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Glenn Woody
Certified Financial Planner

What Next?

On any given day, some case may be made for the market rising from here and a usually equally credible case can be made for the market sinking from here. That is because there is always something to worry about and economic signals never all point in the same direction at the same time.

This market advance is now two years old and the gains have been considerably above average. After all that, does the market still offer any upside?

Two years ago, investors had priced securities for the second coming of the Great Depression. Perhaps the actual risk at that time was the lowest in modern times simply because the perceived risk was the greatest. But, that is hindsight.

The investing mindset has turned somewhat more optimistic since then. The economic recovery finally appears sustainable. Deflation risk has seemingly passed while concerns about inflation are now growing. The question of when the Fed will raise interest rates is big on everyone's mind.

However, against this backdrop, questions remain numerous and the decisions facing investors seem increasingly challenging.

In the next 12 months, what will be the dominating theme driving the market? Does the market still have some gain left in it? Will small caps and emerging market stocks continue to lead or is it time to be more defensive, by turning to large domestic stocks? When and by how much will inflation be a threat? When will the Fed begin to tighten? What will be the fate of the U. S. dollar?

We think the positives continue to outweigh the negatives.

Job gains are increasing, enough to suggest about 4 percent real GDP growth, to lower the unemployment rate by about 1 percent a year and make the economic recovery feel rather normal for a change.

Contributions to growth from business investment spending, renewed consumer spending and more gains in net exports should outweigh any pressure on GDP growth coming from weaker government spending or continued weak housing and construction.

It is obvious that developed economies are still struggling with their debt issues and slow growth, while emerging country economic growth rates should continue to outpace the developed ones. So, it appears continued exposure to emerging markets, and even emerging market small caps is appropriate.

A History Refresher

The stock market is a leading indicator for the economy. It changes directions in advance of a change in the economy usually by some 3 to 9 months, averaging 6 months.

We were in a deep recession and a stock market slump of a severe magnitude through 2008 and into 2009. The stock market bottomed on March 9, 2009, and started a dramatic climb. A bit ahead of schedule, the economy turned up and the recession was declared over in June/July 2009.

So, it has been two full years since the market turned and we are approaching the second anniversary of the end of the economic slide. During that time, we all have been subjected to one "end of the world" disaster after another. The disaster du jour is Middle Eastern tension and resulting oil prices, the on-going saga of European sovereign debt risk and lately the triple tragedies in Japan.

In spite of it all, the markets and the economy have persisted in improving, climbing that proverbial "wall of worry". Both have continued to perform better than expectations.

In mid-2010, most expected 1.5-2% GDP growth for the last half of the year. Instead, it came in at 2.7%. In March of 2009, 67.5% of the S&P 500 companies beat Q1 2009 earnings estimates. Now, in the most recent quarter, 67.8% of those companies outpaced earnings expectations. Throughout this two-year period, earnings have been so stellar that Wall Street can't seem to catch up with Main Street, in spite of the dramatic rise in stock values.

So, isn't the market over-valued after its eye-popping run-up? That relative valuation is most often measured by the price/earnings ratio (PE). Surprisingly, not much has changed.

In March 2009, the S&P 500 Index was at about 13.5 times the one-year forward earnings estimate. Even after the market advance, that same index is trading at a PE ratio that is actually lower at about 13.4 times. And, interest rates have remained virtually unchanged, also. As a result, the stock market is no more expensive today, on either an absolute PE basis or relative to interest rates, than it was two years ago.

The issues that typically warn of a cycle end are not yet evident. Greed has not overtaken fear. The economy is not sputtering. Company earnings are not disappointing. Officials have not raised interest rates and choked off liquidity. Businesses and households are not out of cash. Companies are not overstaffed. Businesses are not over-invested in buildings and equipment. Folks are not paying too much for houses. Banks are not lending too much. Consumers and businesses are not borrowing too much. Investors are not over-exposed to the stock market. The market is not over valued.

To be sure, we have some issues to worry about but, all-in-all, things sum up pretty well when you look at the overall picture.

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# Economic Highlights

## April 2011

### Positive:

- The Leading Economic Index increased 0.8% in February. The Coincident Economic Index increased 0.2% and the Lagging Economic Index increased 0.2%.
- Nonfarm payroll employment increased by 216,000 in March, and the unemployment rate was little changed at 8.8%.
- Real (adjusted for inflation) gross domestic product increased at an annual rate of 3.1% in the fourth quarter of 2010.
- Economic activity in the manufacturing sector expanded in March for the 20th consecutive month, and the overall economy grew for the 22nd consecutive month.
- U.S. retail e-commerce sales for the fourth quarter of 2010 increased 5.6% from the third quarter.
- Personal income and disposable personal income each gained 0.3% in February.

### Mixed/Cautious:

- Consumer confidence declined sharply in March due to rising gas and food prices. The index was 67.5, down from 77.5 in February.
- The Consumer Price Index increased 0.5% in February. Over the last twelve months, the index increased 2.1%. The Producer Price Index increased 1.6% in February.
- New home sales in February were 16.9% below January and 28% below February 2010.
- Sales of existing homes fell in February after three straight monthly increases. According to the National Association of Realtors, homes sold at an annual rate of 4.88 million in February, down 9.6% from January and 2.8% lower than February 2010 sales.
- New orders for manufactured durable goods in February decreased 0.9%. This decrease, down four of the last five months, followed a 3.6% increase in January.
- Industrial production declined 0.1% in February after rising 0.3% in January.
- Construction spending in February was 1.4% below January and 6.8% below February, 2010.

### Informational:

- March saw value outpace growth, and small-caps and domestic stocks fared better respectively than large-caps and non-domestic.

## FYI: Short-Term Observations

*These comments are offered for your information and thought. They are short-term and tactical in nature. We invest for the long-term, three to five years plus. Don't confuse these short-term observations with what may be the best decisions for the long-run. Some even believe it is confusing, at best, and distracting, at worst, to involve short-term issues in long-term investing.*

### Markets Move On and Up

**T**he first line in the April 1 *Wall Street Journal* article about the market reads, "Overcoming a pair of major shocks in the first quarter, global financial markets recovered amid growing optimism that the recovery from the financial crisis had become self-sustaining".

The 6.23% gain in the Dow was the best first quarter in 12 years. But, as has been the norm in recent months, there was enough volatility to give investors queasy stomachs. In the month of March alone, the Dow had 16 days in which the index traded up and down in a triple-digit range over the course of a single day.

The European debt crisis continues to loom large in the news. The latest shaky country is Ireland with talk that their banking system may have to be nationalized.

There is increasing questioning about when the Fed may begin to raise interest rates and what stance they may take as the end of their unprecedented second round of quantitative easing (QE2) approaches. The strategy will end in June. It is unclear what the Fed will do next. It is also unclear how much good the stimulus has provided to the economy and the markets. Most of the Fed's conversation lately indicates a coming end to their loose policy. The Fed meets next on April 27.

It is thought that the cheap money has been a stimulus to the rally in stocks and commodities, so the end of that benefit would stifle future gains. The other side of the coin, however, suggests an end to the QE2 policy would signal policy makers' comfort with the continuation of the economic expansion, which in turn could cheer stock investors.

### A Plus...Barely

**T**he month of March was rocked by the fall-out of the triple tragedy in Japan, on top of the continuing concern over rising oil/gasoline prices. But, it managed to come in with a mixed, barely positive result, depending on which index you consider.

Here are the results:

#### Dow Jones 30 Industrials

|                |           |
|----------------|-----------|
| March          | + 0.08 %  |
| Last 3 months  | + 6.23 %  |
| Year to Date   | + 6.23 %  |
| Last 12 Months | + 13.48 % |

#### Standard & Poor's 500 Index

|                |           |
|----------------|-----------|
| March          | -0.07 %   |
| Last 3 months  | + 5.40 %  |
| Year to Date   | + 5.40 %  |
| Last 12 Months | + 13.43 % |

#### NASDAQ Composite

|                |           |
|----------------|-----------|
| March          | + 0.04 %  |
| Last 3 months  | + 4.82 %  |
| Year to Date   | + 4.82 %  |
| Last 12 Months | + 15.97 % |

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