



A View from the Tower

Mid Quarter Update
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Certain aspects of the financial world have changed significantly since the View From The Tower was written at the end of June. Those include:

- To most observers, the debt ceiling debate concluded in an unsatisfactory manner, leaving many to doubt the ability of the government to effectively deal with the problem.
- Some economic data points suggested the 'transitory economic soft patch' that the Federal Reserve had forecast was not accurate and the economy was weaker and the weakness could last longer. Many economists (Morgan Stanley, Goldman Sachs) reduced their GDP forecasts by ½% to the 1 ½-2% range.
- The sovereign debt problems within the European Monetary Union showed signs of spreading from Greece to Spain and Italy. The European Central Bank at first resisted and then agreed to purchase the bonds of these countries in an effort to restrain rising rates for those countries.
- During the US budget debate, S&P stated that unless a congressional agreement was reached with significant spending cuts, S&P would downgrade US Treasury debt from AAA. Over the weekend, Standard & Poor's followed through on their pledge and reduced the rating on US Treasury debt.

The combined result has been diminished investor confidence and confidence is a necessity for buyers. With buyers stepping to the sidelines and sellers aggressively selling, the markets experienced a sharp sell-off in stock prices and a significant increase in volatility. At the same time, bond prices rose sharply as interest rates declined.

Yesterday the Federal Reserve weighed in on the situation by pledging to keep interest rates at very low levels into 2013. The functional purpose of their announcement was to show they are involved and still had options to help support the economy. Additionally, it suggested that the return on cash was going to be very low; investors seeking a higher return should move to longer maturity bonds or stocks or other investments.

Some critical elements to remember regarding the stock market:

- Market volatility is separate from economic and corporate fundamentals. While the markets have been very volatile, corporations reported good 2Q11 earnings.

- Economic fundamentals are weaker than we had hoped for, but GDP growth is still positive. As a result of this weakness, some corporations are reducing their guidance for second half earnings. Importantly, even in the event that GDP turns negative (which we do not anticipate at this point), corporations will continue to operate, earn money, pay dividends, etc.
- Beyond potentially softer 1H11 earnings, corporate fundamentals remain relatively strong.
 - Corporate cash flow levels remain high, and, on-average, balance sheets are strong.
 - Current estimated earnings per share for the S&P 500 are about \$95 for 2011 and \$102 for 2012. Today the S&P 500 is around 1330, and the price/earnings ratio is about 14x 2011 estimates and 13x 2012 estimates. Even if earnings fall short of those estimates, the market would not be expensive at this point, especially given the low level of interest rates. For example, if earnings were 20% lower than estimates in 2011 (\$76 per share), the price earnings ratio on depressed earnings would be about 17.5x.

Further, the fundamental situation is not similar to 2008 when a borrowing binge fueled by bad mortgages and leveraged derivatives led to a true financial crisis. This time around, the issue is not that companies do not have access to money. In fact, cash holdings of corporations are at record levels.

The problem this time is one of confidence, and that is a hard thing to solve, especially when recent polls show 83% of the US disapproves of the job Congress is doing. We believe that it continues to be a good environment for stock investments. GDP is expanding, inflation is benign, interest rates are at historic lows, most companies have rock solid balance sheets, the price of oil is falling, jobs are being created – and, importantly, dividend yields are very attractive, especially compared to bonds.

Monday's decline had many characteristics of a capitulation selloff. Over the near term, we anticipate a period of volatile back and forth advances and declines as the equity market moves through a bottoming process to establish a base for the next move, which we believe will be to higher stock prices.

Our advice - stick with a diversified investment plan. Do not over react to the barrage of negative headlines or news programs that frequently use fear to sell their news product. Market declines are always painful to endure, always offer opportunities and rational decisions do prevail in the long term.

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