StaufferWilliams
ASSET MANAGEMENT · LLC

NOVEMBER 2012 INVESTMENT COMMENTARY

THE GREAT UNWIND

Several years ago PIMCO coined the phrase "New Normal". The "New Normal" was an economic state that PIMCO saw resulting from the deleveraging world that emerged from the shock of the 2008-2009 financial crises. This new economic state was also supposed to constrain public capital market returns with slow economic growth weighing down equity returns, and loose monetary policy creating inflationary conditions, putting upward pressure on bond yields and downward pressure on bond prices.

Now, four years later, we know that the "New Normal" did not quite work out the way PIMCO envisioned. We did experience a "New Normal" in terms of a persistent anemic economic recovery, however, U.S. investors witnessed a very strong stock market rally coming off the 2009 lows, while investors who were skeptical of the those stock market returns sought shelter in the bond markets. These shell-shocked investors, combined with aggressive Federal Reserve quantitative easing, pushed interest rates down to 70 year lows and created what many are calling a "bond bubble".

So was the prediction of a "New Normal" right or wrong? Certainly the verdict is in as far as the capital markets are concerned, there was no evidence of a "New Normal", as both stock and bond markets posted strong returns over the period since the Great Recession ended in 2009. However, as with many investment predictions, a prediction can be correct, but the timing can be wrong. That may be what we will eventually say about the "New Normal". We do not see the sub-par economic growth and above trend unemployment rate changing anytime soon, equities are now not as significantly under-valued as they were three years ago, and bond yields have seemingly bottomed out at 70 year lows. Back in early 2009, the "New Normal" prediction failed to take into consideration that stocks were sitting at unsustainably low valuations and that the Federal Reserve would be successful in holding down bond yields without sparking rampant inflation.

Curt went on record in his previous firm's commentary in February 2009, stating that equity valuations were unsustainably cheap and at the same time he aggressively snapped up very attractive tax-free bonds that were trading very cheap because many investor believed that many municipalities were on the verge of financial insolvency. On many occasions over the course of 2009 and 2010 Curt documented his doubts about the concept of a "New Normal" and this viewpoint was justification for buying equities when they dipped, and sticking with attractive individual bonds.

TIME FOR ACTION

Today, as we look forward, we see a fairly valued equity

market and bond yields that do not provide enough income to justify new investment. So, something has to give. Stocks are not sitting at an extreme level as they were in early 2009, but have not overshot enough for us to be concerned about a significant downward correction. However, bonds seemingly have reached extreme and unsustainable price and yield levels. Since bonds are not traded as actively as stocks, we doubt that we will see these extreme conditions reversed rapidly, however we would expect this over-valuation to unwind over a period of years.

This outlook means that we do not foresee a repeat of a Japan like deflationary, zero interest rate stagnation lasting a decade or more for the U.S. If we are correct, this means that equity markets will likely be one of the best performing asset classes, along with real assets such as commodities, real estate and energy. However, this also portends a very challenging environment for U.S. bonds of all types.

Our reaction to this forecast will be to maintain equity allocations, reduce bond allocations and increase client exposure to non-traditional asset classes. Currently most of our clients have between 10% and 20% exposure to non-traditional asset classes through mutual funds, ETF's and equity in timber REITS. We will expand the non-traditional category to include private funds that provide direct investment in various attractive investment strategies that will be non-traded, and thus highly independent of stock market volatility and interest rate swings.

We are going to keep this commentary short and to the point. Our confidence in our outlook and strategy enhancement is very high; therefore we look forward to having a lot of good conversations with clients over the next several months in order to determine the best method of making the portfolio changes that we see as necessary going forward.

We wish everyone and their family members a Happy Thanksgiving.

CURT R. STAUFFER
Partner, 717 877 7422

JONATHAN M. WILLIAMS
Partner, 717 810 6705

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