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THE SEIA REPORT

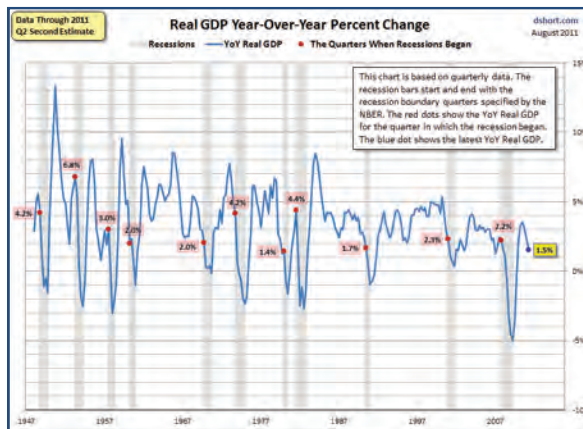
Successful wealth management is the result of an ongoing collaboration between investor and advisor, built upon trust and maintained according to the highest standards of integrity and expertise.

Relative Valuations Amid Economic Uncertainty

By Deron T. McCoy, CFA, CAIA, CFP®, AIF®
Director of Investment Strategy

Summer Slowdown

The government recently said that the economy grew at a 1% annual rate in Q2, down from its initial estimate of a 1.3% pace and not much better than Q1's 0.4% growth rate. With the two most recent quarters posting growth rates below 1%, recession worries have increased as periods of 1% growth or less have preceded nine of the past 11 recessions. Year-over-year GDP now stands at 1.5% which is again below the level at the onset of all the recessions since the first quarterly GDP was calculated — with one exception: The six-month recession in 1980 started in a quarter with lower GDP (1.4%). On only one occasion (Q1 2007) has GDP dropped below 1.5% without a recession starting in same quarter—but in that case the recession began three quarters later in December 2007.



Recent Economic Signposts

Economists see the slowdown as temporary and few expect an economic downturn this time but the threat is real and increasing. It seems the consensus puts the chance of recession at about 1 in 3 with the most recent data points painting a mixed picture.

- The initial large trigger for elevated recession chatter was the extremely weak regional measure of activity put out by the Philadelphia Federal Reserve (Philly Fed). It dropped to -30.7 in August from +3.2 in July—its lowest reading since March 2009 and a level that's always been historically recessionary (Caveat: It's only for the Philadelphia region and is extremely volatile, but its warning is worth heeding nonetheless).

- The Institute for Supply Management (ISM) said in late August that its manufacturing index slipped modestly to 50.6—a level still suggesting growth. The 25th straight month of growth was a hopeful sign that U.S. factories weathered a difficult summer for the economy. Although the ISM softened slightly the report was a far cry from the August Philly Fed report, which suggested a looming recession.

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Relative Valuations Amid

SEIA

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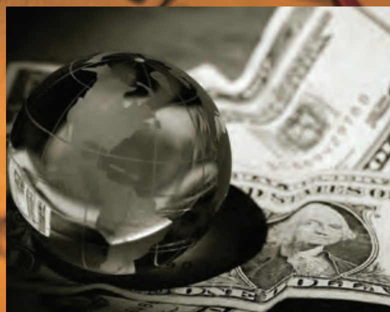

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• The Weekly Leading Index (WLI) growth indicator of the Economic Cycle Research Institute (ECRI) dropped deeper into negative territory (-4.3) in early September.

• Consumer Sentiment Index hit lows not seen since November 2008. The lack of confidence can turn into a self-fulfilling prophecy. But formal recessions require a big drop in many segments of the economy, and let's not forget that several segments—housing, automobiles and small business—really never exited recession in the first place. As a result, the likelihood of major drops from these levels is low.

• In fact, although confidence is low retail sales are holding up. Retailers such as Saks, Nordstrom, Macy's, and Target all posted same store sales growth over 4% in August perhaps due to a drop in oil prices. Auto manufactures also posted 10%+ growth in August after a weak July perhaps due to abating negative effects from Japan's disaster(s). This all suggests Americans are spending despite what they are telling the economic-confidence pollsters.

• And then there is the lagging indicator of jobs. August showed nonfarm payrolls were unchanged and that private sector payrolls rose just 17,000. In addition, revisions in July and June data show 58,000 fewer jobs than previous reported.

• Despite the macro-economic data, companies have recently posted another strong quarter of earnings. According to Barclay's, in only two cases—the 1974 oil shock-induced recession and the 1981 monetary policy-induced recession—were earnings still rising when the recession began.

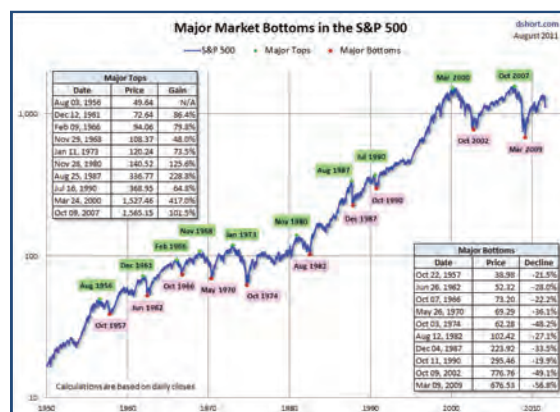
With consumer sentiment returning to recession lows and most regional activity indexes declining, evidence is mounting that the soft patch of this year's first half could turn into contraction in the near term. However, this may not translate into stock market weakness for several reasons. Selling interest could be tempered by the belief that the August employment report will be seen by Fed officials as a marker that they need to implement more stimulus. The question is what kind—monetary or fiscal?

Additional Stimulus

At a recent conference, Fed Chairman Ben Bernanke for now put the burden of additional stimulus squarely on the shoulders of politicians, "Most of the economic policies that support robust economic growth are outside the province of the central bank." While stressing the need for fiscal adjustment, however, the Chairman argued that "fiscal policymakers should not…disregard the fragility of the current economic recovery" meaning austerity measures or budget tightening should be carefully constructed. Obviously, President Obama has a vested interest to spur the economy and job growth—and his speech in early September was probably the first in an onslaught leading to next year's elections.

Calendar turns friendly.

According to Doug Short, since 1950 the S&P has had 10 major tops and bottoms. The tops have been spread across a range of months but October has hosted 5 of the ten bottoms.



Major Tops		
Date	Price	Gain
Aug 03, 1956	49.64	N/A
Dec 12, 1961	72.64	86.4%
Feb 09, 1966	94.06	79.8%
Nov 29, 1968	108.37	48.0%
Jan 11, 1973	120.24	73.5%
Nov 28, 1980	140.52	125.6%
Aug 25, 1987	336.77	228.8%
Jul 16, 1990	368.95	64.8%
Mar 24, 2000	1,527.46	417.0%
Oct 09, 2007	1,565.15	101.5%

Major Bottoms		
Date	Price	Decline
Oct 22, 1957	38.98	-21.5%
Jun 26, 1962	52.32	-28.0%
Oct 07, 1966	73.20	-22.2%
May 26, 1970	69.29	-36.1%
Oct 03, 1974	62.28	-48.2%
Aug 12, 1982	102.42	-27.1%
Dec 04, 1987	223.92	-33.5%
Oct 11, 1990	295.46	-19.9%
Oct 09, 2002	776.76	-49.1%
Mar 09, 2009	676.53	-56.8%

If there is a 33% chance of recession, should investors even be invested at this point?

In looking at the data provided by JP Morgan, it is possible that the forward-looking capital markets have already priced in a new Recession. For U.S. equities, the average historical Price/Earnings Ratios during expansions is 14.3 but drops to 13.3 during recessions. As of August 22nd, P/Es are around 10.5 suggesting that the stock market has already priced in a potential recession.

For bonds, the average historical real yield (after inflation) of the 10-year Treasury bond during expansions is 2.9% and drops to 1.6% during recessions. Today, real yields now stand around 0.30% (2.10% 10-year Treasury yield

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– 1.8% core CPI) suggesting that bonds have also already prepared for a potential slowdown. So if capital markets have mostly priced in a recession, which asset class should dominate investors' future asset allocation decisions?

Capital Allocation Decision: Equity Earnings Yield and the Fed Model.

Before we illustrate which asset class is superior, it is necessary to find a valuation metric that can be compared and contrasted between the two asset classes as bonds don't have a P/E and stocks don't have a yield-to-maturity. Some argue that investors can compare stock dividends to bond yields. While easy, it is important to note that when buying a stock, an investor is not merely buying a dividend stream but rather laying claim to a future stream of earnings. We can then divide these future earnings by the purchase price to give us the Earnings Yield (which is the inverse of the P/E ratio). The earnings yield can be used on a stock, a sector or the whole market and can then be compared against bond yields. Generally, the earnings yields of equities needs to be higher than the yield of treasury bonds to entice investors to accept the inherent volatility of earnings, margins, and stock prices over the smooth and predictability of bond coupons and the pre-determined return of capital at maturity (even if U.S. Treasuries are rated AA). This model, the Fed model, was popularized by former Prudential Securities strategist Ed Yardeni, and he asserts that the difference between the earnings yield on the S&P 500 and the yield on the 10-year Treasury note exposes an equity market that is either undervalued or overvalued. In the simplest of terms, if the earnings yield is higher than the 10-year Treasury yield, one would want to own stocks. The converse would hold true if the earnings yield is lower than the 10-year Treasury yield.

Capital Allocation Decision: Where should investors increase their asset allocation?

Bonds: Assuming we have a 10-year investment horizon, we have already discussed that the 10-year Treasury is priced to produce marginal after inflation returns. If we include food & energy in our inflation calculations, this "safe" asset class will produce negative real returns—and that does not even account for taxes. Bonds simply don't look attractive if history holds.

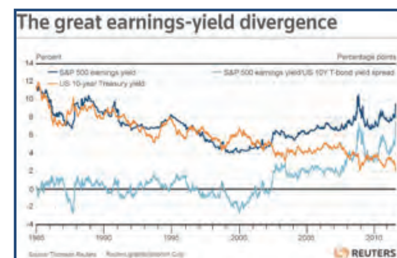
Stocks: The average P/E ratio for U.S. stocks over the last 100 years is 14 which equates to an earnings yield just over 7%. But today the earnings yield has increased to 9.5% due to the combination of still strong quarterly profits (higher earnings) and the recent sell off (lower price). Thus, relative to history stocks look attractive versus themselves.

Historically, the average yield spread between the two asset classes is 2.8%--and it has been extremely rare for spread to rise above 6.0%. Today the spread stands at 7.40% (9.50% earnings yield - 2.10% ten-year Treasury) which is a level is unprecedented over the last 30 years (this is not a prediction, but if earnings hold and equity prices revert to the mean spread of 2.8%, then the S&P would trade north of 1600 from its current level now around 1200). The case for equities is not only strong relative to its own history but also strong relative to other investment choices out there—namely bonds.

Capital Allocation Decision: Where types of equities should investors own?

But one can argue that earnings today are too volatile, that margins are at record highs and can only go down, and that the Fed Model didn't work prior to 1970. It's a valid argument in part, so let's consider another relative valuation framework—dividends. The dividend yield of the S&P 500 is 2.04%, thus the dividend yield spread is basically nil at -0.06%. But equities dividends are more attractive on two fronts: Dividends have the prospect of growth whereas bond coupons are fixed and odds favor that interest rates will rise over the next 10-years reducing the value of already-negative-real-return bonds acquired today. Furthermore, if we focus not on the stock market as a whole but merely on high quality, large-cap stocks with strong business franchises, above average dividend yields, a history of sustained dividends as well as a history of dividend growth, the relative valuation becomes even more compelling. High quality dividend stocks can be found with dividend yields of 3%, 4% and some even 5% or more.

High quality, above average yield stocks produce positive real returns at this time, and have produced real growth in the past and presumably in the future. Bonds do not produce any growth in income—thus the name fixed income. Dividend stocks deserve an increasing role in conservative portfolios.



Conclusion

It is not customary to end with gloomy news, but consider what gloomy news is these days. John Hussman of Hussman Funds (one of the more bearish investors today) calls for prospective equity returns over the next 10 to be about 5.1% annually. Although not glamorous, 5% per annum the last time we checked is still better than a 2% bond yield. With the magic of compounding, he predicts stocks could generate a 63% total return by 2021 if reinvested—outmatching any Treasury bond.

There are serious hurdles that we need to overcome on Wall Street, Main Street, Washington D.C. and Europe—not the least of which is renewed recession fears, damage to investor psyche, a lack of consumer confidence, high unemployment and a burdensome overhang of government debt. However simply put, most of that is already priced in. The time will soon be upon us when stocks again regain their status as king of the investment choices, if only because the opportunity cost of not buying stocks is so enormous.

The shrinking dollar, expanding debt and inflation - how can I protect my purchasing power?

Gary K. Liska, MS, CFP®, AIF®
Senior Partner, CFO

Heightened uncertainty, sovereign debt fears, the U.S. debt future austerity, higher inflation and taxes are front and center. Here are key themes to understand and embrace (like it or not) and plan for accordingly.

Inflation. Current CPI stands at 3.1 percent (1.6 percent in 2010), which many believe is drastically understated; real inflation is much higher. Wage pressure (employment) and housing (42 percent of CPI) are lagging economic indicators; when these indicators improve significantly, inflation can quickly ramp up.

Weak dollar. Ben Bernanke's playbook and moves by the Fed via QE I (TARP) and QE II (ending June 2010) have increased dollars in circulation, thereby devaluing the dollar and attempting to inflate the economy out of recession. The falling dollar also forces our trade partners to pursue their own inflationary policies.

Fiscal/monetary policy. The Fed funds rate is at record low levels and is remaining accommodative. Deficits in the United States and across the developed world are higher than ever as a result of the stimulus policies intended to lift the global economy. These policies and several pronounced global economic imbalances suggest an environment of rising and higher inflation.

Emerging economies transformation. Emerging economies have effectively exported deflation to the developed world for 30-plus years, and the tide is beginning to change. Commodity- driven emerging market economies will continue to face higher costs. There are warning signs of emerging market inflation, wage pressures and a higher share of global GDP.

Here are recommendations to consider that may protect your purchasing power against the double whammy of inflation and a weak dollar.

Income/debt. Inflation hedges for your income portfolio should include TIPS (Treasury inflation protected bonds), specifically short-term TIPS to reduce duration risk. "Un-fixing" your income with floating-rate bonds and floating-rate preferred stocks is a way to hedge for rising rates. Additionally, high-yield bonds and convertibles will have less interest rate risk by adding credit risk while increasing yield. These are great alternatives while the economy and corporate profits continue to improve.

Non-dollar investments. Increasing contributions to global growth from emerging economies and less from developed countries will continue to create significant value and greater return potential. Diversify a minimum 20 percent of your equity and fixed-income holdings in nondollar- denominated assets (emerging market and overseas equities, debt and currencies). International TIPS and emerging market bonds of countries with improving economies, pristine balance sheets, and stable currencies can hedge currency depreciation.

Commodities/commodity stocks. Commodities are priced in U.S. dollars on the world markets, therefore we pay more while other currencies pay less as the dollar weakens. Exposure to tangible assets and commodities, such as metals (gold, silver, copper), oil, and agriculture, is an excellent way to hedge declining purchasing power and inflation. Commodity stocks' high operating profit margins will benefit from the increase in the prices of the underlying commodity as demand outstrips supply.

Equities/MLPs/REITS. Dividend stocks with solid balance sheets and growth stocks with international reach and market share remain very attractive. The weak dollar has helped many multinational, export-heavy corporations sell more goods and services overseas and increase profits. Master limited partnerships have traditionally paid high, steady and rising dividend income and are tied to the energy and oil markets. Lastly, equity REITS (yes, real estate) should benefit as rents rise in inflationary periods in addition to the underlying tangible asset appreciation. The best time to prepare for inflation is before it begins. It is increasingly important to include explicit inflation and weak-dollar protection in your portfolio. Everyone is NOT keenly aware of the effects of inflation on purchasing power. Do not be late to the party. Act before inflation expectations are fully priced into the asset.

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SEIA Opens New Office in Redondo Beach

Adds Momentum to Consistent Caliber of Client Service

Signature Estate & Investment Advisors, LLC (SEIA) is excited to announce the opening of its new office in Redondo Beach, CA. The firm's expansion was prompted by its continued growth, addressing the need for high-caliber wealth management services throughout the South Bay community for individual and institutional investors alike.

Led by industry veterans and longtime South Bay residents, Senior Partner Vince DiLeva, MS, CFP®, AIF® and Senior Associate Eric Pritz, CFP®, CMFC, the office allows SEIA to close the gap between the firm's Century City headquarters and Irvine office. The South Bay establishment currently serves a growing client base of more than 300 families and businesses.

"We are excited to bring our expertise and superior level of service to the South Bay," said Vince DiLeva, Senior Partner, SEIA. "I grew up in the South Bay and take great pride in opening SEIA's newest office in such a wonderful community. Our team looks forward to continuing our trusted relationship with the entire South Bay and its residents through our array of wealth management services and philanthropic efforts."

"Our continued expansion is a true testament to our commitment to our clients," said Brian Holmes, President and CEO, SEIA. "I am confident that our comprehensive wealth management solutions will bring tremendous value to the residents of the South Bay, and will further develop our offering for all of our exceptional clients throughout Southern California."

SEIA's new office is located at:
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We would be happy to schedule an appointment for you to come and visit our office.

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SEIA believes that investment management and prudent portfolio allocation can be accomplished with an overall wealth management strategy.

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Assessing the American Jobs Act

Provided by Peter Montoya

On September 8, President Obama announced a new plan to improve the economy – the $447 billion American Jobs Act, a sequel of sorts to his past economic stimulus proposals. His announced goal: job creation without new taxation.

What's in this bill? The AJA would try to boost the economy through seven different tactics – extensions and expansions of tax breaks, and infusions of federal dollars.

1. The current payroll tax holiday would be extended through the end of 2012.
2. The payroll tax would fall to 3.1% - not only for workers, but also for businesses with payrolls of $5 million or less.
3. Companies could get a tax credit as large as $4,000 for hiring the long-term unemployed (people who have been out of work for at least 6 months).
4. Long-term jobless benefits would again be extended.
5. $80 billion of federal money would be assigned to new infrastructure projects (highways, bridges and schools).
6. Businesses could expense 100% of their investments in 2012, just as they have been able to do in 2011.
7. Additional federal money would be given to struggling state and local governments to help them avoid layoffs of first responders and teachers.

How could this all be funded without new taxes? President Obama states the effort can be paid for as a byproduct of his plan to reduce the federal deficit (a plan he will discuss in greater detail in a September 19 speech).

The bill isn't set in stone yet. The AJA goes to the House for a vote the week of September 12th, and though the House Republican leadership likes the essence of the plan, it may seek major alterations.

In a jointly authored statement issued on September 9, House Speaker John Boehner (R-OH), House Majority Leader Eric Cantor (R-VA), Majority Whip Kevin McCarthy (R-CA) and Conference Chairman Jeb Hensarling (R-TX) said the plan "merits consideration", but they also hoped that the President's ideas were not offered "as an all-or-nothing proposition, but rather in anticipation that the Congress may also have equally as effective proposals to offer for consideration."

What do economists think the AJA could accomplish? Some think the economy would get some short-term relief if it became law. Others see an upcoming object lesson in failed Keynesian economics.

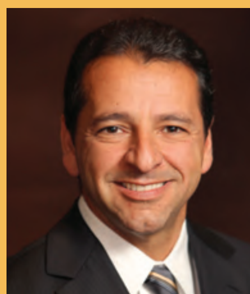
- Moody's Analytics chief economist Mark Zandi is big on the bill – he believes it could add 2% to GDP, cut 1% off the jobless rate, and create 1.9 million jobs in an economy "on the edge of recession".
- University of Pennsylvania Wharton School of Business professor Susan Wachter thinks the payroll tax reductions alone could generate 1 million jobs and expand the economy by 1%.
- At Pimco, Mohamed El-Erian calls it a "credible program that is focused on the right structural areas."
- Unicredit's Harm Bandholz thinks the AJA could "add up to 2 percentage points to growth in the coming year."
- "Bottom line: not a lot of bang for the buck here," states Tom Porcelli of RBC Capital Markets, who feels that the economic impact of the infrastructure investments will likely be "fairly modest … the red tape and politics involved in allocating these funds makes the implementation a long and drawn-out process."
- The Heritage Foundation's J.D. Foster sees "a bunch of retread policy ideas that two years after they were first tried managed to create an arithmetic novelty – exactly zero job growth in August. In total, the President is calling for more new spending on proven policies that are proven failures."

As the economy is in such a low gear, you may see Democrats and Republicans support the bill with newfound unity or at least tolerance. While America can't reach across the Atlantic and fix the Eurozone crisis hampering world stocks, this envisioned stimulus could help our economy make some small strides.

Did You Know?

Did You Know?

Paul Taghibagi, Vince A. Dileva, Theodore E. Saade and Deron McCoy recently received their Accredited Investment Fiduciary® (AIF®) designation. This specialized designation can be an invaluable resource to investment management clients, private foundations and ERISA retirement plans. The AIF® designation represents their knowledge of Global Fiduciary Standard of Excellence and their application of the global standard into their own practices.



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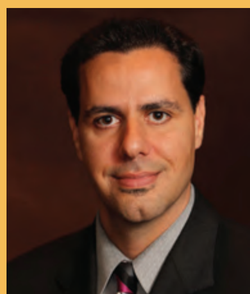

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