

## CCR WM OUTLOOK

April 15, 2011

Dow Jones: 12,264      S&P 500: 1,312      Ten Year Treas. Yield: 3.483%

A client of ours called about 5 or 6 weeks ago in a bit of a panic. In fairness, it wasn't just this client—there were several—but for some reason this particular conversation comes to mind. In short, the client's question seemed to be *when* (not if) to get out of the market. Of course the Dow and the S&P 500 at the time had fallen 6.7% & 7.0% respectively from their recent highs, and all cables and airwaves were filled (as they are today) with non-stop chatter regarding the series of Middle East revolutions and violence, soaring oil prices, domestic budget battles, and of course the triple whammy of Japan's earthquake, tsunami and nuclear catastrophe.

Given the highly charged emotions of the moment, we recall our advice seeming rather simplistic; "*focus on the economics*". To be sure—economic implications run through all of these events, but with regard to the macro economic indicators we outlined in our January Outlook, the trend remained positive despite these eruptions, as it does today.

Since the geo-political and natural disasters of the first quarter, we have witnessed *remarkable resilience* in the equity markets. At this writing, the Dow Jones Industrial Average is up 6.0%, and the S&P 500 is positive by 4.5% year-to-date. CCR Wealth Management attributes much (if not all) of this resilience to **The Power of Zero Interest Rates**. Understanding the flow of money from one asset class to another (cash to stocks, stocks to bonds or bonds to cash) requires a general acknowledgement that money will ultimately find its way to the better return. This is not to say it makes *prediction* of future flows any easier—but at times it can "stay the hand" when emotion is recalling recent market disasters. Zero interest rates, in our view, continue to have the most profound influence on where capital is flowing—and it has just been tested by a series of otherwise extremely negative global events.

We also take a moment to reiterate a "tag line" that has been in all of our Outlook communications since January of 2010; we remain in an early-cycle economy. At the time, we recommended a higher weighting in Small Cap equities, and since Jan. 1 2010, the Russell 2000 Small Cap Index has outperformed the S&P 500 by an *annualized* rate of about 9.50%. But this is looking in the rear-view mirror. Our conviction about where we are in the economic cycle today is bolstered by the evident Power of Zero Interest Rates, manifested as a significant increase in risk appetite. Year-to-date, there has been an abundance of M&A (mergers & acquisition) activity both in the US and around the globe, encompassing major players in the Telecom (AT&T/T-Mobile), Utility (Duke/Progress Energy), Biotech (Genzyme/Sanofi) and chemical (DuPont/Dansico)

sectors, not to mention the NSYE/ Deutsche Borse takeover. Current interest rates make these deals particularly attractive relative to the risk they represent; in a zero interest rate environment—it's cheaper to buy than to build.

### **Looking Ahead:**

- “Earnings Season” is getting into full swing as we write. CCR WM expects earnings, as a whole, to be good (though perhaps not *great*). We expect to see cross currents at play in Q1 reports showing the positive effects of the Power of Zero Interest Rates, as well as negative pressure inflicted by higher oil and raw materials prices. Obviously, these forces will have uneven effects across various sectors.
- Additional external effects that will pressure/benefit earnings on a global scale will be growing currency disparities due to the fact that many central banks around the world have become hawkish on inflation, while others (notably the US) have not. Currency is a more complex and inter-related subject than a single paragraph can adequately clarify. It is, however, important to make note of the *numerous* variables which influence currencies, as well as the *numerous* currency denominations at play in the global economy. We often hear people reflect that the “Dollar is weak”—but this statement may only be true when modified by a specific comparable (i.e. “relative to the Swiss Franc”).

Generally, large exporting concerns (whether domestic or non US) will be influenced by the value of their local currency as revenue is repatriated. For example; Nestle (Switzerland) just announced a disappointing quarter due to (among other things) that fact that the Swiss Franc has been quite strong *relative to their major trading partners*; the EU and the US.

We are generally bullish on US exporters for this reason—but again, exported manufactured goods are costing more to make (higher commodity prices), and it remains to be seen whether this economy will allow for a full pass-through of these higher costs to consumers.

- In the weeks and months ahead, we expect to hear and read more frequent stories about the scheduled end of the Fed's second round of quantitative easing (QE2). In January we attributed much of the market's second-half performance last year to both the announcement and implementation of QE2. There is already speculation that the end of this Fed action (June 1) will have a negative effect on both the market and the economy. We are not convinced this is true:

- 1) The fact that QE2 ends in June is a known fact. While expectations to the contrary are speculation, there is too much economic data due out between this writing and June to form a firm opinion in our view. As we've pointed out, economic trends remain positive, if tepid.
- 2) Ben Bernanke, Chairman of the Federal Reserve (and architect of QE1 and QE2) wrote a white paper in 1997 entitled *Systematic Monetary Policy and the Effects of Oil Price Shocks*, which can easily be found by typing this title into Google. The general thesis of this paper is that oil prices *alone* do not have an outsized negative influence on economies, but rather it is the combination of rising oil prices and tightening monetary policy that engenders recession.

We have no way of knowing how Bernanke's views have evolved over the last 14 years, but this paper suggests to us that the Fed is looking at rising oil prices as a *license* for continued easy monetary policy (and not necessarily an *effect* of these policies). In this view, oil acts as a "tax" on the economy—preventing a tendency of core inflation from becoming a problem ("core" inflation strips out food and energy from the headline CPI).

Our guess is that QE2 ends in June, but zero interest rates stick around at least through the end of the year. Either way, we are living in a bit of a Petri-dish; as the Federal Reserve's policy is the exact opposite from the EU's and other major central banks' focus. Getting it wrong will have consequences.

### EQUITIES:

- We retain our emphasized weighting in smaller companies--our models continue to hold at least a weighting of 12% (of equities) in small cap stocks, and higher for longer term horizons. As mentioned, we are in an early-cycle economic environment, and smaller companies tend to out-perform.
- CCW Wealth Management continues to hold an equal weighting of growth and value style equities in our models. Notably, while the S&P 500 is up 4.50% year-to-date (at this writing), the energy sector within the S&P turned in a 16.29% Q1 performance. Energy only has a ~13% weighting in the S&P 500—and as we pointed out in our January Outlook, most of these stocks fall within the "value" universe.
- Emerging Markets: Regular readers of these pages know that CCR WM has been "harping" on Emerging Markets for the last 24 months—imploring an equity weighting of at least 16% (to match the MSCI ACWI weighting). Yet these

stocks largely underperformed most developed indices since last October. In January we identified inflation in China, Brazil and other EM powerhouses as a concern—and certainly inflation has manifested in these economies. Yet we believe investors should take heart in the almost universally aggressive central bank actions taken across the emerging market economies. While this attempt to check runaway growth by hiking interest rates has (predictably) checked their spectacular market advances over the short term, we’ve seen an encouraging resurgence in EM equity indices over the last 60 days. Furthermore—as we’ve stated in many client reviews, EM growth dynamics are virtually as immutable as their favorable demographics and technological advancement trends.

### **FIXED INCOME:**

We have little to add to our fairly extensive (and oft repeated) commentary on the interest rate and fixed income markets over the last 9 months or so;

- Avoid Government and government-backed securities, particularly longer durations.
- Keep bond portfolios weighted in the high-end of high-yield, or the low-end of high-grade credit qualities (BB+ to BBB).
- Embrace “satellite” bond strategies, to include high-yield, emerging markets debt (local currency) and floating rate bond funds.

The municipal bond market underwent significant volatility in December and January, and in our view certain segments hold good value at these levels. Volatility generated by media hype tends to be short lived. Ironically, the negative attention received by municipal debt markets of late will likely prove to be the biggest catalyst for fundamental improvement. When have so many politicians (at all levels of government) displayed so much fiscal concern? The spotlight is on municipal and state debt issues—and they know it.

From a value perspective, we look for the same durations and credit weightings in the municipal market as we do in the taxable market.

We continue to view emerging markets bonds as very attractive. Of late, we have gravitated more toward local currency issues (vs. a prior equal weight with US denominated).

## COMMODITIES/ALTERNATIVE:

- In January we wrote; “*We believe we are once again in a bull-market for crude oil...it may be wise to consider rebalancing commodity allocations into oil at this time*”.

At the time, oil was trading at \$91/barrell. Oil is up almost 20% since January, however no one (including us) was forecasting the Tunisian uprising would affect an overthrow in Egypt, civil war (with US involvement) in Libya, and further violence across North Africa and the Middle East.

We continue to look at the fundamentals of global energy consumption rather than the supply bottleneck that is the Gulf States and surrounding region. We are not experts in the geopolitical tensions in the region, but we suspect there exists a ~\$10 premium in the current price of oil as a result. That said, *we remain* bullish on oil for fundamental reasons, and where appropriate we have expanded our commodity allocations to include Brent crude and US Gasoline futures ETFs.

- Precious Metals: we continue to hold meaningful allocations to Gold and especially Silver. In many cases, we have recommended removing some profits (which generally have been considerable) in our rebalancing efforts into oil in Dec '10, Jan '11. We continue to believe these holdings are an important component in efforts to balance portfolio risk in a rising interest rate environment.
- Base metals round out our *basic* commodity allocation model, and to-date the broad index (Deutsche Bank Commodity Index, Base Metals Sub-index) is relatively flat. Internally, this index is driven largely by the price of copper and aluminum, which are both “hyper-sensitive” to short-term economic data (as well as rumors of “hoarding”).

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