

A Fork in the Road

September 30, 2011

Like many, we are pessimistic about the economy, but we see a fork in the road potentially leading to attractive returns for stocks.

The first road could be long and painful. We study data and commentary that suggests sustained economic woes as we continue global deleveraging. We ponder the question, “If it took over 25 years to build up debt in the developed world, is it likely to fix itself in 25 months?” Creditors do not like defaults, but borrowers are struggling to make payments. The Great Recession is more about balance sheet debt and less about the normal business cycle. This one started with too much debt in too many places. Thomas Friedman recently wrote in the NY Times, “If our political leadership does the right thing, we are in for a bad ten years. If they do not, we are in for a bad century.”

This economic road could severely test our patience as it continues to be a bumpy, start/stop, headline ridden emotional roller coaster with many a political sideshow and crisis. This road could be one long, exhausting trip of government debt restructuring, a sustained bear market for the housing industry, low interest rates for savers, job “churn” for workers, reduced lifestyles and ultimately, more rational expectations.

This paper is too short (and we believe the case is too obvious) to lay out a pessimistic outlook of low GDP growth for much of the developed world. In spite of this, our research encourages rational optimism regarding equities. We acknowledge the appearance of a “mixed message.” Some of our research can be found on our website, www.davidsonwealthmgt.com, more specifically in our briefing, “Why It All Matters”. We also welcome a one-on-one discussion for a more complete explanation.

The second road is less obvious, will take time, but offers encouragement.

We are going on record with our belief that investors who are willing to look past the today’s headline news will be financially rewarded for investments they make today.

When you get to the fork in the road, take it. Yogi Berra

We think we could be at a fork in the road. Our road map suggests prices of equities will diverge from the economy. This opinion is best summed up by an article in Barron’s (September 1, 2011) entitled “Buy Stocks, Not Economic Data.”

This second road looks more promising, if you are an investor.

This road provides returns on invested capital. Its roadmap is marked by mathematics and finance, where value matters. In September, Wells Fargo Advisors published two white papers, “Spotting Opportunity Amid Uncertainty” and “2011 Strategic Allocations and Capital Markets Assumptions.” This is but one of the road signs indicating to us, “a fork in the road.” Citing their view “that persistent headwinds from both private and government sector deleveraging will dampen returns in the coming 10 to 15 years,” they still forecast equity returns ranging from 8.12% to 10.12%, depending on the specific asset class. If they are wrong to the downside, we believe valuations are so attractive the downside is mitigated. (They are available on our website.)

This opportunity exists in large part due to the pessimistic economic outlook. Investors are paying lower prices for each one dollar of corporate earnings than in the past. Behavioral finance teaches us this is ultimately unsustainable, just like high prices relative to earnings of the late 1990’s were unsustainable.

Our research suggests this “fork” exists due to data suggesting that not only are prices cheap, but corporate earnings (and especially cash flow) will persistently push higher over time in spite of today’s economic problems. Low interest rates help drive this. Corporate balance sheets, for the most part, are strong and prepared for a sustained low growth environment. The second road to investment returns is much more promising, due to a combination of attractive valuations, cautious corporate CEO’s and strong balance sheets. There was a quick response to the credit crisis of September 2008.

How did this happen? The first to adapt to deleveraging, in our view, were corporations who began with massive layoffs followed by a radical restructuring of balance sheets partly by refinancing at low interest rates. Corporations are now hoarding cash, but have not yet chosen to invest in growth (due in part to uncertain consumer demand – 70% of GDP in the US), purchase of other companies (mergers and acquisitions), stock buybacks or dividend increases. Even a dreaded double dip recession, in our opinion, has been anticipated by corporations worldwide and priced into stocks.

Professor Jeremy Siegel affirms the above in his August 19, 2011 newsletter, *Note that earnings per share can still grow in a no-economic growth world as firms use the earnings... to repurchase shares...*

Bottom line: *stock prices and interest rates are now so low that we do not need economic growth to justify the purchase of equities.*

Unlike real estate, stocks have a daily price and can be liquidated, creating cash for investors – helping create today’s low prices. Real Estate, in general, is still not cheap according to our research and will take much longer to recover. We see it still on the first road. One could argue the Federal Reserve’s low interest rate policy is aimed mostly to help the housing market.

But who actually benefits most from these low interest rates? We submit it is the best stewards of capital, corporations, who will benefit the most from Central Bank policies designed to help the consumer and governments. Corporations with strong balance sheets can selectively choose to borrow money to finance acquisitions and stock buy backs. This “self interest” serves investors first, and later the economy (the first road). To us, the fork in the road is in part created on Ben Bernanke’s August 2011 pledge of sustained low interest rates.

We acknowledge that it may be early in this outlook, but we see valuations – the price investors pay for earning streams and assets – to be attractive. Frankly, the math of price/earnings (P/E) and earnings yield (E/P, earnings/ price) is a day-to-day calculation, given today's price volatility. Please contact us for a full up-to-date explanation of this point.

We also acknowledge current short-term volatility could be long-term volatility, but volatility is not always down. To us, prices of stocks are so cheap; investors may be surprised by volatility on the upside. We also acknowledge the jingle, "markets climb stairs, but fall down elevator shafts." Instead of panicking when they occur, perhaps it is time to buy when these dips occur. Investors may not see the progress immediately as the process could be two steps forward and one-step back, thus "dollar cost averaging" makes sense to us.

We continue to acknowledge that the last 10 years have not been kind to equities. Most of us now admit that the optimism of the late 1990's drove the P/E's well above historic levels. Depending on whom you read, you will find degrees of how much P/E's are below historic levels. There is little debate about valuation, however.

We have not always been or expect to be this bullish. We refer you to our email notification in February 17, 2011 (S&P 500 1341) when we suggested for investors needing short- term liquidity, "this was as good a time as any," based on Wells Fargo Advisors year-end S&P 500 target at that time. On our website, under publications, we refer you to "2010 Market Outlook – Remarkably Unremarkable February 2010." In this briefing, we suggested the S&P 500 could trade in a range between 1,000 and 1,300 for 18 months. We are now at the end of 18 months, waiting to see "a fork."

In summary, if the pessimism created by the first road continues, given today's starting point, (S&P 500 at 1131 September 30, 2011), we believe equities will still offer reasonable returns over a meaningful period of time, offering competitive returns when compared to all other asset classes. As economic woes on the first road abate, we expect perceptions to become less pessimistic and returns are likely to be beyond expectations on the second road. For investors needing liquidity, we expect there will be opportunities to "harvest" profits along the way, and we will do our best to notify you.

As your financial advisor, we will continue to practice holistic wealth management. Together, we will diversify amongst a broad set of solutions. We will continue to employ strategies personalized for each family. Ownership in equities is not our only tool.

We submit there is a fork in the road. Take it, the second one. Our thanks go to Yogi for the metaphor.

We continue to be rational optimists regarding your financial future.



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