



A View from the Tower

4th Quarter 2010 Investment Overview

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The transition from the end of the 2nd Quarter to the beginning of the 3rd didn't change the character or dimensions of the trading range the market had established. The cyclical bull market advance from March 2009 had clearly stalled. Shaped by current headlines, at the forefront of investors' outlooks were the macro questions, "Will the ill effects of the European debt crisis spill over to further slow the domestic US economy? Will it cause a second recession? Will more bad debts cause another liquidity crisis?" And the big question "Is the bull market over?" The answer is "No".

S&P 500 Chart



source: Bloomberg

Certainly the deteriorating economics of Europe would temporarily slow our recovery. The stock market would pause to revalue and reprice this new information of a lower growth rate. This repricing was the catalyst that drove the selloff. However, the recovery continued domestically and growth was even stronger in many countries abroad. There is an additional explanation for the market's trading range behavior; bull markets are not straight-line linear events, but frequently have significant interruptions. Looking at the history of the second year of bull markets, a correction lasting several months is a normal occurrence. The most recent example was in May 06, and before that, in October 04, August 99 and July 96, each lasting 3-5 months with 8-14% price declines. When these corrections occur, the headline events are complex and frightening. While the market's reaction can be confusing, temporary interruptions to bull markets certainly are within the ordinary experience.

The portion of the trading range that occurred in the 3rd Quarter can be broken down into 3 short but distinct cycles. First, the rally from the end of June market lows into early August returned 9.4%. A down cycle followed which gave back-7.1% was followed by a 9% rally through the end of the Quarter. Despite the back and forth movements, this period will go into the books as a +11.3% advance for the S&P 500. More importantly the strong 3rd Quarter erased the negative returns of the 2nd Quarter for a modest, but positive 3.9% year to date return. (Bloomberg and NDR).

There were three factors of significance during the Quarter that caused the market to move back and forth from the 'risk off' to the 'risk on' trade: the European financial crisis moderated, September provided a very pleasant upside surprise, and the Federal Reserve announced a significant change in tactics. First, in Europe the International Monetary Fund (IMF) and the stronger member states, reached funding agreements to enable the weaker members of the European Union to access the debt markets at reasonable interest rates. Several countries have begun the process of reducing budget expenditures, initiating 'austerity measures', usually with significant opposition from their electorate. These agreements are likely no more than temporary fixes, as basic economic differences between member states persist. These agreements do succeed in buying time for government attempts to reduce their budgetary imbalances.

Second, although October has the reputation for being the cruelest month in the stock market, largely due to the unforgettable crashes in October 1929 and 1987, September holds the record for being the month with statistically the poorest equity investment returns. Going into September with the market's direction apparently unresolved, most news reports suggested a September selloff. But the apprehension melted away quickly as the market rebounded sharply and consistently for a +8.92% return, making it the best September in 70 years (Barron's). The third and most important factor was the Fed. In early August the Fed announced a policy called "Quantitative Easing" (QE), a system based on targeting a specific size of the Fed's balance sheet. By monitoring the size and directional changes of the data, a clear statement of the Fed's intentions (easing or tightening) will result.

Beyond revealing their purpose with clarity, the policy change has two other important implications. First, they can declare victory with the previous easing program, which was designed to reduce credit spreads and start the credit markets functioning again in the 2008 liquidity crisis. Second, with those goals accomplished, Bernanke has shown a willingness to adapt new policies in response to new problems. Currently the problem the Fed is trying to address with QE is strengthening the economy enough to generate a rate of inflation in the 2% zone. That's considered a goldilocks-type number, that is, strong enough to stimulate the economy, but not so strong as to create too much inflation. Presently the additional reason for trying to induce 2% inflation is to remove the greater fear of *deflation*. That's a cycle of falling prices, which leads to a downward economic spiral. We have seen in the Japanese experience and in the 1930's the difficulty of breaking such a cycle. Although there are many differences between the US and Japan and the 1930's, the goal is to prevent a deflationary cycle before it ever gets started.

In October 1979, Chairman Paul Volcker announced the Fed would let interest rates rise to seek their own level. Interest rates soared, the prime rate hit 21%, US Treasury bond yields traded in the 14% range and a 20 year T-note was issued at over 15%. While many argued he was killing the economy rather than saving it, Chairman Volcker won the war. The inflationary spiral

was broken, and interest rates began their long (30 year) descent to where we are currently with 2 year Treasuries yielding .4 of 1% and the 10 year Treasury Note yielding 2.40%. Today Chairman Bernanke and NY Fed President Bill Dudley are dealing with the other reverse side of the coin: whereas Volcker was trying to stop inflation, now they are trying to create some inflation (or reflation as it is currently named) to neutralize the deflationary effects of deleveraging in a slow growth, high unemployment economy. A significant concern among investors revolves around the Fed's ability to get it right, to warm up inflation just a little bit more, but not to let inflation get too hot.

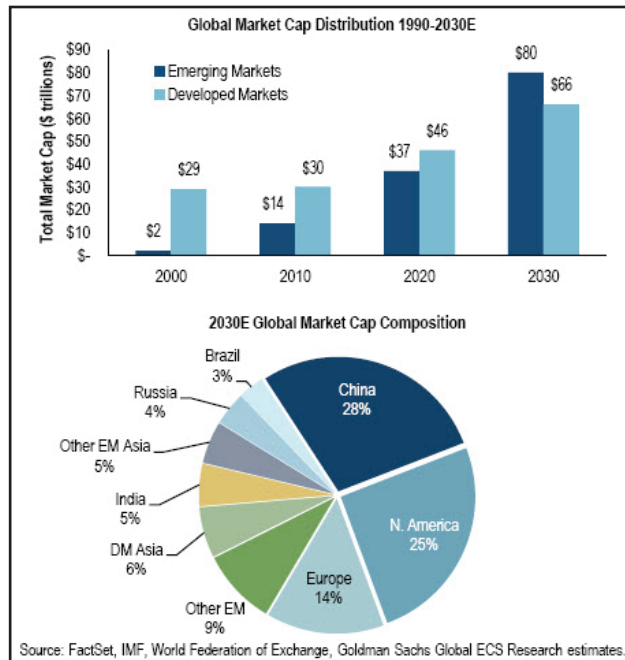
Although the Fed is not expected to begin this round of monetary easing (QE) until mid-November at the earliest, the groundwork is now in place for the Fed to act if there is a "significant weakening of the economic outlook" or "a deviation from price stability in the downward direction" to quote from Chairman Bernanke at the Fed's Jackson Hole conference (Goldman Sachs). Consensus belief is the Fed will act preemptively, rather than waiting and finding itself behind the curve. Two big decisions for the Fed, when to start the new policy and then when to shut it off. Two big decisions they need to get right. The stock market interpreted the idea of additional monetary easing as a positive. For stock investors, having the Fed on your side has proven to be a very meaningful component for an improving stock market.

With a Fed whose immediate goal is improving economic growth by keeping interest rates low and preventing deflation by increasing the monetary aggregates, US stocks are continuing their cyclical bull market from March 2009. But yet, it's a tough battle with persistently high structural unemployment, an unresolved tax policy and increased regulatory burdens. The International Monetary Fund (IMF) estimates US GDP growth for 2011 will rise slowly to a 2.6% rate while the entire developed world can only reach a slightly lower growth rate of 2.4%. In contrast, for the 21 countries that comprise the *emerging markets* the IMF forecasts a strong 6.5% growth rate or *2.7 times* the developed world. That's a differential that grabs an investor's attention.

In the investment world that seismic shift is occurring similarly between the developed economies and the emerging markets. This change started about the time of the bursting of the tech bubble and the new millennium. Before then 'emerging' was thought of as synonymous with a dangerous investing place of poorly developed or non-existent capital markets. Alternatively developed economies were considered safe and well managed. However, with Enron/Madoff scandals, credit crisis's in developed countries and dramatically improving business conditions in emerging markets, the experience has somewhat reversed and belief patterns have changed.

While not dismissing the potential risks in emerging markets of governmental intrusion, different interpretations of the rule of law and lesser developed capital markets, let's also consider the potential for rewards. First, institutional investment managers of large pension funds and consultants have been steadily steering their portfolios to a higher weighting in emerging market debt and equity. Another type of sophisticated asset allocator, the corporate CEO, has been active in exploring foreign and especially emerging markets. Looking at recent examples, Bob McDonald the CEO of Proctor & Gamble (PG) stated his company wants to acquire "brands with international appeal. I'd love to buy more global brands". Since becoming CEO in 2009, McDonald has focused on boosting their operation in emerging markets such as Brazil and China. About 60% of last year's revenue came from outside the US (Bloomberg). Proctor & Gamble, an American icon, earns 60% of its revenue from outside our borders! McDonald says P&G's domestic income has declined but is able to find stronger growth with better profit margins abroad.

Also consider Walmart (WMT). Using money it borrowed in the US at low interest rates, Walmart spent \$4.4 billion to acquire the South African retailer Mass Market. Acquiring Mass Market provides not only an entre into South Africa, an emerging market, but the ability to expand throughout all sub-Saharan Africa to consumers who want moderately priced consumer goods. The message is the same as P&G; WMT is taking cheap money from the US bond market and deploying it to a faster growing international market.



Factors supporting the high growth story in emerging markets include healthy economies that escaped the 2008 financial crisis, lower debt levels, better demographics, lower valuations and diversity in their economies. With the majority of revenue growth for the S&P500 coming from corporate activities outside the US, even a portfolio that seems to be domestic may have a substantial international component. This is an additive factor for stock market performance and is one more reason certain stocks can perform well, even in periods when the domestic economy is plagued with numerous problems. An actively managed, well diversified portfolio that matches an investors risk and return over their time horizon has the best likelihood of finding investment success. Please feel free to discuss the investment in emerging market debt or equities with your Tower Wealth Managers portfolio manager or advisor.

In summary, as the Euro crisis waned and the Fed announced a more supportive policy, the S&P 500 and other indices broke from their summer trading ranges in a continuation of the cyclical bull market. The combination of low interest rates and higher growth abroad is drawing many sophisticated asset allocators, individuals and corporations, to invest abroad, especially into emerging markets stocks and bonds.

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