

# ECONOMIC FRAMEWORK, FINANCIAL MARKET OUTLOOK & PORTFOLIO STRATEGY



PlanMember Advisors Corporation  
PlanMember Securities Corporation  
*Planning your future...today.®*

*Tom Nugent*  
Thomas E. Nugent  
Executive Vice President,  
Chief Investment Officer



## A Period of Uncertainty For the First Quarter of 2012

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### OVERVIEW

Average investors and professional market observers alike are bewildered over the behavior of the financial markets in 2011. Both the European financial crisis and the growing uncertainty over attempts to reduce government spending have led to a surge in market volatility. This increased volatility has shaken a belief that a diversified portfolio of investments can build wealth to finance retirement spending.

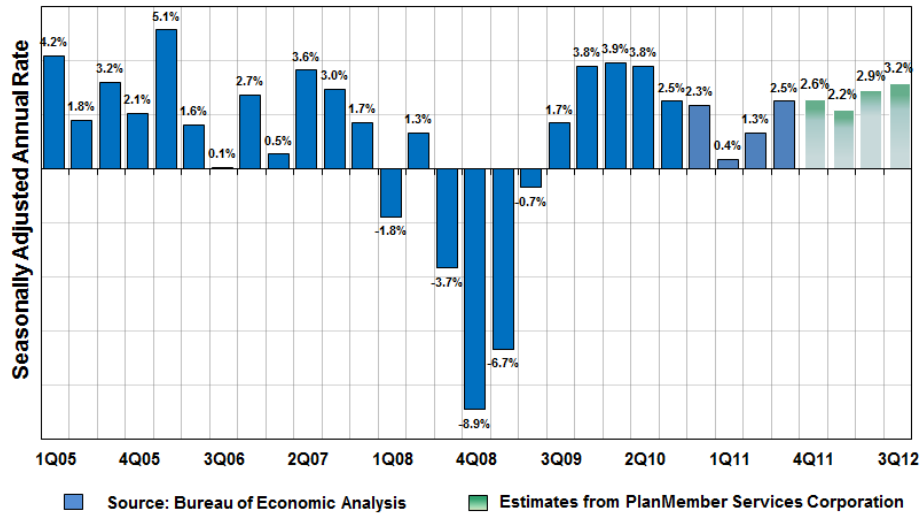
There were five months of equity market declines leading up to October of 2011 that encouraged forecasts of another 2008-like bear market and an imminent recession. The accumulation of weak economic data supported these forecasts. Suddenly, October witnessed a significant stock market rally taking the S&P 500 up 10.8%. Yet, in the face of the rally, the European maelstrom continued with a new focus on Italy's financial problems instead of Greece's woes. At the same time, the situation in the U.S. was still uncertain as the "Deficit Super Committee" struggled to agree on any steps to reduce the current budget deficit. Without a resolution, automatic spending cuts will likely come into effect which will contribute to another round of economic uncertainty.

The October equity market surge appears to have been brought about by a confluence of good economic news, which was led by a preliminary report stating that economic growth for the third quarter was 2.5%. Even though this was a sub-par growth rate, it was certainly not a confirmation that a recession was underway (as had been assumed by more than one recognized economist). Stronger consumer spending, rising inventories, higher manufacturing orders and other solid economic data offset continued weakness in both housing and employment. Long-term investors also got an optimistic boost as third quarter corporate profitability indicated better than expected growth. This increase in profits confirmed that corporate America remained in a solid position to weather the swings in politics and economics.

The final approval of a free trade pact with Colombia, Panama and South Korea is favorable news for corporate America, as it should foster demand for exports and job creation in 2012. One anecdotal piece of evidence in this regard comes from the CEO of Caterpillar Inc., who indicated that the free trade agreement would reduce the tariff on one large Caterpillar truck by approximately \$300,000. Our guess is that Caterpillar will be selling more trucks overseas in the near term. These trade pacts were actually proposed five years ago, but never jumped the political fence until the U.S. economy needed the boost.

## Exhibit #1

Growth Rate of Real Gross Domestic Product (GDP) as of November 2011



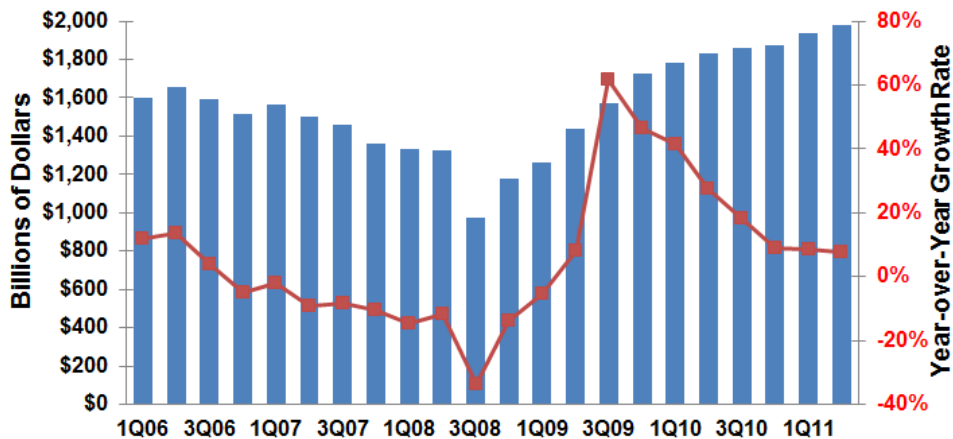
As November began, the surprise bankruptcy of MF Global (the eighth largest U.S. bankruptcy) contributed to another downturn in stock prices. Fears of another "Lehman Brothers" event encouraged investors to move to the sidelines. Even though this bankruptcy should not be a huge factor in future financial market returns, we remain somewhat cautious as the full effects of this event have yet to be seen.

### ECONOMIC UNCERTAINTY

The federal government's decision to expand spending in order to escape a financial market meltdown in 2008-2009 has produced record federal deficits and growing national debt. The backlash against this spending as a percent of gross domestic product (GDP) has been substantial. This concern over debt and deficits has led to a growth in the influence of the Tea Party in response to the perceived risks to America's solvency due to the continuation of the current deficit. Regardless of which side of the debate one may fall on, the response from politicians on this issue has been lacking. For example, the outcome of the "Super Deficit Committee" remains uncertain and many observers believe that there will be no agreement because of the wide gap between the competing economic philosophies.

Fortunately, the economy is benefiting from a strong corporate sector, where both good management and the implementation of technology to improve productivity have produced strong corporate wealth as measured by cash on the balance sheet. The Exhibit #2 details the recent rise in corporate profits. One factor to consider is whether these strong corporate profits can continue given the austerity measures being implemented in Europe and the resulting prospect of lower earnings attributable to foreign business activity. In addition, if the Deficit Super Committee cannot agree on a budget plan, then there will be mandated cuts in selected areas of the United States federal budget. Given such cuts, a number of industries may experience substantial declines in their revenues. Therefore, given current conditions, the outlook for corporate earnings remains questionable for 2012 and will be strongly influenced by government spending decisions.

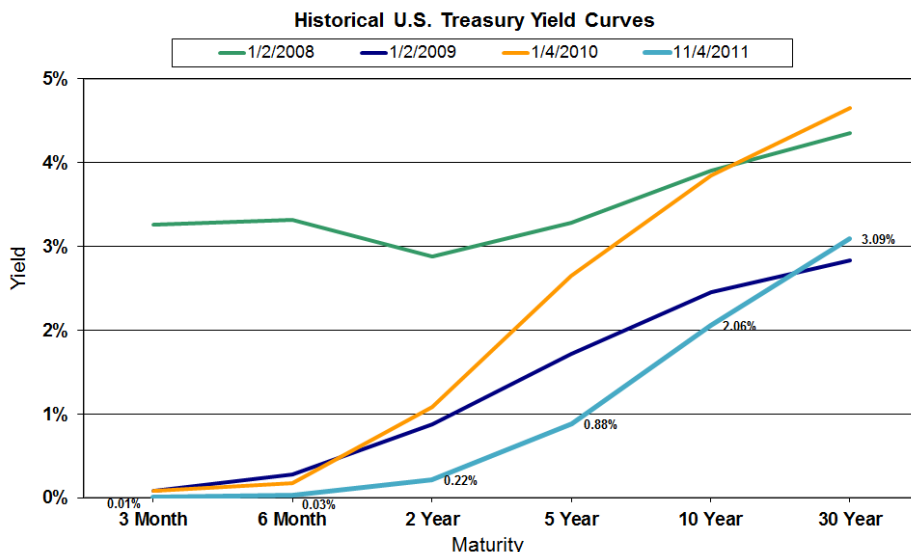
Exhibit #2  
**Corporate Profits with Inventory Valuation and  
 Capital Consumption Adjustments**



Source: The Federal Reserve Bank of St. Louis

The Federal Reserve remains a key player in any forecast of future economic growth. Chairman Bernanke has committed to holding short-term interest rates near zero, while pressuring intermediate-term interest rates lower to help encourage borrowing. However, keeping interest rates lower has a negative side, as investors' income is penalized when fixed-income securities pay out less interest. While there has been some mention of this effect on the economy, a formal measurement of the effects of this lost income on consumer spending and saving has not been prominently featured in the media. As the population ages and more individuals rely on income produced from fixed-income securities, there is an increased risk to the economy if the Fed continues to implement a low interest rate policy.

Exhibit #3



Source: The Federal Reserve Bank of St. Louis

The emergence of the "Occupy Wall Street" (OWS) protests around the country is a response to the growing income disparity between economic classes in the United States. Anger focused against the wealthy financiers

who benefited from favorable settlements during the 2008-2009 financial bailouts increased support for this movement. The failure of the federal government to produce policies to reduce unemployment also adds support to the OWS thesis. Unfortunately, the legitimacy of the protests has been undermined in the media by scenes of physical confrontations with law enforcement officials. Such events have created divided opinions within the general populace over the legitimacy of the movement. In any case, these demonstrations point out the rising concerns of one segment of the population that feels the country is going in the wrong direction.

Another important input to the national economic situation has been the financial health of state and local governments. In addition to the bankruptcy of MF Global, November witnessed the bankruptcy of Jefferson County, Alabama. This was the largest municipal bankruptcy in U.S. history. While many states and municipalities struggle with falling revenues, layoffs and spending cutbacks, a recent uptick in tax revenues at the state level could signal an overall improvement to municipal finances.

## **INVESTMENT AND PORTFOLIO STRATEGY**

As we approach year-end we are somewhat optimistic that a stock market rally could take us to new cyclical highs. However, making any forecasts of stock market behavior must be tempered by the ongoing financial events in Europe. Since there appears to be no clear indication regarding a resolution to the European situation, U.S. markets remain in turmoil even though the underlying fundamentals remain strong. As a result, stocks appear to be inexpensive in a historical context.

Interest rates have been trending lower for intermediate and long-term treasuries due to both the Fed's policy of pushing rates lower and investors' desire to hide in safe government securities. The exceptional rally in thirty-year government bonds suggests that investors are willing to risk rising interest rates in order to get a below average return on safe investments. This is not a risk-free strategy, however, as a bounce-back in yields would have a negative impact on government bond prices. For example, if the yield on a newly issued thirty-year bond were to suddenly increase to 4% from 3% (close to where it is now), that bond would drop approximately 17% in value. Given this risk, we have generally reduced our holdings of long-term government securities and increased our weightings in intermediate-term government bonds.

We have continued to maintain a reduced exposure to equities across the PlanMember Portfolios. That being said, we still feel that exposure to equities is warranted even in our more conservative portfolios. For example, in Portfolio I we have decided to retain a 10% equity weighting. One reason for this is to hedge against the aforementioned interest rate risk. Another reason for maintaining an equity position in Portfolio I is the prospect for portfolio appreciation should the stock market begin to recognize the continued fundamental attractiveness of common stocks.

Within the equity space, turbulence in foreign markets has encouraged us to lower our weightings of foreign equity securities. Domestically, there has recently been a performance disparity between large-cap and small-cap stocks, with small-caps lagging on a relative basis for a good part of 2011. Given that we see no significant fundamental reason for this disparity, we have decided to add to our domestic small-cap positions by lowering our weightings in domestic large-cap stocks and foreign equities in the portfolios where it is appropriate.

### **Investment Outlook Summary**

Despite several obstacles, we have a favorable long-term outlook for equity markets based upon several factors. First, we see strong corporate profit growth in select industries, along with extremely low interest rates that favor corporate investments. Second, across a variety of industries there should continue to be increased productivity

due to technological advances. Finally, it is possible that the European financial crisis can be resolved by political decisions, resulting in a much needed boost to investor confidence.

Our intermediate-term outlook for equity markets remains neutral due our concerns that the various austerity measures currently being implemented will likely undermine global growth. Domestically, we worry that some of the political actions being proposed on both sides of the aisle have the potential to undercut economic progress. Such potential political roadblocks challenge the notion of whether United States corporations can continue to produce strong earnings going forward.

For fixed-income securities our long-term outlook is negative, as interest rates are currently at or near record lows and a future economic expansion could lead to an increased demand for funds. In addition to this, the Federal Reserve will likely tighten monetary policy if the economy begins to show signs of sustainable strength. Such a policy will most likely include an increase in interest rates.

Over the short to intermediate-term, our outlook for fixed-income securities is favorable because of their role as a safe-haven for worried investors. The economy is languishing at near recession levels, with the housing industry remaining in a depression and home prices continuing to fall. In addition, the prospect of political gridlock remains high as Congress is at a standoff regarding solutions to current economic problems. For these reasons, we believe that investors will continue to flee to fixed-income securities for safety from the increasing volatility of stock investments.

November 4, 2011

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