



GV Financial

ADVISORS

Market Commentary

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As of August 9, 2011, the markets are down about 15% since the beginning of July (www.finance.yahoo.com). The United States federal credit rating has been downgraded for the first time in its history so we are indeed sailing in uncharted waters. Here is a broader view of the current state of markets that we hope will give you some perspective beyond the immediate headlines.

Since 1962, there have been 25 market corrections greater than 10% during bull markets. The average correction was 13.2% and lasted 118 days. Nine of those 25 corrections resulted in bear markets (defined as corrections of 20% or more), which means that 16 out of 25 times, the bull markets persisted after the correction (*Laszlo Birinyi*). Put another way, based purely on this data from recent history, there is a 64% probability that this correction, as scary as it may be, is merely a correction and not the start of a new bear market.

No matter how we feel, the news is never all bad, and begin with the case for optimism, followed by the case for pessimism and finally, with some closing thoughts.

The Case for Continued Optimism. The U.S. has a lot going for it even as we grapple with a series of monumental changes and challenges. If we take a step back from the headlines, we find it hard to be bearish over long term when you consider the following:

1. ***Corporate profits remain robust.*** To date, approximately 80% of the companies included in the S&P 500 have reported their most recent quarterly results and both aggregate corporate earnings and revenue were both up about 13% from the year-ago period (*Yardeni Research*). American corporations have demonstrated that they can make a lot of money even if the economy is not operating at full speed.
2. ***Stock market valuations are cheap.*** In terms of valuation, the run of strong earnings combined with declining stock prices translates into some attractively priced stocks. Investors can buy earnings for less. As recently as August 4, 2011, the S&P 500's composite Price/Earnings (P/E) ratio, based on forward earnings, stood at 13.15. To put that P/E ratio in perspective, the long-term average ratio is closer to 16 (*Bloomberg*).
3. ***Cash is still king.*** Corporate cash balances are at record levels. A growing number of companies are using some of their cash to buy back shares and raise dividends.

4. **Consumer balance sheets have gotten much healthier.** Over the last three years, American consumers have gotten better control over their household finance (www.research.stlouisfed.org). It appears that as a whole, we are spending less and saving more.
5. **World- wide demand is growing.** New car sales are up 5.8% year-over-year (*Fidelity*). The reality is that even reluctant consumers eventually will have to replace big-ticket items (cars, refrigerators, etc.) as they reach the end of their useful life. The same holds true for business consumers. As global growth expands, we expect the U.S. consumer to shoulder less of the world-wide buying load as demand for consumer goods picks up in other parts of the world.
6. **Oil prices have dropped.** We have seen a quiet, but massive correction in oil prices. Since April, oil prices have dropped a whopping 30% (www.finance.yahoo.com). Lower oil prices are good both for individual and business consumers as it cuts the cost of doing business.
7. **The Fed continues to maintain very low borrowing rates.** The Federal Reserve pledged for the first time to keep its benchmark interest rate at a record low at least through mid-2013 which could help spur growth (*New York Times*, August 10, 2011).
8. **The unemployment rate has improved slightly.** Even though the unemployment rate remains high, unemployment fell slightly in July to 9.1% (www.bls.gov/cps). More than the slight decline, it is the breakdown that we find encouraging. While governments are slashing jobs to reduce spending, the private sector is adding jobs.

The Case for Pessimism. Lest we appear overly optimistic or blind to the serious issues we face, we also want to acknowledge there are a number of crucial challenges that are having or could have a negative impact on our economy and the markets. Here are some of the headline-grabbing challenges we see now and in the near future:

1. **U.S. credit rating has been downgraded.** Standard and Poor's has downgraded the U.S. credit rating, our nation's lower AA+ credit rating. We have seen tremendous volatility as the markets and many affected businesses (insurance companies, banks, etc.) will have to make changes adjusting to the "new normal."

Despite the downgrade, investor confidence in U.S. Treasuries may persist. The most recent T-bill auction demonstrates that high demand for U.S. Treasuries may persist despite the chink in our credit rating. Longer term, we may see borrowing costs rise

Questions are being raised about the validity of Standard & Poor's rating and perhaps the value of rating agencies in general. Having admitted to a \$2-trillion calculation error and having been one of the agencies who gave high rating to the now-discredited mortgage default swaps, Standard & Poor's legitimacy as a ratings

agency is understandably being called into question. While some may want to debate S&P's flawed methodology rather than address the concerns raised by the rating itself, we think that debate misses the point. While we are troubled by the downgrade and the questionable math upon which it was based, we nevertheless believe that it could serve as a necessary wake-up call, hopefully compelling our policymakers to take meaningful action to ease diminish the ballooning debt crisis.

We expect the debate could spill over into debate about the usefulness of ratings agencies in general.

2. **Concerns over European sovereign debt issues continue.** Serious sovereign debt issues among several of the countries that comprise the Euro-zone have not been resolved.
3. **The economy has slowed.** There is mounting evidence of a slowdown in Gross Domestic Product (GDP) both at home and abroad, Historically speaking, mid-cycle slowdowns occur regularly, and given the continued positive corporate earnings, we believe the economy may have slowed somewhat.

We expect that the markets will be volatile and the ride may continue to be bumpy for the next few weeks or longer. Consider the alternative to remaining invested. Many studies and perhaps your own experience confirms there is often greater danger in jumping in and out of the market in an effort to dodge the unpredictable ups and downs than there is in sticking with a solid long-term investment strategy. Timing the market has never been a reliable long-term investment strategy.

We Share the Common Goal of Fixing our Economy. In much of what we do in life, there are not only winners and losers, but people whose own success depends upon our failure. Despite all the political rhetoric, discouraging data, and tough decisions ahead, the good news – indeed, perhaps the best news – is that we are all pulling on the same end of the rope. Yes, politicians have their differing agendas and opposing solutions, but it is important to remember that by and large our fellow countrymen share the goal of fixing what is wrong. When we are listening to the daily sound bites and frustrated by all the nonsense, it can be comforting to know that while we may have differing ideas of what success looks like, we mostly agree that failure is not an option.

We hope this market commentary helps put the current crisis in perspective. We also hope it provides you with greater confidence and allows you to worry less and live better. Please call us if we can answer any questions or be of any further assistance.

For more information, please contact us at info@gvfinancial.com.



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