



AMERICAN FINANCIAL ADVISORS, LLC

Market Review 3rd Quarter 2009

The error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born not an infant, but a giant. - Arthur C. Pigou, English Economist (1877-1959)

The 3rd quarter was financially rewarding for investors. With an additional 15% rise, the stock market is up over 50% from its lows in early March. Many asset classes have continued doing well including international equities, real estate, corporate and high yield bonds.

Much of the recent strength in the markets is directly related to the excessive error of pessimism to which Mr. Pigou refers in the quote above. As history has shown us many times – the pendulum of pessimism had swung too far in the opposite direction. We now know the end of the world has been postponed again – indefinitely. Unfortunately, for some investors, there remains \$4 trillion on the sidelines that simply missed the rapid recovery of the global capital markets over the past six months.

However --- two questions have investors concerned:

- (1) Why do signs point to a market recovery that is real and sustainable?
- (2) Why are both stocks and bonds doing so well?

The answer to both questions is: “Cheap money”.

With the Fed keeping interest rates near zero, the catalyst for stocks and both corporate and high yield bonds remains in place. The most recent Fed meeting signaled they have no intention of raising interest rates anytime soon – for fear of sending the economy into another recession or “double dip”. Additionally, inflation is not a factor yet, nor is it on the near-term horizon. Unemployment at 10% keeps a lid on any wage pressures across most sectors of the job market.

The market and the Chairman of the Federal Reserve seem to agree that the recession is over. Unemployment remains high and will stay high for some time. The Fed has two objectives; controlling inflation and maintaining full employment. It faces a delicate balancing act that includes maintaining sufficient stimulus long enough to avoid having the economy backslide into another recession (a “W” shaped recovery) and then withdrawing the stimulus before inflation ignites - all while keeping the banking system and credit markets healthy.

The sharp advance in securities brings to mind the rise in risky assets in the bull market preceding the “Great Recession” of 2008. However, there's a significant difference. This time around, investors are climbing a wall of worry basing decisions on fundamentals - not on speculation. The world is in the midst of reducing, not increasing, leverage. Confidence has returned, but not overconfidence.

At this time, we see the markets returning to more normal and healthy patterns. A healthy capital market is not one that just goes up. Rather it is one that allocates capital efficiently, taking it from unattractive enterprises and giving it to attractive ones. Healthy markets are forward looking.

The data from the Bureau of Labor Statistics show inflation has been mild to non-existent. The CPI fell 1.3% for the twelve months ended September. Excluding food and energy, prices rose 1.5%. The market for TIPS (Treasury Inflation Protected Securities) offers evidence that investors worry about future inflation. The TIPS iShare has gained 7.3% this year compared to 3.0% in the Aggregate bond ETF. Given the enormous stimulus programs around the globe, inflation will eventually return. So while inflation is not threatening near-term, we maintain some protection against it with TIPS.

The earnings reports from companies announcing their third quarter reports came in ahead of estimates. Forecasts for higher earnings are being revised upwards. Given where forecasts are, the market has more upside potential indicating to us that the market is reasonably priced. However, given the breadth of the current recovery, we think advances from here will be smaller on average and less consistent. Future returns will be tied to improvement in fundamentals rather than the error correction due to excessive pessimism.

There have been recent articles declaring that diversification and Modern Portfolio Theory (MPT) does not work. In short, the theory and the benefits of diversification have been misunderstood. We never believed that blending risky assets such as global stocks, real estate, and bonds would create a magical portfolio with high returns and no losses. If such financial alchemy were possible, there would be no point in having safe investments like Treasury bonds. As long as the future is uncertain, there will be risk and volatility in the markets. It is intuitive that to get higher returns, an investor must take higher risks. MPT refines this concept with some important points. The definition of higher risk is directly tied to the potential for greater loss. This risk of loss exists even over longer periods - otherwise no one would own long term Treasury bonds.

Diversification does not eliminate risk. It reduces it. Investors are compensated only for risks that can't be diversified away. Investors are not compensated for the risk associated with putting all their eggs in one basket – like a single stock. They are compensated for investing in a diversified portfolio of assets. This “compensation” is an expected return, not a promised return.

As we look forward, we envision several possible scenarios – none of which are knowable with any certainty. But what we do know is that we have faith that IBM, Exxon, Pfizer, Microsoft, Apple, AT&T, Chase, SONY and Toyota are not going out of business anytime soon. They will continue to make money as the global economy recovers. As this takes place, their stocks will increase in value as earnings increase. In turn, the economy will regain its footing and the job market will improve, as hiring resumes.

Please feel free to call us or e-mail any questions about your portfolio or other financial matters. As always, we sincerely appreciate your business and value our relationship with you.

The greatest compliment we can receive is a personal referral of a friend or family member.

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