KWAG August E-mail Update

Good Morning! I hope everyone is enjoying this hot summer and I hope you are staying cool. This summer, I have had the pleasure of visiting both my Mother in upstate NY and my siblings out west and on the coast. In each place, I have encountered record heat everywhere I've been. Apparently we are headed for another hotter than average summer. The good news is the heat has lit a small fire under the stock market. Since July 1st, the S&P500 and the Russell 2000 have increased over 9%. In essence, after a few months of consolidation, it looks like the market is ready to move onward and upward.

My Observations

In my 23+ years of teaching finance in academia/or managing assets, it has always been interesting to observe how the stock market digests both micro-economic and macro-economic news. As everyone knows, both play a very important (and interesting) role in how we value stocks individually and as a whole. Many people don't know that my first academic job as an adjunct professor was to teach micro-economics. I love that class, as it provides an important framework for understanding how companies work and behave individually and in groups. A few years later, I had the privilege of teaching macro-economics, which examines the business world and our economy in aggregate. Each economics class provides unique and valuable insights into how our economy works. However, you have to be careful how you use the information when it comes to long term investing.

Difference Perspectives

Our managers spend most of their time looking at individual companies and how they behave. In essence, they look at the economy from the "bottom up." Specifically, they are interested sales, earnings, cash flows, market share and the like. Today, they are optimistic as they see clean balance sheets, excellent cash flows, record productivity and consistent growth. They obviously look at the overall economy, but they are much more interested in the specific companies within the economy. Most individuals, on the other hand spend

most of their time examining the economy (and thus our stock market) from a macroeconomic perspective. Specifically, they worry about unemployment rates, deficits and credit crunches. In essence, they look at the economy from the "top down." They examine a few companies, but are much more interested in (or exposed to) the aggregate numbers. Frankly, most investors have very little time to dig deeper than that. In general, they get small snippets of broad economic news (like GDP or our deficit) and use that to make economic decisions.

I hope you see the important distinction in each groups perceptive.

Here's the Problem

At the end of the day, we are buying companies…not our deficit or GDP. As everyone knows, when you aggregate (or lump) everything together, it can obscure individual industries or sectors that may be thriving or be undervalued. This in turn can lead to some very poor conclusions about the economy and/or long term investing. Over time, the reporting of macro news and micro news seems to oscillate back and forth in its importance to market participants. When market participants focus on macroeconomic issues, such as economic cycles, credit conditions, interest rates, and Greece – it's usually for the worse, when it comes to performance. In contrast, when market participants focus on the fundamentals such as earnings (which we think ultimately drive stock prices) – it's usually for the better.

Observing 2010: The First Quarter

In January, traders and market participants were obsessed with inflation, Greek Debt and Spending. Macro items. And, in turn the market decreased. Then, when we started to get earnings reports from each company for 2009, the information set shifted and prices increased. Why? Well, companies ended 2009 with record levels of free cash flow and the global economy continued to advance steadily. In addition, first-quarter earnings of the S&P 500 companies were up a whopping 57% from the previous year. As a result, by the end of April the S&P 500 and the Russell 2000 had increased more than 5% year-to-date…and over 80% from their lows one year earlier.

Observing 2010: The Second Quarter

Of course, in May investors began to obsess about several macroeconomic issues like the sovereign debt crisis in Europe; China's efforts to reign in its steamroller of an economy; and the United States' stubbornly high unemployment, drooping consumer confidence, and weak housing market. All of these issues, it was feared, might lead to a double-dip recession in the U.S. The notion of pessimism was further reinforced by the awful TV pictures of oil gushing out of the Deepwater Horizon well in the Gulf of Mexico. With fundamentals taking a back seat to macroeconomic worries, the S&P 500 and the Russell 2000 dropped about 15% from its near-term peak to its low on July 2. We believe the market took a normal pause that was exacerbated by the macro-economic news. Since that time, daily earnings reports have come back into the forefront.

The Current Micro News?

The earnings news has on balance been encouraging, to put it mildly. About 300 of the S&P 500 companies have released their earnings to date, and about 77% of them have beaten Wall Street analysts' estimates, according to Thomson Reuters. That's the highest percentage of positive earnings surprises since Thomson Reuters began compiling the data 16 years ago. Earnings per share have risen an average of 35% year-over-year, compared with a rate of 27% that was expected by analysts just a few months ago. And companies aren't just reporting better profits - three out of four of them are also beating revenue targets as well. In response, the S&P 500 and the Russell 2000 has rallied 9% from its July 2nd low.

So, where do we go from here?

Well, after the earnings season is over, people will obviously obsess about macro events again. If you follow the media, you know it's not that difficult to find bad news. In other words, investors will grimly resume their preoccupation with macroeconomic matters like Europe's government debts, China's slowing economy, and higher than normal unemployment. For our part, we think micro-economic news will win out over time and command center stage for an

extended period (or over the long run). As we see it, the perception of macroeconomic conditions is worse than the reality of those conditions. If perception changes for the better, it may help concentrate investors' minds on the favorable fundamentals for the rest of the year. Of course accentuating the positive is always difficult when investor sentiment is largely negative.

How Negative?

In a recent article, Forbes magazine characterized current investor sentiment as "*battered investor syndrome; a form of slow psychological torture that can eat away at your confidence and your portfolio. In essence, it makes you want to just sell stocks and curl up in a fetal position."* But before you curl up in a fetal position, we would like to point out three items, which I will spell out in more detail in our next monthly update.

First, Europe is commendably addressing its sovereign-debt problems head on. And for those who compare their crisis to Lehman Brothers in Oct 2008, you fail to recognize a key difference between the two. For now, note the Euro's recent strength.

Second, the Chinese (who have the third biggest economy worldwide) and other non-European emerging market economies are still growing at a rapid clip. These consumers are only going to increase over time. This is great news for our world economy long term.

Third, although the U.S. economy is in fact slowing, employment is starting to improve, housing appears to be bottoming, capital spending and inventories continue to revert to normal levels, and consumer spending is growing at about a 3% annualized pace. As such, we consider the recent signs of economic sluggishness nothing out of the ordinary. In fact, if you go back and look at previous recoveries, it's quite normal.

So, overall, we believe the fundamentals of individual companies will more than outweigh macro-economic fears. And at this point, the data confirms this stance.

In Closing

As usual, if you have any questions about this update, our newsletter, your accounts or our managers, please feel free to call or e-mail us anytime. Enjoy the rest of your summer…and thank you for your continued confidence in our firm. The recent referrals are much appreciated and as you know, we remain 100% committed towards your financial well being at all times. As we go forward, we remain committed to continuing to refine and improve our proactive strategies and portfolios. As always, our goal is to provide each of our clients with the best possible mix of assets given their particular situation. If you need anything or your goals or time horizons have changed, please do not hesitate to call or drop an e-mail to set up an appointment. We are here to serve your financial needs, whatever they may be.

- ***Joe and The Gang at The Kiely Group***