footing, helping them to outperform the rest of the economy and gather a greater share of the nation's income. "U.S. companies became leaner, meaner, and hungrier," said Sung Won Sohn, a former chief economist at Wells Fargo & Company. (Source: WSJ, April 9, 2012, A1)



Source: Barron's Statistics

Still, some investors remain concerned that the markets are ripe for a pullback and suspect this year could be a repeat of the past 2 years. In 2010 and 2011, stocks got off to a similarly strong start, but then plunged later in the year as the U.S. economy faltered and Europe's crisis worsened.

The big question is whether stocks are either relatively inexpensive or more overvalued than they were three months ago. Both sides have good arguments supporting their conclusions.

There are many reasons to believe the rally will continue.

The first indicator is the price/earnings (P/E) ratio, which is calculated by dividing a stock's or an index's market value per share by its earnings per share. By looking at the ratio over time, you can see if the company or the market as a whole is trading at a discounted premium compared with its long-term average. Currently, the S&P 500 has a P/E of about 13, well below the historical average of about 15. That indicates stocks are undervalued.

The counterargument states that the problem with this approach is that analysts can be wrong about earnings estimates.

Market expectations have fallen amongst many economists, making it easier for the economy and companies to surpass expectations.

Supplies of low-cost domestic energy are being discovered within our own borders. New techniques are unlocking huge reserves of natural gas deep within underground shale formations. In fact, it is now estimated the U.S. is sitting on 2,543 trillion cubic feet of gas, enough to power the nation's needs (at the current rate of consumption) for more than a century! Low-cost gas is already stimulating our domestic steel and petrochemical industries, and others will most likely follow.

Another interesting observation is the persistent drain of U.S. manufacturing jobs overseas may soon begin to reverse. For example, surging costs for labor, transportation and real estate in China, together with issues related to inventory management and quality control, are changing things. According to a recent Accenture survey, 61% of North American manufacturers with overseas operations are considering bringing some of them back here. (Source: Profitable Investing, February 2012)

Another major positive change was a sharp decline in volatility. During the first quarter, the S&P 500 Stock Index closed up or down more than 1% only 7 times. It didn't have a single session with a move of more than 2%. In contrast, the fourth quarter of 2011 saw 36 days with 1% moves and 14 sessions with 2% or greater moves. This reduction in volatility certainly has had a positive impact on many investors—and most likely reduced their blood pressure as well! (Source: WSJ, April 2, 2012)

Unfortunately, a number of downside risks persist.

High gasoline prices could also begin to weigh on stocks. Oil prices soared close to $110 a barrel in February as tensions in the Middle East grew, driving gas pump prices higher. (Source: WSJ, March 31, 2012) Every 1 cent increase in the price of a gallon of gasoline costs Americans $3.4 million a day. (Source: BTN, AAA & Fortune, February 6, 2012)

An unpredictable lame-duck congress is likely to make matters worse as it struggles to deal with a series of controversial, financially sensitive issues:

- Deep automatic spending cuts slated for January 2013;
- Expiration of the Bush tax cuts;
- Uncertainty regarding the constitutionality of ObamaCare; and
- When the housing market will bottom.

One of the other major concerns is the U.S. deficit, which is projected to be $1 trillion for the fiscal year 2012. For every $1 of expected tax revenue, our government is anticipating spending $1.37. (Source: BTN, Treasury Department, February 6, 2012)

Unfortunately, concerns of many investors ended up being true, at least for the first part of the second quarter: stocks suffered their biggest declines of the year, especially due to worries over rising borrowing costs for European countries. Concerns flared anew about Europe's troubling economies. Many investors are growing increasingly skeptical about the ability of Spain and other heavily indebted nations to successfully implement mandated austerity measures. (Source: WSJ, April 11, 2012)

The Fed officials have suggested their broader plan is to wait and see how the economy performs before making any other changes to monetary policy. Many investors interpreted the minutes from the Federal Reserve's most recent policy-setting meeting to mean that no additional monetary status is on the way soon. (Source: WSJ, April 4, 2012)

Despite the drop during April, the Dow remains up 5.8% for the year, while the S&P 500 has gained 9.9% and the NASDAQ has climbed 17% as of April 9, 2012. (Source: WSJ, April 10, 2012)

Interest Rates

Another issue that affects most investors is the interest rates. The Federal Reserve cut its target for the Federal funds rate to a 0-to-0.25% range on December 16, 2008 and Ben Bernanke said last month that interest rates would remain "exceptionally low" at least through late 2014. While the unprecedented period of near-zero rates is meant to aid an ailing economy, it poses challenges for banks, insurers, pension funds and savers.

The hope is that by making mortgages and other loans cheaper, ultra-low rates may eventually revive economic growth. Unfortunately for now, they're squeezing profits at banks and disrupting investment strategies at insurance companies and pension funds.

The flipside of low borrowing rates is that savers can't earn a reasonable rate of return on their money in low-risk investments like bonds and bank accounts. In fact, most savers won't even keep pace with inflation. Many savers will have to either adjust to a much lower level of income or change their approach with their investing.

Rising interest rates are not threatening the U.S. economic recovery. However, a sudden spike or sustained jump could eventually pose a problem. Some investors have predicted that the Fed's short-term interest rate could come sooner than expected.

An interesting fact: The average interest rate paid on the $15.2 trillion of debt the U.S. has outstanding is 2.8% as of December 31, 2011. Every 1% increase in the average interest rate paid by the U.S. government would add $152 billion of additional cost per year, equal to $4,820 of additional interest expense per second for the entire year. (Source: BTN, Treasury Department)

Reducing Your Risk

Since no one knows for sure exactly what's going to happen in the future, one of the best ways to reduce your risk in the long run is through rebalancing. Rebalancing is really nothing more than keeping your portfolio true to its intended asset allocation. Over time, asset classes tend to grow at different rates. Without rebalancing, this may cause the overall risk profile of the portfolio to change substantially, likely getting riskier as higher-risk/higher-return asset classes outgrow their counterparts.

Rebalancing seeks to restore order by trimming the leaders among the asset classes and investing the proceeds into the laggards. Although this is a risk management device, the best-designed asset allocation and rebalancing systems are not infallible—they were not designed to meet every market circumstance.

Unfortunately, some investors try to reduce their risk by attempting to time the market and guessing what the market will do, especially in the short run. If anyone could really do that, as you know, they would all be billionaires and wouldn't have to worry about anything!

The reason timing is difficult, if not impossible, is that the investor would have to correctly answer the following 3 questions:

1. When is the best time to get out?
2. When is the best time to get back in?
3. What do you do with your money in between these two times?

If you don't answer these questions, you could certainly be left out in the cold, so to speak.

"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves." (Source: Peter Lynch, Davis Advisors)

Conclusion

As mentioned throughout this report, there is no "right way" to invest considering all of the different possibilities that could affect your investment. However, it is important to remember the 3 rules of investing**:**

- ***Diversify***
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- ***Diversify!***

As comedian Marty Allen, quoted in the Buffalo news said, "A study of economics usually reveals that the best time to buy anything is last year." (Source: The Week, April 13, 2012)

P.S. The U.S. government paid $1 billion of interest expense on its outstanding Treasury debt every 40 hours during the month of February 2012. (Source: BTN, Treasury Department, March 19, 2012)

As always, if you have any questions or would like to discuss the specifics of your portfolio, please call our office at (781) 728-9001.

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In general, the bond market is volatile, bond prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. The investor should note that investments in lower-rated debt securities (commonly referred to as junk bonds) involve additional risks because of the lower credit quality of the securities in the portfolio. The investor should be aware of the possible higher level of volatility, and increased risk of default.

Please note that rebalancing investments may cause investors to incur transaction costs and, when rebalancing a non-retirement account, taxable events will be created that may increase your tax liability.

Sources: Wall Street Journal (3/1/12, 3/31/12, 4/2/12, 4/4/12, 4/9/12, 4/10/12, 4/11/12), Barron's (4/2/12), The Week (4/13/12), By The Numbers (2/6/12, 3/19/12), Davis Advisors (2012), Money Advisor (April 2012), Journal of Financial Planning (February 2012), Profitable Investing (February 2012)

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Complimentary Financial Check-up

If you are not currently a client of Coromandel Wealth Management, we would like to offer you a complimentary one-hour private consultation. To schedule your financial check-up, please call George Gagliardi at: (781) 728-9001.

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