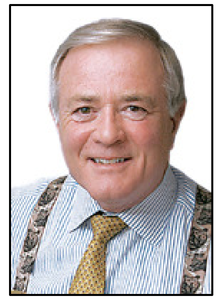
DJC
THE DAILY JOURNAL OF COMMERCE, PORTLAND, OREGON



William Rutherford

Market in schizophrenic mode

Published December 10, 2012

U.S. equity markets suffered more volatility this past month as headlines veered from optimism to pessimism over "fiscal cliff" negotiations. Investors have become accustomed, if not comfortable, to extreme volatility over the past few years as the economy and policy makers in Europe and the U.S. have provided a litany of mostly negative surprises.

Investors have sought refuge in bonds during this time to avoid risk, but in so doing they have bid bonds to a risky level – perhaps even a bubble. They also have forfeited returns. As long as investors are as worried about the equity market as they are now, the appeal of bonds will continue. However, at some point we can expect that trend to unwind with investors returning to equities.

With bonds returning low yields and possessing little upside potential, there is definitely a possibility that investors will run to the other side of the boat. When that happens, we can expect a sell-off in bonds and an increase in equity prices. The catalyst for such a move could be a resolution of the "fiscal cliff" disagreement, or a solution to the various European crises.

The U.S. is probably closer than Europe to reaching an agreement. While one does not appear imminent in the U.S., it is still likely that some sort of agreement will be reached, even if it is only to "kick the can down the road" – a real possibility.

As bad a job that the legislative and executive branches have done, and are doing, neither side wants a calamity. The impetus for a deal is strong. What they are trying to gain now is bargaining position and painting the other guy as the bad guy.

At this moment there are neither statesmen, nor a realization that give and take will be necessary. Such is the nature of politics. The president believes, rightly so, that he was elected on a platform of raising taxes. Republicans are willing to see revenue growth, but through limiting deductions. Republicans also want spending cuts that the president is not willing to give. Thus, a stalemate, for the moment, is reached.

But the risks of failure are too great, and an agreement of some sort will be reached. In the past, in these brinksmanship disputes, the agreement has come between Dec. 15 and 27. President Obama has promised a deal by Christmas. So, the scratching and biting will continue for a while longer.

Economists and investment strategists, in the meantime, predict a bad result if an agreement is not reached, but also believe a deal will be struck.

Popular consensus is that earnings will grow about 7 percent in 2013; this is not robust growth, but it is growth nonetheless. Furthermore, there is a growing consensus that investors will gravitate out of fixed-income investments and into equities, reducing the value of bonds and increasing the P/E ratio on equities.

With some economic growth and with some P/E expansion, one can expect a decent return on equities with continued muted returns on bonds. The broad market has risen 10.8 percent exclusive of dividends since market lows were reached on June 1.

The S&P 500 is up 14.32 percent since Jan. 1. The Barclays all-bond index is up 4.3 percent. At some point, that difference will have an effect. When adding to expected GDP growth the massive buybacks the U.S. companies are doing in order to return money to shareholders, and the special dividends they will pay this year to escape higher taxes, the equity markets look attractive.

Europe has not solved its debt problems and its economy continues to slow with unemployment rising. Even with slow GDP growth, the U.S. looks relatively better than Europe from an investment perspective. Emerging markets look the best of all, given their faster rate of GDP growth. Emerging market bonds also are attractive from a yield point of view.

China, always opaque, appears to be bottoming – primarily because of massive government intervention in the economy. Such intervention may be creating its own bubble.

My recommendation is to turn off the talking heads, tune out the background noise and keep a steady hand on the tiller. Above all, do not panic.

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