Robshaw & Julian Associates, Inc.
Trusted Investment Advice Since 1979

Investment Matters

For the quarter ended December 31, 2012

The Stock Market Is Now Risk Driven

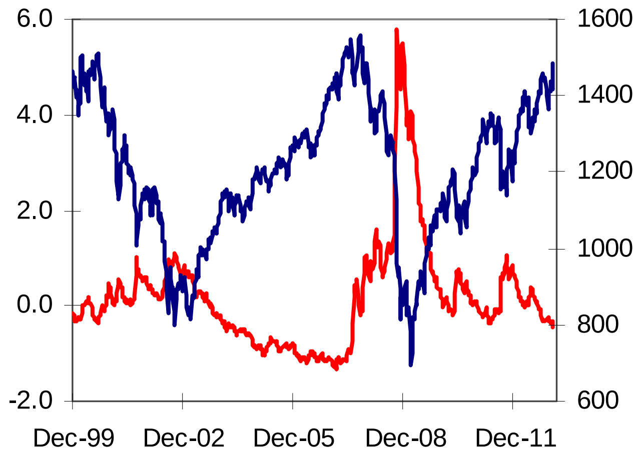
When evaluating the stock market most investors tend to focus on earnings. After all, profits are the source of money for dividends and for business expansion. A stock is generally thought to be worth some multiple of its annual earnings. Over history stock prices have generally followed rising corporate earnings.

But this has not been the case since about 1999. Since then the earnings of the S&P 500 Index have doubled while the price of the Index has struggled to hold the old levels. What's going on here?

Risk has always been a factor in valuing stocks. As worries about an impending financial crisis or recession appear, stock prices turn down. When the worries recede, stock prices return to prior levels. If worries about risk didn't fluctuate, stock prices would track earnings much more closely than they do.

Consider two stocks, both with the same long term earnings growth rate: one with earnings which rise in a predictable fashion every year and the other which has unpredictable earnings. The steady earner always deserves a higher price-earnings ratio. So it is with the stock market: when the future becomes less predictable, stocks receive lower valuations.

In the 1980's and 1990's, most risk episodes were fairly short-



STOCK PRICES MOVE IN THE OPPOSITE DIRECTION OF RISK

FINANCIAL STRESS (LEFT SCALE)

S&P 500 INDEX (RIGHT SCALE)

lived. Financial crises and recessions came and went and the economy and the markets moved on. In the last 10-12 years however, worries about the viability of the financial system have increasingly influenced the direction of stock prices.

The Federal Reserve has developed a measure of financial system worry called the Financial Stress Index. The Index quantifies the level of fear in the pricing of various types of financial instruments, not just in the U.S. but around the world. The Index rises as investors become more and more concerned about the viability of the financial system and falls when confidence in the system returns.

The graph on this page illustrates the extent to which variations in risk have driven the stock market since 1999. The blue line which forms the letter "W" is the S&P 500 Index. The red line is the Financial Stress Index. The Stress Index peaked during the 20008-09 financial crisis, exactly as you would expect.

Notice how the S&P 500 Index follows a path almost exactly opposite that of the Stress Index, particularly after 2007. A monstrous increase in the Stress Index in 2008-09 accompanied a gut wrenching 56% decline in stock prices at almost exactly the same time. The rising risk of a European financial collapse in 2010 and the U.S. debt ceiling impasse in 2011 corresponds perfectly to mid-teens percentage declines in U.S. stock prices. The small increase of the Stress Index in mid 2012 matches a relatively modest decline in stock prices at that time. The recent decline of the Stress Index to a five year low matches the return of the S&P 500 Index to a five year high.

The Stress Index is back to where it was in late 1999. In fact it is slightly below the average level it maintained throughout the 1990's. If risk is back to historically low levels, is it possible that the market will also resume a level of valuation which characterized the 1990's, i.e. 25-50% above where it is now?

History provides a clue. In the 1970's inflation was the big risk which drove down stock valuations. From a peak of more than 13% in 1980, the annual rate of inflation fell below 3.0% in June, 1983. Although stock prices went up during those three years, it wasn't until three years later that the price earnings ratio of the S&P 500 hit the historical average 14-15 level. It took three years of low and stable inflation before investors accepted that the inflation scourge had been tamed.

So it is today. Although

Continued on page 2

Risk: continued

financial system risk has declined, investors, having been burned by two 50% stock declines in less than 10 years, are reluctant to believe that the all-clear signal has been given.

If financial system risk as measured by the Stress Index stays low for a few years, stock valuations should slowly return to normal. Whether this happens depends on if the governments of the world are successful in addressing their structural economic problems, specifically the growing mountain of debt here, in Europe and in Japan.

U.S. Government debt is at a high level and growing faster than the economy, a trend which increasingly compromises financial stability. If this continues financial shocks will be more frequent and stock valuations will remain depressed. If government enacts policies which result in stronger economic growth and reduced government borrowing, investors are likely to be rewarded with higher stock valuations.

How Bad Is Our Budget Deficit?

The U.S. federal budget deficit, the amount by which federal spending exceeds taxes and other sources of revenue, was $1,089 billion in 2012, or about 7% of the entire economic output of our country. This is down somewhat from $1,413 billion in 2009, during the deep recession. All of this money must be borrowed and added to our external national debt which now stands at $11,500 billion, equal to 73% of our annual GDP. These are big numbers but do they portend serious danger for the economic well being of our country? Could we become like Greece?

Clearly, a national economy growing at only 2% cannot borrow 7% per year forever. Eventually, interest on the national debt would crowd out all other federal spending and overwhelm our ability to pay. Long before this happened however, lenders here and abroad would demand higher and higher rates of interest and eventually refuse to provide funds to us at all.

This is essentially what happened to Greece. The growth of their national debt exceeded the growth of their economy for many years until a crisis finally developed. Spurred on by cheap borrowing costs resulting from their adoption of the Euro in 2001, the Greek government went on a borrowing binge. Within just a decade collapse became inevitable. They had borrowed more than they could repay.

If Greece had a dynamic growing economy the crisis might never have happened. Rising growth would have generated rising tax revenue, perhaps enough to satisfy government spending needs, certainly enough to delay the day of reckoning. But Greece was lucky. Eurozone leaders decided to intervene in the crisis, not only to help Greece, but to prevent a collapse of the Euro. They provided enough bailout money and loan guarantees to assuage Greek creditors and prevent the crisis from spreading, but at a severe cost to the Greek standard of living. The Euro was saved but the Greeks were impoverished.

Lately some have argued that U.S. debt is far from problem levels. They point out that the recent explosion of our annual federal deficits was mainly the result of the 2008-09 recession and subsequent slow economic growth. Not only did a weak economy result in lower than normal tax receipts but it required more government safety net spending for people in need. They argue that once the economy returns too normal, deficits will drop to 2-3% of annual GDP. If the economy grows at 2-3% our deficit can remain stable at 2-3% of our economy. If the economy grows at a more normal 3-4%, we will actually be able to shrink our mountain of government debt, at least relative to the size of our economy.

This analysis includes at lot of “ifs”, and if it is incorrect in any substantial way, we are well on the road to a U.S. debt crisis, from which there is no one to bail us out. In order to make sure we avoid a Greek tragedy, it would be prudent to institute policies which address the debt build-up today rather than to trust in assurances that everything is under control and, “it can’t happen here”.

Our external national debt amounts to about $38,000 for every man, woman and child living in the U.S. , more than owed by individual Greeks.

The Bottom Line: 12/31/2012

Market Indicator	Current Value	One Year Change
Large company stocks *(S&P 500 Index)*	1426	16.0%
Small company stocks *(S&P Small Cap Index)*	476.57	16.1%
Short term interest rates *(3 Month T-Bill Yield)*	0.1%	No change
Long term interest rates *(10 Year T-Bond Yield)*	1.8%	From 1.9%
Inflation *(Consumer Price Index)*	231.0	1.8%
Energy *(West Texas Intermediate Crude Oil)*	$91.74bbl.	-7.5%
The economy *(Inflation adjusted GDP)*	$15.8 trillion	2.5%

QUOTABLE

“Markets can handle almost anything, except the lack of accurate information.”

William M. Isaac

Robshaw & Julian Associates, Inc.
6255 Sheridan Drive, Suite 400
Williamsville, New York 14221
Tele: (716) 633-6555
E-mail: info@robshawjulian.com
Website: www.robshawjulian.com