



A View from the Tower

October, 2009

3rd Quarter Investment Overview

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Defining the Continuing Stock Market Rally

The stock market rally that began in early March 2009 was based on the belief that the global financial system would survive and that the investment future would become more positive. As fear and pessimism began to fade to hope, stocks and bonds looked cheap. Investors jumped into both asset classes, driving up stock prices into positive territory for a 3.16% year-to-date gain by mid-year. As the market outlook evolved through the latest quarter, the primary driver of the stock market became the widespread confidence that the recession had ended and a world-wide economic recovery was underway. The powerful summer advance for the 3rd Quarter for the S&P500 was 15.61%, bringing the year-to-date return to 19.26%. To keep the magnitude of this rally in perspective, we should also recall the S&P began the year at 902, fell to 666 in March and climbed to 1057 at this Quarter end. Since the March low that's a 58.25% total return.

The phrase '*cyclical advance*' doesn't quite capture the significance of this wealth boost. So how did this return come about?

Dissecting the Stock Market Rally

The S&P500 is comprised of 10 Economic Sectors and, as the performance leadership rotates among the sectors, a pattern develops that establishes what type of market exists and where we sit in the market cycle. For example, Consumer Staples (foods, soaps, etc.) exhibit a historic tendency to perform best during weakening economic conditions or declining markets. Similarly Information Technology tends to perform best in the early stages of expansions and advancing markets. Examining the data from the last 6 months (roughly the period from the March low through quarter end), the 4 economic sectors that had the highest returns were Financials (+70%), Materials (+41%), Consumer Discretionary (40.9%) and Information Technology (+40%). Although the percentage returns are eye popping, these are the sectors which could be expected to perform best during the initial stages of an expansion/market

advance. That is, except the Financial Sector, and clearly its performance is derived from the drubbing these stocks received in the credit crisis of last fall. They dropped the most and recovered the most, a concept tagged *reverting to the mean* or simply getting back to their normal value (Barron's). On a year-to-date basis through the end of the 3rd Quarter, as you might expect, the same four sectors are the leaders, except their order has changed. Info Technology is the leader (+46%), followed by Materials (38%), Consumer Discretionary (+29%) and Financials (+21%).

Beyond Sector returns, the huge rebound in Financials heavily influenced equity index performance in two other meaningful categories: Style and Market Capitalization. Frequently stocks are divided into two camps, either Growth or Value. Growth stocks are those whose appreciation potential is more closely associated with rapidly improving earnings and Value stocks are typically those that have lower price to earnings ratios or simply are just considered "cheap" when compared to their cash flow, earnings or balance sheets. Segregating stocks by Market Capitalization (outstanding shares X share price) places stocks into three categories, cleverly called small, mid and large. The reason for the distinction is that financial dynamics can be related to size and as a result larger companies and their stocks behave differently and produce a different return profile than smaller companies. The idea is large companies have more in common with large companies in other sectors than they do with smaller companies in the same field.

The Financial Sector is dominated by Banks and Insurance companies which typically are both Large Cap (big companies) and Value style. Consequently the somewhat unexpected rebound in Banks and other Financials pushed up the returns for the quarter to make Value and Large Cap the superior characteristics over Small Cap and Growth for the recent Quarter.

Clearly Financials and the overall stock market have rebounded, correctly anticipating an end to the recession and better economy. So why doesn't the recovery feel better?

A Clumsy Recovery

All of us experienced a series of painful and frightening events last fall. The credit crisis/recession unfolded with daily reports of corporate failures and asset value declines that left us in a state of diminished financial well-being. Although we know today the

economy and stock market are on the mend and housing prices have generally stabilized, significant uncertainties have kept consumer confidence hovering at low levels. Both consumers and investors are still paying an emotional price that is likely to shape our views for some time.

A primary reason the recovery feels soft is the unemployment level remains around 10% and is forecast to move higher toward 11% over the next year (Goldman Sachs). Combined with weakness in labor income, consumer spending has remained moderate. Fearful of losing their jobs and trying to rebuild their financial nest egg, some households are actually saving! Certainly the stimulus programs, such as cash for clunkers and the extension of unemployment benefits, have generated some positive offsets or at least moderated some of the negatives. Furthermore, the low levels of inflation and interest rates have assisted individuals and corporations with rebuilding their balance sheets.

But secular (long term) problems such as huge governmental borrowings and budget deficits, tax increases and regulatory constraints on businesses persist. Without solutions that are apparent to us today, these problems may appear insurmountable. Remember in a dynamic economy, market forces will move to correct imbalances and alter the outcomes of static projections. These issues didn't arise overnight and will linger as problems for many years, inhibiting, but not eliminating growth and potential prosperity.

The existence of these problems without current solutions is displayed by the falling value of the US Dollar. What difference does that make?

The Price of the Falling Dollar

The US Dollar has declined on a trade weighted basis to a 14 month low and is barely above its all time low. Despite our improving economy, our currency is falling because the government and the Federal Reserve have lent, spent or guaranteed \$11.6 Trillion (Bloomberg) while keeping interest rates as low as possible to fight the recession/credit crisis. Somewhat surprisingly there are some positive offsets. A low Dollar also helps US companies expand their exports, as our prices have fallen for foreign consumers. This extends beyond products to our stocks. Non-Dollar denominated investors have found our companies and their earnings cheap relative to

those in most other countries. This buying by International investors has supported our stock market and may induce a spate of buyouts of American companies. However, should the dollar continue to fall, the gains from these good values would disappear and could offset the potential gain from their investment. Having declined is one thing, the fear of continued declines represents the real issue. That direction hinges on the amount of future borrowings needed to fund monetary actions and fiscal deficits in an environment of low interest rates.

Realizing secular (long-term) problems exist, what's the cyclical (near term) outlook for the market?

Conclusion and Outlook

Although the market has produced strong returns since the March low, the positive conditions of low interest rates and inflation, the moderate level of investor optimism, the improving earnings comparisons, and the global nature of the advance continue to support further price advancements. Additionally declining credit spreads, strong breadth/volume and accumulation/distribution indicators provide the evidence for further appreciation of this market. The 15.61% S&P500 return from the last 3 months was wonderful and based on historic tendencies, future appreciation for the next quarter is unlikely to be quite so strong. Expectations should be for more moderate returns.

Investors should remain as fully invested in equities as consistent with their personal risk tolerance. Furthermore, investing is not a static event and although cyclically the evidence points to a further advance, longer term significant secular problems remain. Reviewing and maintaining the appropriate asset allocation (stocks, bonds, cash) is of paramount importance for investment success.

Equity allocations should be actively managed to control risk and to take advantage of the rotation of attractive opportunities in Domestic/Global, Developed/Emerging Markets, Growth/Value and Small/Mid/Large Capitalization stocks.

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