

The Aftermath

November 2010



Well, at least that's over.

But what does it all mean? As always, we will try to minimize the political analysis and focus instead on the issues we believe are of the most importance to the long-term investor, to people trying to make some sense of all this. Over the last two years we have had a million questions about the economy and the market, with many people basically asking us to explain why they ought to invest in the market despite all the terrible problems they see, such as:

- No end in sight to the real estate debacle
- 9.6% unemployment, not improving at all; we are stuck
- Doubling the national debt in two years, to well over \$10 trillion
- Banks still very weak and vulnerable
- Dysfunctional politics
- Fed policy seeming to have no effect:
 - Fed funds at zero, now what?
 - "Quantitative easing" – buying another trillion dollars of treasuries?
 - Banks are sitting on all the free cash, not lending
- Major legislation, such as healthcare reform, with huge and unknown consequences coming down the pike, creating fear and uncertainty
- Consumption still sharply down
- Businesses sitting on a \$2 trillion cash hoard, not investing and not hiring, fearful
- Big tax increase starting in January? Will Congress act effectively for a change? Want to count on them? I didn't think so...

The list goes on ad infinitum. And yet the market has done very well! As always, the market was looking past our present troubles and comparing the most likely future outcomes to the values assigned to businesses today, and the market decided it was, on balance, time to buy at bargain prices.

By March of 2009, the market was pricing in mass nationalization of the banking system and a shutdown of the American auto industry. Fortunately those fears went unrealized. Then, rather impressively, corporate managers adjusted to the new economic reality with great urgency and effectiveness. It is said that earnings are the mother's milk of equities. We are completing yet another surprisingly strong quarterly earnings season. For the full year 2010, earnings for the S&P 500 are expected to jump 42.4% and then another 11% in 2011. No industry sector is expected to see an earnings decline in 2010. And it is not just cost cutting -- revenues, excluding financials, are expected to grow 8.36% in 2010 and 7.00% in 2011.¹ Corporations are healthy and are able to finance themselves very cheaply -- not so surprising, therefore, to see market values recover to pre-crisis (Lehman bankruptcy) levels.

Now that the big event (the mid-term election) has happened, will the market once again "buy on the rumor, sell on the news"? Depends on who you ask; as always, there is no dearth of opinions.

Our "New Normal" friends at PIMCO aren't sure. Mr. El-Erian wonders if divided government will help or hinder the process of addressing our big issues:

"The uncertainty relates to the basic characterization of the economy,' he added. 'Will animal spirits be ignited just by reversing the intrusion of government or does the economy requires meaningful reforms to deal with structural rigidities, debt overhangs and the malfunctioning of the housing market?'"²

Meanwhile, up the hill in Woodside, Ken Fisher was less tentative, calling for the S&P 500 to rally "as much as 16% in the next six months," as Congress stops legislating, and presumably doing less damage, in a state of gridlock.³ I guess we will see how this develops soon enough.

OK, a little about the Politics

To put it in simple terms, the electorate was very unhappy with the Republicans and the Bush administration, and pounded the Republicans in 2006 and 2008. But policy since 2008 has not pleased the voters at all, and this time they pounded the Democrats. I think it fair to say that the last several elections have been largely determined by voter unhappiness and desire to see effective change; both parties are viewed unfavorably. And time is short; deliver soon or stand by for the consequences.

There has been a lot of talk about what this is about, whether the voters are angry and out of control, ignorant and emotional. Interesting question -- are the politicians wise and mature,

¹ Van Dijk, Dirk (2010, Nov 1). "Still Going Surprisingly Well". *Zack's Investment Research*. Retrieved from <http://www.zacks.com/newsroom/commentary/archive.php?=2>

² Benjamin, Jeff (2010, Nov 3). El-Erian: 'Jury still out' on gridlock's boosting the economy. *Investment News*. Retrieved from <http://www.investmentnews.com/article/20101103/FREE/101109975>

³ Bloomberg (2010, Nov 3). Ken Fisher: Look for 16% post-election rally. *Investment News*. Retrieved from <http://www.investmentnews.com/article/20101103/FREE/101109978>

abused by those ungrateful voters, or are the fundamental workings of democracy, messy as they appear at times, once more stopping people in their tracks and causing course corrections that may just turn out to be beneficial? One thing we do know is that one often needs the passage of time before these things become clear; in the heat of the moment it is often difficult to discern the truth.

One of our favorite books

New Yorker business columnist James Surowiecki, in his marvelous book *The Wisdom of Crowds*, says that "under the right circumstances, groups are remarkably intelligent, and are often smarter than the smartest people in them." He proceeds to develop and support a compelling argument that large, diverse groups of people with independent opinions frequently prove to be far wiser than the smartest "experts" (p. xiii).⁴ I would add that we have always believed that the financial markets, as imperfect as they are, defy the experts on a regular basis, and are better at forecasting the future than the best highly paid Wall Street prognosticators. In fact, it usually proves to be no contest at all.

This is a wonderful book, and one that will cause you to rethink much of what you might believe now about the knowledge and wisdom of "experts." I suggest we are seeing the "unwashed masses," so despised by beltway elites, expressing a sharp difference of opinion with first one political party and then the other, trusting neither. I am betting on the voters and hoping for the best. How about you?

Sincerely,



Roger C. Hewins III
President

⁴ Surowiecki, James (2004). *The Wisdom of Crowds*. New York: Anchor Books.

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