



A View from the Tower

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View From the Tower 3rd Quarter 2011- Beyond Risk On/Risk Off

It's human nature to try to make mental tasks easier on ourselves. Both financial theorists and neurologists contend that humans find it easier to define, categorize or compartmentalize issues when we see them strictly as two sided: right vs. wrong, good vs. evil, and in stock market terms this quarter, "risk on" vs. "risk off." While that technique makes data easier to store, it may not lend itself to the best analysis, or consequently, the best investment decisions. Decision making under complex uncertainty is more complicated, but that's why we're here.

S&P 500 Chart



source: Bloomberg

The stock market, as measured by the S&P 500 Index, began the second quarter at 1325, rebounding from the sell-off related to the disastrous Japanese earthquake, tsunami, and radiation leak. The rally continued through the end of April, peaking with a closing high of 1363. The tide of the news shifted as data suggested a slowing economy, a flare up of financial contagion from Greece and a broad correction in commodities. The decline in prices persisted through mid-June until a bottoming process established a low at 1265. It may seem trivial, but the 1265 low was higher than the previous 1249 March low. A pattern of higher lows is necessary for the continuation of a bullish uptrend. With a higher low in place and the anticipation of better earnings reports in July, the market rose sharply, closing the quarter at 1320. For the second quarter, the S&P 500 Index exhibited wrenching volatility, with a -7.2% correction followed by a 4.3% recovery, all en route to a slim better than break even +.10% return. So what's causing these frequently damaging corrections?

Corrections are common in market averages and individual stocks. Typically, three to five downturns occur in a year, which further reduces prices four to seven percent over a period of several weeks. But why did the market experience a significant correction in March and then again in May/June? First, it helps to think of corrections in price movements as a physics concept, where a body expends energy to overcome inertia and move in one direction and then rests before a) another move forward or b) it's pushed back by stronger forces. In relation to the stock market, the forward movements occur when demand, specifically aggressive buying (accumulation), is stronger than supply, specifically aggressive selling (distribution). Of course, it's imperative to access an accurate indicator to determine the level of aggressive buying relative to aggressive selling.

Price movements are the result of market participants' collective view of anticipated future financial market events. As news or forecasts change, the view of future price movements is updated accordingly. Corrections, or price consolidations, occur when prices rise above a level that exceeds investors' aggregated view of the future. The attraction to aggressive selling is stronger than the attraction to aggressive buying, resulting in falling prices.

Conversely, the same process comes into play with a bullish upturn. For example, consider the market advance in August 2010. The Fed's announcement of Quantitative Easing 2, a liquidity stimulus program, caused investors to change their views in anticipation of higher commodity and equity prices. Most importantly, the effect of this news was so positive that it resulted in significantly more aggressive buying. Prices rose in an uninterrupted uptrend from the August 2010 announcement until the Japanese disasters of mid-February 2011.

By comparison, the two rather deep corrections in quick succession this calendar year should likely be viewed as one correction that was temporarily interrupted. The underlying cause of both corrections stemmed from concerns that the global and U.S. economies would slow due to supply interruptions after the Japanese earthquake and fear of financial problems from European sovereign debt issues. The concern of weakening economies caused stocks to re-price lower. The brief price advance, or temporary interruption, to the correction occurred when the Japanese radiation disaster appeared less serious than initially feared. The result contributed to a more aggressive "buy the dips" mentality after the Japanese issue receded and before Greece moved to center stage.

Asset Class Returns 2nd Quarter 2011		
Commodities	-7.82%	Reuters Commodity Index
Domestic Stocks	0.10%	S&P 500 Index
Global Stocks	0.25%	MSCI All Country World Index
International Stocks	0.33%	MSCI AC World X-US Index
Fixed Income	2.29%	Barclays Aggregate Bond TR Index
T-Bills	0.01%	3 Month Treasury Bill Index
US Dollar	-2.25%	US Dollar Index

source: Bloomberg

Although the U.S. dollar has been one of the most meaningful drivers of stock market returns since the credit crisis, the historic theory that "a strong dollar means a strong stock market" hasn't yielded positive results in recent years. In fact, returns have been the opposite, as the correlation coefficient between the change of the U.S. Dollar Index and the S&P 500 Index has been -.78 (source: NDR). Regardless of the statistics, think of it this way: Although the dollar and the stock market generally move in opposite directions, when the dollar declines, stocks tend to improve, and when the dollar appreciates, stocks decline. This reasonably strong relationship is the cornerstone of an investment concept known as "risk on/risk off". According to the theory, when the dollar is declining, put "risk on," meaning flip the buy switch and get into stocks and commodities (risk assets). Conversely, when the dollar strengthens, run — don't walk — to "risk off" assets, such as cash or Treasury Bills.

Evidence supporting the risk on/risk off trade can be found by examining the monthly asset class returns during the second quarter. In April, the U.S. Dollar Index was the weakest asset class with a -3.97% return, while stocks and commodities went risk on and were up +2.96% and +4.57%. In May, the dollar strengthened +2.19% and stocks and commodities were down

-1.13% and -6.79%. In June, the dollar rose to the second best performing asset class, while stocks recovered and commodities remained the weakest at -1.67% and -5.43%. For the year to date, the dollar is off -5.85%, while stocks are at the top of the asset class list with the S&P 500 up +6.02% and commodities up +5.86%. The dollar was down (put risk on) and stocks were up.

Although those results seem to support the risk on/risk off theory, digging deeper yields some valuable benefits. The second quarter sector returns provide an interesting starting point. The dollar was weaker and the S&P 500 Index was nearly flat, yet Health Care, the leading sector, was up +7.87%. Additionally, each of the top three sectors — Health Care, Utilities and Consumer Staples (foods, soaps etc.) — were up strongly. Looking to the bottom of the return spectrum, Information Technology, Materials, Energy and Financials were decisively the lowest. Excluding the Financials sector, which has been fighting regulatory burdens and lawsuits resulting from the 2008 credit crisis, the other three are decidedly pro-cyclical or economically sensitive. While risk on/risk off has shown some success, simply buying stocks or not isn't quite the best answer. As the returns illustrate, the return profile of each sector or style of sectors (defensive vs. cyclical) may vary significantly from the return of the overall market. Looking beyond risk on/risk off, an actively managed, diversified portfolio can provide additional return benefits within a risk controlled environment.

Health Care	7.87%
Utilities	6.15%
Consumer Staples	5.25%
Consumer Discretionary	3.47%
Telecom	2.11%
Industrials	-0.67%
Materials	-0.77%
Info Technology	-1.35%
Energy	-4.63%
Financials	-5.92%

source: Bloomberg

Returning to the broader view of the market, since the 2008 recession, several stimulus programs have been deployed to revive or accelerate economic activity. One common thread throughout these programs has been increasing our exports via the planned decline of the U.S. dollar. Simply put, when dollars are cheaper, prices of American goods are more attractive in the international marketplace, resulting in more exports. It's hard to argue with that logic, but there are other consequences. Consider the real income (income reduced for actual inflation) for the average worker. For more than a year, take-home pay for this group has continued in a downtrend! The economic recovery clearly has reached some, but remains elusive to many others, even those with jobs.

With the end of Quantitative Easing 2 (QE2) on June 30, this liquidity injection will end. Hopefully, in turn, efforts to stabilize and terminate the purposeful debasing of the U.S. dollar will end. In fairness, many countries have tried various methods to lower their currency, usually through simple devaluations. This tactic is no longer available to individual countries within the European Monetary Union (EMU) because they share a common currency, the Euro. Within the EMU, the notable problems of Greece, Italy and Portugal have weighed on the currency and have pushed Euro lower. Germany, a vibrant exporting economy, has enjoyed the fruits of this lower currency with strong sales abroad. It seems reasonable that its participation in the Greek bailout correlates to its realization that keeping the Greeks (Italians, Portuguese, etc.) in the EMU lowers the Euro. To the Germans and to a lesser extent, the French, the economic benefits of their exports outweigh the costs of subsidizing the bailouts.

Conclusion and Outlook: During the second quarter, three related factors drove equity prices down and later back up. In a nutshell, the script for the correction went like this: First, the global and U.S. economies were slowing down, unemployment remained higher than anyone's comfort level, an economic recovery (outside the export sector) was generally weak, and the housing sector showed little improvement. The concern was that the economy was sinking and that this downturn could turn into a big slowdown (in fact, the term "double-dip recession" was reintroduced into the eco/political discussion). Second, if the slowdown turned out to be big and serious, it would cause a major stock market correction. Third, if there was a major slowdown and correction, the cyclical bull market would likely end, replaced by a new cyclical bear market. No wonder defensive sectors fared well in the second quarter.

But better than expected U.S. Industrial Production numbers and moderating inflationary pressures (Capital Economics) encouraged the belief that the economy was more likely in a "transitory soft-patch," to use Federal Reserve Chairman Bernanke's phrase, than heading for a recession. The growth rate was revised to 2% — a level (Goldman Sachs) consistent with a continuing recovery, albeit a weak one. Similarly, a "soft patch" in the economy is more consistent with a stock market correction than a bear market. Quite interestingly, the stock market has continued to exhibit good internal strength characteristics (advance/decline numbers, breadth indicators, etc.) consistent with a market that's in a correction, but within an ongoing bull market.

Yet this cyclical bull market raises some concerns for the future. The list of economic trials and uncertainties are plentiful, ranging from sovereign debt issues along the periphery of Europe to a weak and uneven recovery in the U.S. It's complicated by the uncertainty of whether our politicians are willing and able to deal with debt ceiling confrontations, while still borrowing too much money. However, these issues are well known and have been discussed since the bull market began in March 2009 and are likely now priced into the market.

An additional concern relates to the age and returns from this cyclical bull market. The median advance for a cyclical bull market is about +70% and lasts about 600 days, while this bull has returned about 96% and lasted about 780 days (NDR). So it's longer and advanced further than average. While this represents a warning sign rather than a sign of immediate danger, it could also be viewed as a sign of strength.

The more important factors remain on the positive side of the ledger as the economic system has plenty of liquidity, interest rates and inflationary pressures are low and credit conditions are improving. Globally, the supply chain disruptions from Japan are ending, while Chinese and Indian economic data is showing renewed strength. The earnings season that begins in mid-July is expected to show continued sound earnings growth with positive profit margins. It's a bull market until proven otherwise, and currently the weight of the evidence supports a positive view of the domestic and global equity markets.

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