



A View from the Tower

View From the Tower 2nd Quarter 2011 – Resilience!

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It never really felt like a very good quarter for equity performance, alternating between feeling a correction was just about to send stocks lower and feeling respectful of the strength this two year old bull market still possessed. But feelings and emotions often focus our interest toward the more easily or visually grasped issues, diverting our attention from the meaningful drivers of stock returns. No matter how it felt, by the end of the 1st Quarter, the S&P 500 had overcome shocking obstacles for a positive 5.92% return. The Dow Jones followed suit up 7.07%, resulting in the best 1st quarter return for that Index since 1999, when the tech bubble was forming.

S&P 500 Chart



source: Bloomberg

As illustrated by the S&P 500 chart, the 1st Quarter was divided into two stages. The initial stage was a continuation of the strong cyclical advance from September 2010, generally coinciding with the announcement by the Federal Reserve of the stimulus plan called “Quantitative Easing 2” or “QE2”. By mid-February 2011, this uninterrupted advance left the market extended and vulnerable to a normal correction. After the S&P 500 peaked at 1344 on February 18, the market declined 3.5% to break just below 1300. The market traded sideways for nearly a month, brushing off concerns about the turmoil in Tunisia and Egypt. The market began to feel it was finished with the correction; however, the correction was not finished with the market. As the MENA (Middle East North Africa) rebellions spread to Libya, Japan was rocked by three shocks: an earthquake of unprecedented scale,

a tsunami that caused widespread destruction with a horrible loss of human life, and a radiation leak from a damaged nuclear facility. The market tumbled below 1260 for a 7% correction before sensing the worst was over. Rallying sharply through the end of the month, the market broke even for March and returned 5.92% for the quarter.

Looking at performance by various asset classes, the 1st Quarter returns were positive for all classes except the US Dollar. The decline of the Dollar occurred as other countries raised rates, making their currencies more attractive. The Euro appreciated against the Dollar, even in the face of the mounting sovereign debt problems within the European Union, as Portugal, and potentially Spain, careened towards bailouts. Although a weakening Dollar frequently sends commodity prices higher, the persistent investment theme of commodity demand (oil, copper, wheat, etc.) is more consistent with the global economic expansion, especially in the fast growing emerging markets. Stung by the fear of sovereign debt defaults and rising rates in several countries, International equity markets were under pressure for most of the Quarter.

Asset Class Returns 1 st Quarter 2011		
Commodities	6.90%	Reuters Commodity Index
Domestic Stocks	5.92%	S&P 500 Index
Global Stocks	4.42%	MSCI All Country World Index
International Stocks	3.41%	MSCI AC World X-US Index
Bond Aggregate	0.42%	Barclays Aggregate Bond TR Index
T-bills	0.03%	3 Month Treasury Bill Index
US Dollar	-3.78%	US Dollar Index

source: Bloomberg

Returns from the S&P 500 Economic Sectors consistently show the investment theme of global economic expansion with the stellar returns from Industrials and from the commodity related Energy Sector. Interestingly, only those two Sectors outperformed the S&P 500, although several others were bunched quite close and all sectors produced positive returns. However, it is important to note that the Finance Sector, which has the largest weighting in the composition of the S&P 500 Index, underperformed for the Quarter. Continued legal issues resulting from the Mortgage Crisis of 2008 and intense regulatory hurdles have hampered the Financials performance. As meaningful distinctions between specific stocks are recognized, investment opportunities may present themselves.

Domestic Equity (S&P 500) Sector Returns 1 st Quarter 2011	
Energy	16.79%
Industrials	8.75%
Health Care	5.62%
Telecom	4.79%
Consumer Discretionary	4.71%
Materials	4.54%
Info Tech	3.48%
Finance	3.06%
Utilities	2.78%
Consumer Staples	2.52%
S&P500	5.92%

source: Bloomberg

Despite not regaining the 1344 high point, the rally which drove the S&P 500 to close at 1325 was impressively strong, but more importantly it demonstrated *resilience* in the face of a multitude of negatives. So what factors built this resilience?

The cyclical bull market which began with the March 2009 bottom remains the first and foremost point of the investing landscape. Simply stated, in a bull market, equities will have a general upward bias. Secondly the bull market is not just a domestic phenomenon, but a global affair with 38 of 42 worldwide stock markets in bullish modes (NDR Research). Supporting the cyclical bulls is the continuation of the global economic expansion and low interest rates. On the domestic front, the stimulative liquidity additions from the Federal Reserve's QE2 program remain an active force. Finally although unemployment has remained stubbornly high, recent reports have shown positive improvements. As Capital Economics recently reported, the unemployment rate fell from 9.8% in November to 8.8% in March, with the direction of the trend more important than the actual numbers.

The other side of the story is always worth considering and the bearish thesis holds some sound points in their case. First, the bull market having passed its birthday in early March is over 2 years old and each day is drawing us closer to the eventual end. True enough, while we are no longer in the early stages of this advance, the majority of our directional indicators remain in bullish territory. This bull market will end, of course, but not now. Secondly, because QE2 is set to end in June, the bears suggest the absence of the stimulative liquidity injections will cause the economy and equity markets to tumble. However, when compared to last summer, the economy and the equity markets are now in more firmly established uptrends. Their vitality has now become self supporting; they can grow without the stimulus assistance. After all, stimulus is similar to medicine; a certain

amount is good, but too much can lead to unintended consequences. The primary consequence would be rising inflation. Other countries/regions around the globe have increased interest rates to fight their inflationary concerns. While China, the European Central Bank and the United Kingdom have raised rates, our Federal Reserve has not. The US is likely to continue to follow a separate pathway because our economic conditions and our monetary policy objectives are different from these trading partners. What economic conditions would build the case for following suit and raising rates? A combination of several key factors, such as, surging *economic growth*, increasing pressure from *wage growth*, dramatically falling unemployment and a spiraling core *inflation* rate consistently moving higher would likely be required to trigger a change in Fed policy.

Looking at the status of those conditions at this juncture, the economy, aided by global trade, is growing soundly but at a 2 1/2 %– 3% rate. Forecasts call for a stable to modestly declining growth rate for the next year (Credit Suisse). Regarding the labor market, with the unemployment rate remaining high, perhaps falling to 8% next year (Goldman Sachs) and with manufacturing continuing to operate at even somewhat higher levels, enough spare capacity exists to mitigate cost-push inflationary pressures. Currently price increases are largely being fueled by input costs from commodity sources, especially energy. Their push is likely to decrease as economic growth rates ease and the QE2 stimulus program is completed. Pending a dramatic change in these factors, the Fed is likely to remain on hold, that is, maintain the low rate policy for at least another 9-12 months.

Conclusion: During the 1st Quarter, it never felt as though the equity returns were good because the geopolitical turmoil and repeated disasters grabbed the headlines and kept repeating them, presenting a challenge to comprehend the human interest stories so diverse and on a scale so enormous. The market, however, quickly digested the news, repriced securities and then advanced. This global bull market is supported by ample liquidity with demand fostered by the global economic expansion with increasing demand for products as diverse as mining equipment, railroad shipments and new medicines. Earnings are improving, interest rates are low and valuations are reasonable. In the end, the market was focusing on these issues and in the end it is easy to feel good about the returns from this *Resilient* stock market this Quarter.

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