Making Sense of Finance

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Third Quarter Review

STOCK MARKET

It was a good summer for the stock market as all major U.S. market indices gained during the third quarter. The tech heavy NASDAQ led the way increasing 6.2% in the third quarter. After losing some ground in the previous quarter, both the NASDAQ and S & P 500 indices are showing impressive gains year to date of 19.6% and 14.6% respectively, and the Dow Jones Industrial average is not far behind with a 10% gain for 2012 as of the quarter end. Amidst statements from Federal Reserve Chairman Ben Bernanke in July and August hinting about a new round of quantitative easing (QE3), the stock market rallied though details of QE3 did not come out until mid-September. The Federal Reserve will be purchasing $40 billion of mortgage backed securities per month in an effort to spur the economy and therefore the job market. Although it is hard to say what the effect of QE3 will actually have on the U.S. economy, investors appeared satisfied at least something was being done, for now.

Typically, presidential election years have been positive for the stock market (a big exception in 2008). Average election year returns are close to 7% dating back to 1928. Election year returns are second only to a pre-election year (third year of a term), which has on average resulted in double digit percentage gains in the S & P 500. These are averages, and in general there is no statistically significant correlation between party affiliation and stock market performance.

Among the primary market sectors, energy was the top performer for the third quarter gaining 10%, helped by the rebound in crude oil prices. In this weak economy it may surprise some investors that consumer discretionary stocks were also among the better performing groups last quarter.

After accounting for inflation, real GDP for China is more likely closer to 1%-3%, but we find all macro numbers suspect; especially those from China. For example, the initial U.S. GDP number for the second quarter was 1.5%, revised to 1.7% and then revised again to 1.3%, which we translate into "We don't know" from the Commerce Department.

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Everybody and their neighbor has an opinion. At Karagosian Financial Services, we have a combined 40 years of investment experience. We have seen the markets at their highest highs and lowest lows. Through this newsletter we attempt to convey our opinions on current events in the investment world and their likely outcomes. Forecasting is inherently difficult and our advice is more about making sensible and prudent choices based on logic and experience, and not on emotion.

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Utility stocks as a sector lagged the overall market as "riskier" assets with more appreciation potential were favored in the third quarter.

Most developed foreign markets did as well if not better than U.S. equity markets last quarter, (the exception being Japan which had a slight loss). The MSCI (Morgan Stanley Capital Index) EAFE, a non-US equity index, gained over 6% in the third quarter in U.S. dollar terms. European developed markets did well as MSCI Europe, excluding the UK, rose over 9% in U.S. dollar terms benefitting from the weaker dollar. Also the MSCI Emerging Markets Index posted over a 7% gain in U.S. dollars. A laggard in the world markets was China, with a loss of over 6%, as worries of slowing economic growth weighed on equity investors there.

Bond Market

Although recording positive returns for the third quarter, bond indices lagged their equity counterparts. The Barclays U.S. Aggregate Bond Index, which is constituted of Treasuries and other investment-grade debt securities, increased 1.6% in the quarter. The multi-year advance in Treasuries continues as interest rates hold near record lows. The 10-year Treasury note yielded 1.65% at quarter-end, versus 1.67% at the end of the second quarter, not far from the record low of 1.43% a few months ago. One of the best performing fixed income sectors was the below-investment grade high yield category which returned 4.5% last quarter. Fixed income investors continue to stretch for yield in the riskier bond categories including emerging market sovereign and corporate bonds which had even greater returns in the third quarter. Municipal bonds continue to climb as interest rates remain pathetically low yet still paying, on a tax free basis, more than their comparable maturity taxable Treasury counterparts!

Huge bond mutual fund inflows are part of the reason for this persistent bond rally. The Federal Reserve position of keeping interest rates (Fed Fund target rate) low, through at least mid-2015 according to their latest statement, may also be behind the enormous demand for bonds. With the most recent U.S. inflation rate close to 2%, it is difficult to stay ahead by owning a One Year Treasury yielding only 0.17%.

Fund Flows

As we mentioned earlier, funds are flowing out of the stock market and into the bond market. Fundamentally, this means people are continuing to sell their stocks; however, the stock market has been rising at the same time, leading us to believe that the "smart" money sees good value. This makes the upside potential in the stock market even greater over the coming years, in our view. When funds begin to flow back into stocks, it will drive prices higher simply due to greater demand.

Oddly enough, as investors pour money into bonds in search of safety, they are actually making things more risky. Bond fund managers are undoubtedly forced to buy bonds whatever the price due to the incoming cash. As noted in previous newsletters, we think there is much more downside than upside in the bond market. Interest rates are unlikely to go below zero (occasionally this does happens in other countries), and the greater likelihood of rising interest rates over the next few years would hurt bonds that are not held to maturity. For investors looking for safety, we would recommend shorter-term, (less than 10 years), investment grade (BBB- or better) bonds held to maturity. On a risk versus reward ratio, we think stocks are a better bet.

Fiscal Cliff

The media has become very good at making up names for doomsday events. The "Fiscal Cliff" refers to the tax cuts and many stimulus programs that come to an end at the end of 2012. But like Y2K, the stock market has likely discounted most of its effects before they take place. What makes markets move are surprises which this clearly is NOT. There is uncertainty on tax policy after 2012 though. If Romney wins, he would likely try to extend most of the tax cuts, similar to what Obama did in 2010. The bottom line is there is likely to be increases in taxes no matter who takes office in 2013.

China

In the second quarter, China reported 7.6% GDP growth, compared to a revised 1.3% for the U.S. China's GDP number does not take into account inflation, unlike the U.S. number. After accounting for inflation, real GDP for China is more likely closer to 1%-3%. We find all macro numbers suspect; especially those from China. For example, the initial U.S. GDP number for the second quarter was 1.5%, revised to 1.7% and then revised again to 1.3%, which we translate into "We don't know" from the Commerce Department. Our research shows that suppliers and manufacturers in China are definitely seeing a slowdown in the region. However, these international companies are experiencing a rebound in U.S. demand for goods. Remember that the U.S. economy is still double the size of China's. Ultimately, although China's slowdown will hinder the U.S. recovery somewhat, we think economic growth will be determined domestically.