# KWAG March E-mail Update

Good Afternoon! We hope this update finds you well and looking forward to a warm and beautiful spring after this cool harsh winter. Thankfully, my favorite season – spring - is just around the corner. I love the spring because it provides a sense of renewal and new growth. Unfortunately, my expectations going into the spring are always too high. Every year, I expect all of my flowering trees to explode with amazing color and then I expect my tulips and creeping phlox to accentuate the trees with spectacular color, which I expect to last for months. Of course, I always have to remind myself to temper my expectations and just enjoy whatever spring provides for me. It has taken a long time, but I am now learning to manage my expectations and just enjoy the hand that nature deals me each and every year.

Unfortunately, I view my spring garden like many investors view the financial markets. Sometimes all of our expectations are just too high. I find myself constantly reminding investors that things are never as good (nor as bad) as they seem. Then I look at my garden and realize I should be taking my own advice. Of course, I ignore it…

**The Markets**

Over the last three and a half months the markets have enjoyed a significant rally. In fact, since mid-November 2012, the S&P 500 has increased 12%, while the Russell 2000 is up more than 18%. When the markets rally significantly like this, we find some investors get very antsy about their deposits being invested immediately. In addition, we find some investors want to shift money out of bonds into stocks, even though nothing has changed regarding their goals or time horizons. They simply don't want to miss the next upward move and they tend to get aggravated if everything doesn't happen "yesterday". It's a natural reaction, which we have come to expect, since it falls right in line with the research on investor psychology.

As fear dissipates from our subconscious and becomes more of a distant memory, greed often takes over. It's a subtle shift that takes place over years. Unfortunately, we also know that this kind of behavior can signal market highs. When people are clamoring to get into the stock market, and then calling us out of the blue to increase their stock allocations…it's usually a sign that the stock market is overdue for a pullback. This indicator isn't perfect, but it's been pretty darn accurate over time.

So, you're probably wondering how the stock market performed for the month of February? From the beginning of February through Fridays close, the S&P 500 and the Russell 2000 are virtually unchanged. However, volatility—another signal of a topped out market—was up significantly. This has us somewhat concerned.

**My Point:** Between the middle of November and the end of January we had a heck of a run, where stocks beat bonds by a significant amount. If anything, prudent investors should now be rebalancing away from stocks…not increasing our allocations to them. However, individual investors are prone to doing just the opposite, by chasing what's hot. Many believe the stock market will continue to grow at an explosive pace over the short run. Maybe it will, or maybe it won't. We don't pretend to know what will happen over the short run. What we do know is that we've had one heck of a nice rally and now is probably not the best time to get greedy. The best time to be greedy is when everyone else is fearful, as Warren Buffett has always said. Look at investors today and you see fear subsiding and people taking on a lot more risk. At times like these, it pays to remain patient and stick to your long-term investment strategy.

**Government Debt**

On the opposite side of the spectrum we have the fearful and politically sensitive issue of the national debt. Most people are under the impression that we have

run-away debt, and assume we need to do something drastic today in order to save ourselves from tomorrow. In fact, they're wrong on both counts.

Unbeknownst to the majority of the American populace, the U.S. Government posted a $3 Billion budget surplus in the month of January. Yes, you read that right. For the first time since 2008, the government actually collected more than it spent! Although this tiny surplus does little to reverse the $290 billion in debt accumulated since October 2012, the fact that there was a surplus at all suggests the fears of a run-away deficit are a tad overblown. Indeed, the Congressional Budget Office (CBO) estimates the budget deficit will shrink to $845 Billion this year, which equates to just 5.3% of Gross Domestic Product (GDP), the smallest annual budget deficit since 2008. Also largely unnoticed, is the fact that this continues a three-year trend, where the budget deficit has fallen from 10% of GDP down to an estimated 5.3% of GDP by year-end.

In other words, we are already moving in the right direction, and we are doing so at the sort of methodical, measured pace that won't unduly harm the still fragile economic recovery. The truth is, the best way to reduce our deficit is to generate more tax revenue, and the only way to increase tax revenue without raising interest rates is to continue to grow the economy. A growing economy makes it possible to reduce the budget deficit, without painful spending cuts or tax increases. This is what everyone in Washington should be talking about. Today, as we write this, the economy now has enough momentum to grow all by itself…so long as Washington stays out of its way.

Interestingly, as we look two or three years out, our fiscal debt picture gets even better - even with the tepid CBO growth and unemployment forecasts. Specifically, the CBO believes the budget deficit could be cut in half (from today's levels) by the end of 2015. This implies we have plenty of time for comprehensive budget reform. Beyond the next three years, the picture dims a bit as an aging population, rising health care costs, and growing interest payments on the federal

debt will all put more pressure on the budget. As a result, the CBO anticipates that the deficit as a percentage of the GDP could start rising again in 2016.

In other words, the near term problems are not as bad as the media and our politicians portray them. However, we need to be working on our longer-term challenges now, while we still have time.

**My Point:** Nothing is ever as good or as bad as it seems and it's easy to let emotion trump intellect. Our belief is that the stock market will probably continue grinding higher throughout the remainder of 2013, but we suspect volatility will continue to rise, maybe significantly, thus increasing the potential risk exposure in our portfolios. In the long run we still feel the prospects for stock investors are terrific, but we may experience some turbulence in the near-term. If your goals and time horizon have NOT changed, then it makes no sense to change your long-term portfolio allocation. If your goals or time horizon have changed, then we need to sit down and have a discussion.

We when examine the national debt, we see no reason to be overly concerned, so long as the deficit continues to shrink relative to GDP. We would clearly prefer a balanced budget over any type of annual spending deficit. Who wouldn't? However, given the hand our economy was dealt four years ago, we believe we are on the right path, and any hysterics regarding the impending bankruptcy of our grandchildren's future are just that…hysterics.

**In Closing**

As usual, if you have any questions about this update, our newsletter, your statements or our managers, please feel free to contact us or e-mail us at any time. The recent referrals are much appreciated, and as always we remain 100% committed to your financial well-being.

- **Joe and The Gang at KWAG**

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