October 3, 2012

Third Quarter Commentary:
"The Economy & The Markets: Going Into the Home Stretch"

Dear Client,

Despite a long list of potential and actual economic headwinds, U.S. and international stock markets continued to scale the proverbial “wall of worry” during the third quarter. And, in a marked change from the summer of 2011, stock market volatility was way down this summer. The S&P 500 Index\(^1\) gained 6.3% during the quarter and is up 16.4% year-to-date through September 30. The MSCI EAFE Index\(^2\), a broad measure of developed international markets, rose 6.9% during the quarter and is up 10.1% year-to-date, despite Europe’s well-publicized economic problems. Within fixed income markets, the yield on the 10-year U.S. Treasury bond ended the quarter at 1.66%, virtually unchanged from where it began the quarter.

While the stock market has recovered most of the ground lost during the 2008-09 financial crisis, many investors remain skeptical that this rally is for real. Investors have pulled more than $137 billion out of U.S. stock funds this year while pouring $267 billion into bond funds*. Many others are sitting on the sidelines in cash, waiting for the “all-clear” signal. I don’t know whether the stock market will be higher or lower three months or three years from now, but I do know that trying to time major market moves by jumping in and out of the markets is usually a recipe for failure.

Looking ahead to the year’s final quarter and to next year, the biggest concern is the impending “fiscal cliff.” The fear is that a combination of sharply higher federal tax rates and across-the-board cuts to discretionary government spending currently scheduled to take effect on January 1, 2013 could drive the economy back into recession. The non-partisan Congressional Budget Office has warned that—if Congress fails to act before year-end—the economy will contract by 2.9% in the first half of 2013 and job losses could total two million.

With Congress in recess until after the Presidential election, our government leaders will have only a few weeks to reach a compromise solution that balances spending cuts with the need for additional revenues. While I am hopeful that Congress will ultimately put the country’s economic well-being ahead of partisan politics, the process could make for a volatile end to what has so far been a solid year for stocks.

Of course, the fiscal cliff is just one of several challenges facing the U.S. and global economy. The news out of the euro zone continues to veer from hopeful to pessimistic. Several European nations are already in recession and unemployment across the euro zone has risen to 11.4% (it’s a whopping 24.6% in Spain).

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In an effort to reduce government borrowing costs, European Central Bank (ECB) President Mario Draghi announced his intention to launch a new program that allows the ECB to purchase the short-term government debt of struggling euro-zone nations. That announcement followed Draghi’s earlier vow to “do whatever it takes to preserve the euro.” Time will tell if these measures will prevent further deterioration of euro-zone economies and the dissolution of the euro zone itself. In either case, Europe remains the United States’ largest trading partner, so what happens there bears close watching.

While there is no shortage of challenges facing the global economy, there have been some positive developments here in the U.S. Housing starts and housing prices are both on the upswing and automobile sales are close to pre-recession levels. Consumer confidence is beginning to rise again and consumer spending continues to grow. These are all positive signs that bode well for our economy, but if we don’t avoid the fiscal cliff, they could quickly reverse course.

With the Presidential election just five weeks away and the aforementioned fiscal cliff looming, don’t be surprised if the ride gets bumpy before year-end. Remember, however, that your financial goals extend far beyond the next three months, so keep that in mind if market volatility puts you on edge.

Thank you for your continued trust. If you have any concerns you would like to discuss, please feel free to call me anytime or send me an email.

Sincerely,

Mike Ovshak
CFP®

1 The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks.

2 The MSCI EAFE Index an unmanaged market capitalization-weighted index of equity securities of companies domiciled in foreign countries that is designed to represent the performance of developed stock markets outside the United States and Canada.

All indices are unmanaged and investors cannot invest directly into an index. Past performance is not indicative of future results. Diversification does not assure a profit or protect against a loss in declining markets.

* Source: Wall Street Journal, 10/1/12