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Mid-Month Market Cycle Monitor

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2012

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

Last December we wrote about how expectations for economic growth throughout 2010 turned out to be too pessimistic and that the stock market climbed a wall of worry as expectations were gradually revised more positive. At the time, the P/E multiple of the S&P 500 Index to forecasted 2011 earnings was at 13.2, which was below the long term average of 15.7.

Throughout 2011, PacWest has been stating that:

- 1) We do not expect a double dip recession in the U.S.
- 2) We do not expect an unmitigated default in Europe.
- 3) We do not expect a hard landing in China.

Instead, we expected the economy would expand and corporate earnings would grow despite increased political risk.

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

However, as we come to the end of 2011, while the stock market has been more volatile, it is ending the year about where it began.

Economic data has improved over the year. The U.S. Index of **Leading Economic Indicators advanced 5.48%** from 111.3 in October of 2010 to 117.4 for October of 2011. (October data is reported in November, and November data will be reported on December 22nd).

Corporate earnings of the S&P 500 Index have **increased 15.88%** from \$19.52 as of the quarter ended September 30, 2010 to \$22.62 as of the quarter ended September 30, 2011.

Typically, an expanding economy with earnings growing 15% and very low interest rates would result in expansion of the P/E multi-

ple. However, the P/E multiple of the S&P 500 Index to expected 2012 earnings has contracted to 12.2 from 13.2, which means that on a valuation basis, stocks are less expensive now than at the beginning of this year, and thus provide a greater opportunity to appreciate over the coming year should investor confidence improve.

One should position their portfolio to benefit from what one expects to happen in the future, rather than by what has happened in the recent past or by reacting to the news of the present. We continuously examine the current news as it flows in to evaluate whether it provides indications that confirm progression from the environment of the recent past towards an environment congruent with our expectation for the future.

Currently, fears of an unmitigated European default persists, as well as fears of slowing growth in China and the U.S. European officials have so far prevented disaster and are working towards eventual resolution of their crisis. China has so far avoided a hard landing and has begun to stimulate their economy by loosening credit. Federal Reserve Chairman, Bernanke, has pledged to keep interest rates low, the price of gas has moderated, and the recent employment and manufacturing data came in better than expected, all of which will help the U.S. recovery. Nevertheless, it seems that additional evidence is required for the consensus to revise their expectations towards a more favorable 2012, which would allow for the P/E multiple to expand and stock prices to advance.

ASSET MIX: We are **underweighting bonds**. We are **maintaining the allocation to equities**. We are **utilizing cash as a strategic asset** class, raising cash when conditions warrant in order to reinvest into stocks when opportunities arise.

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