



Clients First Transparent Accessible

Mid-Month Market Cycle Monitor

Volume III, Issue XII December 2010



Interest Rates Rise on Higher Economic Growth

The path of the business cycle follows a regular pattern. However, the timing, extent, and duration of each cycle can vary widely.

Last month we wrote about how expectations for economic growth throughout 2010 turned out to be too pessimistic and that the stock market had climbed a wall of worry as expectations were gradually revised more positive. We also wrote about how Federal Reserve Chairman Bernanke is implementing monetary stimulus aimed to evoke consumer spending via “the Wealth Effect.” and we reasoned that if consumer spending resumes, current expectations of economic growth could once again prove too pessimistic.

On December 14, the U.S. Census Bureau announced that **Retail Sales** rose 0.8% in November to \$378.7 billion. This is the **highest level since the recession began** and only \$1.3 billion below the peak reached in 2007.

Another signal of rising growth expectations is the **recent reversal in bond yields**. We saw a similar tick up in bond yield back in April, but then default fears in Europe resulted in weakness in the Euro and thus a stronger U.S. dollar, which in turn dampened growth in the U.S. The Federal Reserve responded by purchasing fixed income securities to push interest rates lower, which occurred thru October. However, as of **Friday, December 10th**, the **ten-year U.S. Treasury note bond yield reached 3.32%**, which is up **nearly a full percentage point from the October lows**.

There are plenty of inflation hawks in the media claiming that the Fed’s plan to hold down interest rates to support the recovery has failed because of this recent reversal in bond yields. However, if the monetary stimulus provided by the Fed resulted in stronger retail sales and thus stronger economic growth, and the **bond market is now adjusting** to such **higher growth rate assumptions**, then the Fed has been successful and we have seen the bottom of the interest rate cycle in this economic cycle. As **interest rates rise, bond prices fall**. Therefore, we would **under-weight bonds**.

An **expanding economy**, supported by **low interest rates**, with **low inflation** and **improving corporate profits** all provide a **favorable environment for stocks**.

The **Price to Earnings Ratio** (“P/E” or “multiple”) is a widely used valuation tool used by investors. The average P/E of the S&P 500 Index over the past 5 years is 15.7, which means that on average, investors have been willing to pay \$15.70 for each \$1 of earnings. Currently, the **P/E multiple of the S&P 500 Index to expected 2011 earnings is 13.6**.

Over the **past 5 years**, the multiple of the **S&P 500 Index** has ranged from as **high as 20** to as **low as 9**. The multiple investors are willing to pay for stocks is most affected by interest rates and earnings growth. Low interest rates and high earnings growth rates lead to higher P/E multiples, while high interest rates and lower growth leads to lower multiples.

At this point in the economic cycle, even though interest rates are rising, the level of rates are still low, which would normally point to a higher than average multiple. However, the multiple has been below average due to pessimistic earnings growth expectations. **As growth rate assumptions increase, we would expect the multiple to expand**. The combination of higher earnings, (“E”) as well as an expanding multiple (“P/E”) leads to higher stock prices (“P”).

ASSET MIX: We have already begun to **underweight bonds**. We **continue to maintain the maximum allocation to equities**. We are also watching for signs that would indicate a stalling recovery, and expect to reduce the allocation to equities if significant evidence mounts.

Grace Y. Lau, CFA

Elliot C. Kauffman, CFA

Professional Staff



Grace Y. Lau, CFA
Chief Executive Officer



Carter A. Pearl, CFA
Senior Portfolio Manager



Elliot C. Kauffman, CFA
Senior Portfolio Manager



Daniel S. Flack, CFP, CFA
Portfolio Manager



Jason Orenzoff
Operations Specialist

PacWest Financial Management
1643 E. Bethany Home Road
Phoenix, AZ 85016

Tel: (602) 997-8882

Toll Free: (888) 997-8882

Fax (602) 997-8887