Investor Insights & Outlook

January 2012 | Vol. No. 1 | Investment Updates

Happy 2012...We Hope!

At the start of 2011, we hoped the recession would fade into the rear view mirror, and equity markets would recover. Unfortunately, political events marred the playing field, making it impossible for invetstors to gain the confidence necessary to commit significant capital to the equity markets. The downgrade of U.S. debt, the U.S. debt ceiling debate, and the European Union soverign debt crises all added to a challenging environment for investors in 2011.

We begin 2012 with several factors in our favor: the U.S. economiy is expanding, unemployment is receding, consumer confidence is rising, and corporate profits are rising. These positive economic indicators, and others, provide a basis for an attractive stock market in 2012.

We do not enter 2012 without concerns, the most notable being the European debt negotiations. Fear or realization of an EU failure could send markets reeling. For the present time, however, European matters have moved from the front pages of the newspapers, allowing the markets to build positive momentum. In addition, the majority of analysts appear to share the opinion that the EU will not suffer a significant default in the forseeable future.

Given the relative stability of the U.S. economic position, and Europe's relative quiet, we are looking at most portfolios returning to a fully-invested, normal long-term allocation. The issues we faced in 2011 have not been resolved, but the likelihood of those issues creating the same level of risk in 2012 appears muted at this time.

Beyond stocks, we see the traditional safe haven of bonds offering a less compelling option as we enter 2012. The ten-year U.S. Treasury yields less than 2% at the time of this writing. With several attactive stocks paying 3%+ dividends, bonds will be challenged to hold their own.

In sum, as we enter 2012 the stock market looks relatively attractive.

I personally wish everyone a great 2012!

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A Quick Guide to Lagging Economic Indicators

Lagging indicators are economic indicators that lag behind the overall pace of the economy, and can confirm or deny the trend shown by leading indicators. Examples of lagging indicators include the average duration of unemployment, average prime rate, inventory-to-sales ratio, and the change in the Consumer Price Index.

The average duration of unemployment measures the average number of weeks an unemployed individual has been out of work, and is inverted to indicate a lower reading during a recession and a higher reading during an expansion of the economy. This statistic is measured by the Bureau of Labor Statistics on a monthly basis, and is seasonally adjusted to reflect the impact of predictable seasonable patterns. For example, retail businesses tend to hire more part-time employees during the holiday season. This is a lagging indicator because during an economic recovery, real wages increase first, followed by hours worked, and finally by an increase in hiring. This indicator is a good gauge for the overall business confidence sentiment.

The Consumer Price Index is released mid-month and measures the average rate of change month-to-month in the prices paid by consumers for a broad basket of consumer goods and services. This is the most widely-used measure of inflation today and is used as a guide by both Congress and the Federal Reserve to formulate fiscal and monetary policies. More specifically, the Core Consumer Price Index, which excludes the most volatile components of the index like energy and food prices, is used by the Fed to measure whether it is meeting its annual target inflation rate of 1.7% to 2.0%. For example, depressed CPI numbers coupled with high unemployment figures were key factors in the Fed's decision to start buying $600 billion in Treasury bonds to boost investment and consumption rates at the end of 2010. Thus, investors who are interested in investing in government bond ETFs should take note of this indicator (prices of long-term bonds might go up, while yields would fall). This is a lagging indicator because it represents prices that have already changed; announces that inflation arrived—one month ago.

The prime rate is what banks charge their most credit-worthy customers, mainly large corporations. Since Dec. 16, 2008, the Wall Street Journal determines this rate by polling the 10 largest banks in the United States, and will update the published rate when at least 7 of these banks have changed their rates. The prime rate is largely based upon the Federal Funds Rate set by the Federal Open market Committee every 6 weeks. The rule of thumb for the value of the prime rate is 300 basis points (3%) above the current fed funds rate, which is currently between 0% and 0.25%. This is a lagging indicator because the Federal Reserve sets this interest rate in response to economic growth rates, and to stimulate growth, the federal funds rate will be set low for a period after the economy is recovering. This is important to investors because many banks use the prime rate as a basis to price loan products such as student loans, credit cards, and car loans, and is a good indicator if one wants to invest in stocks or ETFs in the financial sector.

The inventory-to-sales ratio is reported by the Department of Commerce and measures how many months it would take to deplete the backlog of goods, adjusted for inflation. An increase in this ratio generally means that sales estimates were missed, and businesses will respond by postponing future orders and cutting production rates, resulting in a slowing economy. Beyond looking at the overall figures published monthly, serious investors should look at the numbers for manufacturers, retailers and merchant wholesalers since each sector has different sensitivities to an economic downturn.

Government bonds are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than other asset classes.

Are Bonds Adding to Your Equity Exposure?

These are trying times for yield-seekers. The Federal Reserve has kept interest rates ultralow for more than two years, and Federal Reserve chairman Ben Bernanke gave no indication in his recent press conference that the Fed will depart from that stance anytime soon. That may be good news for those in the market for home loans, but it's surely unwelcome for seniors and others trying to wring a livable income stream from their portfolios. Yields on cash instruments such as certificates of deposit are barely in the black, while you're lucky to pick up a yield of more than 3% on an intermediate-term bond fund.

Given this backdrop, it probably shouldn't be surprising that some investors appear to be chasing yields. Among bond funds, some of the biggest beneficiaries of new assets during the past year have been those that offer higher yields than high-quality bonds in exchange for some extra risk.

Of course, it's highly possible that investors are making the not unreasonable bet that the economy will continue to improve, thereby boosting these credit-sensitive sectors of the bond market. (Issuers are less likely to default on their bonds in a strengthening economic environment.) But it's also likely that some investors are focusing on the potential for higher yields without paying due attention to the downside.

All market shocks are different, of course, but they're often characterized by a flight to quality that puts pressure on credit-sensitive securities such as high-yield bonds and bank loans. During the period from mid-2007 through December 2008, for example, both high-yield bond funds and bank-loan funds performed poorly. This precipitated an unprecedented buying opportunity in credit-sensitive bonds, but following a more than two-year run-up in such securities, valuations aren't what they once were.

In addition to considering the risks, investors who are venturing into credit-sensitive bonds at this juncture should also be aware of what they might not be getting: diversification, particularly if they're looking to bonds as an antidote to an equity-heavy portfolio. It's true that credit-sensitive sectors like high yield and bank loans can be considered a good diversifier for portfolios that are skewed toward high-quality fixed-income securities such as government bonds, mortgage-backed securities, and high-quality corporate debt.

The high-yield sector's performance correlation with the equity market has been strong during the past decade (this means that, whether rising or falling, they tend to move together). The correlation of bank-loan funds with stocks has also been relatively strong (although less so than that of high-yield bond funds). Both asset classes have been more highly correlated with stocks than with bonds.

Does that mean you should reflexively avoid high-yield and bank-loan funds? Not necessarily. These bonds do provide some diversification benefit to high-quality bonds. And while high-yield bonds wouldn't be impervious in a period of rising interest rates, their extra yield cushions would most certainly hold them in better stead than gilt-edged Treasuries in such an environment. And bank-loan funds offer built-in protection against rising interest rates. If the economy continues to strengthen, high yield and bank loans would likely continue to chug along. But it's also a mistake to assume that a bond is a bond is a bond. If you're looking at mutual funds that delve into credit-sensitive sectors, it's crucial to thoroughly understand a prospective holding's strategy and downside potential before adding it to your portfolio.

Past performance is no guarantee of future results. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Diversification does not ensure a profit or protect against a loss in a declining market.

The Rollover IRA, Taking It With You

One of the most convenient and flexible options for dealing with a retirement plan from your ex-employer is to transfer the money to a Rollover Individual Retirement Account. A Rollover IRA is, in essence, a traditional IRA where you can park the cash you're transferring from your old employer's retirement account. The money you invest in a Rollover IRA accumulates tax-free until you take it out in retirement, just as it does in a defined-contribution retirement plan (401k). You can open a Rollover IRA with just about any investment firm, including mutual fund companies, insurance companies, and online brokers. You're allowed to invest the money in stocks, mutual funds, bonds, and other types of investments. That's why the Rollover IRA is your most flexible choice when leaving a job.

You have a number of options after you open your Rollover IRA, too. Of course, you can leave it alone until you retire. But if you move on to a new job, you may be able to transfer the money you have invested in your Rollover IRA into your new employer's retirement plan (assuming the qualified retirement plan has language permitting such rollovers). And if a Roth IRA is more to your liking, you can convert your Rollover IRA into a Roth IRA, if you meet the criteria.

Keep in mind that you can't take a loan from a Rollover IRA as you can from some employer-sponsored retirement plans. Moreover, Rollover IRAs are also subject to the same withdrawal limits as other tax-deferred retirement accounts. So, if you take any money out before you turn 59½, you'll pay a 10% early withdrawal penalty in addition to taxes.

Returns and principal invested in stocks are not guaranteed. Stocks have been more volatile than bonds.

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