TW Advisors

The Economy Still Stinks… Stocks Rallied! Now What?

We are all breathing a little easier than we were two months ago when the S&P 500 touched the devilish 666 level and General Electric dropped below $6. At that time most pundits on CNBC predicted a visit to 600 or below for the S&P 500. Almost to the day the market bounce off its low we published our March newsletter with the title: *The Economy Stinks…Buy Stocks!* While this turned out to be a prescient call our short-term success was not guaranteed, a risk we warned about in the final statement: "It doesn't feel good to own stocks and anything can happen in the short-term, but these are the types of gloomy conditions that have produced excellent long-term buying opportunities in the past."

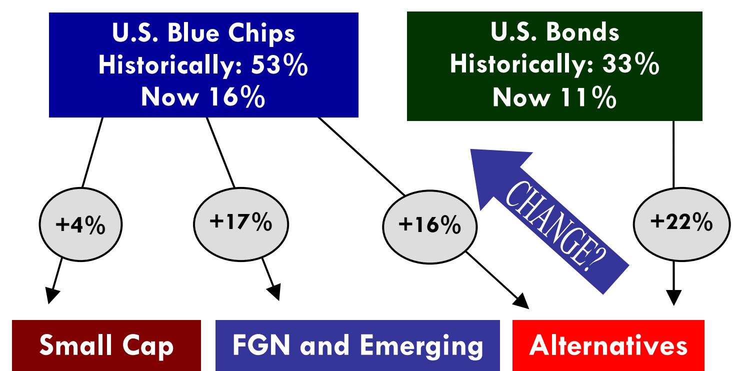
We were buyers of stocks in early March, emphasizing financial stocks we saw as outstanding investment candidates. Markets spend a lot of time trending in one direction making it very difficult to be a contrarian because, as we've witnessed many times over the past decade of booms and busts, markets can go to extremes. However in early March we were willing to endure more short-term pain because we felt the chances of a rebound were good and the potential rewards were great. At its low in March the S&P 500 had a trailing ten year average return of minus 5% ! It was apparent nearly everyone was bearish and ignoring the huge amounts of capital committed by the world's governments and central banks. In the end these positive factors overwhelmed the bears resulting in an almost 40% rally in the S&P 500 with even stronger gains in riskier assets like financials, small-caps and emerging markets.

While the stock market can send many false messages it does seem pretty certain that the Armageddon scenario of a 1930s style depression is off the table which is obviously very good news. But plenty of risks remain. The stock market will have to contend with several structural problems: (1) U. S. consumers must rebuild balance sheets by saving more and spending less; (2) Federal, state and local finances are in poor shape that could result in higher taxes; and (3) Corporate America must contend with increased pension expenses and slower growth. On a positive note large, creditworthy emerging economies seem to be recovering more quickly, especially China and Brazil. Government activism there has been greater as a percentage of GDP than in the U.S. and the consumer is in relatively good shape.

At current levels the stock market looks fairly valued, yet we are still able to find many very attractive stocks to own. Our emphasis will be on companies with strong balance sheets, secure and high dividends, solid long-term business prospects, and exposure to the emerging market economies. With leveraged, easy money strategies (Alternatives) on hold, we believe it is likely that investors will be more discriminating in selecting securities and strategies. "Momentum" was the play of the day for many years draining the traditional marketplace for quality growth and value investments. It is likely in this economic environment that prudent investors will return to strategies where the momentum is in financial strength and cash flow not just stock price(see chart below).

In addition, nimbleness is a virtue we hope to exploit. Already we have adjusted cash levels several times to take advantage of the trading range of the market. We hope to continue to add value through this process. In fact, recently we've used some of the cash we've raised to buy high-quality bond ETFs hoping to achieve an equity-like return through yield and narrowing of risk spreads. These securities have lower volatility making them a great choice after a sharp rally in stocks and, in addition, give us a holding tank with which to buy stocks on a pull-back.

INVESTMENT FLOWS MAY FAVOR QUALITY… AGAIN



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Thanks for working with us.

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