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World Cup Fever

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World Cup Fever

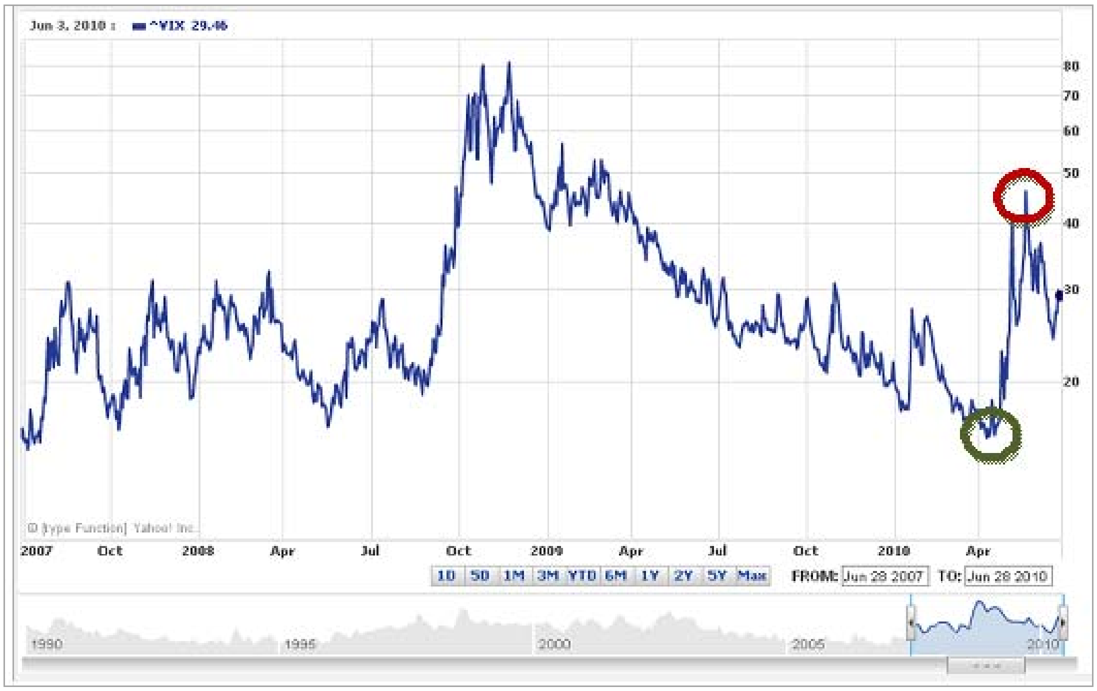
Once every four years, the world stops spinning and fixes its collective eye on soccer, better known as futbol around the globe. Over 200 nations vied to compete in the 19th rendition of the World Cup and 32 made it to the spectacular stadiums of South Africa. Over the course of 31 days, they compete fiercely against each other, first in group play and later in elimination matches, until the champion is crowned on July 11th, 2010. For each of those 32 teams, the weight of an entire nation sits squarely on the shoulders of a dozen athletes and their coaching staff. Fans are unforgiving – high expectations are par for the course and anything less than a trophy is deemed a failure.

The U.S., too, has been swept by soccer fever. At every sidewalk café, in every bar, beside every office water cooler, people are talking about it. Who will be the World Cup champion? With some early favorites making an early and embarrassing exit – think France, Italy, and even England – odds are changing by the day. Unfortunately, after a storybook victory over Algeria, the U.S. lost to Ghana in the round of 16 and is also heading home. Of the teams that are left, it appears that Brazil, Argentina, Germany, and Spain have the highest chances of winning the Championship. But, as the last couple of weeks have shown, the sport is completely unpredictable. One too many yellow cards, a serious injury, or a missed referee call can quickly turn a match around. The final outcome is hard to predict. So we keep watching…

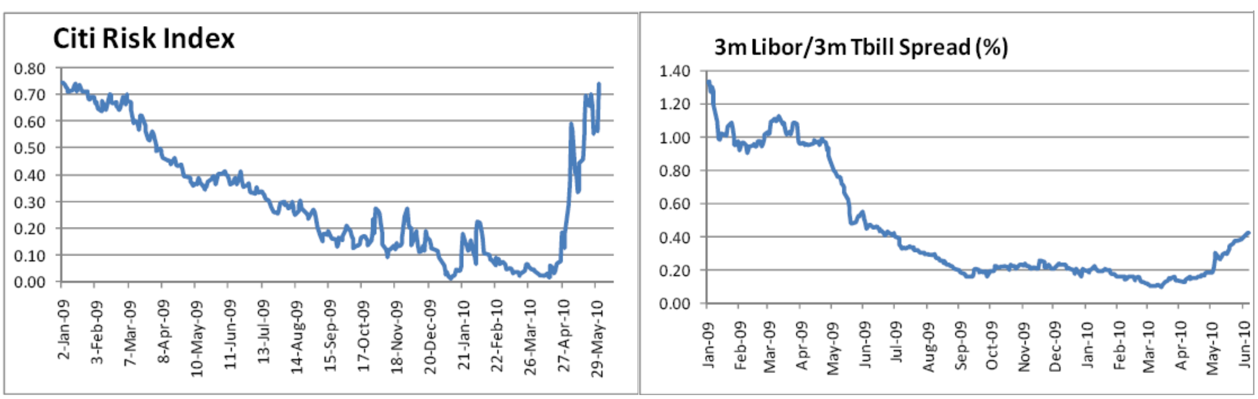
Meanwhile, financial markets seem to be having their own case of summer fever. In just a matter of months, the environment has shifted to one characterized by heightened uncertainty and the return of volatility. According to the latest Investors Intelligence Survey, bearish sentiment has reached levels last seen in mid 2009 (source: Bespoke Investment Group). Investors' concerns today stem from the weaker members of the European Union (the equivalent of injured players on a soccer team), the impact of the BP oil spill (a red card leading to an automatic ejection), legislation and rhetoric out of Washington, DC (game-changing referee calls, some good, others not so), and the potential for a double-dip recession (going into extra time to decide the match).

In discussing the current market dynamics, one investment manager stated that: "*The European sovereign debt crisis and the austerity plans now being considered have created the greatest source of uncertainty, but there are several other factors unsettling the markets, such as the outlook for corporate earnings, global financial reform, ebbing government stimulus and upcoming tax increases. In the U.S. and Europe, governments are struggling to contain record deficits while simultaneously* *addressing high levels of unemployment and trying to avoid a double dip recession, which would be far more damaging, difficult, and costly from which to recover. There is significant disagreement as to which goals to prioritize and how best to accomplish them. One camp is arguing for further fiscal stimulus and the other for fiscal austerity, with each believing their approach to be best for boosting the economy and addressing deficits.* (Source: A.R. Schmeidler & Company, Inc.)

As a result of all this uncertainty, measures of volatility have escalated to levels last seen in early 2009. The VIX Volatility Index hit 45 last month, up significantly from its recent low of 15. The 10-year Treasury bond yield pulled all the way back to 2.95% on June 29, 2010 in a classic flight-to-safety move. Funding and credit market spreads have widened as risk aversion quickly replaced risk appetite as the predominant mindset of fixed income market participants.

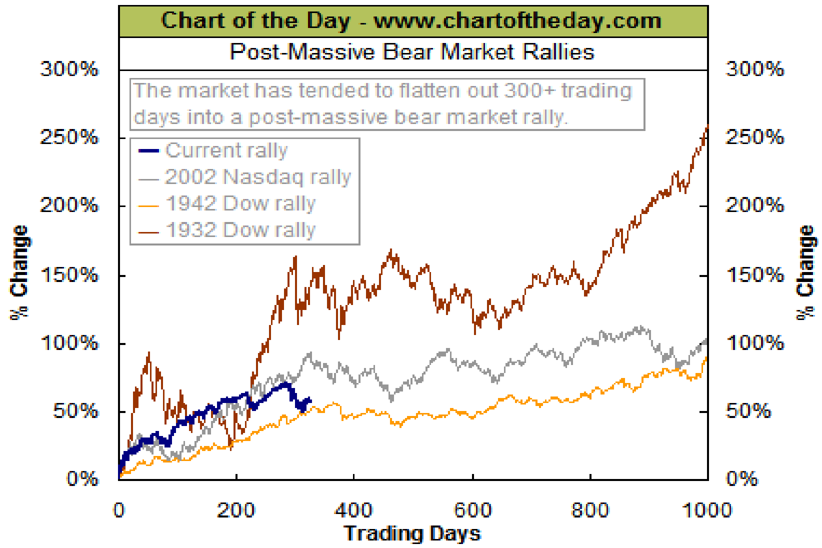


Source: Yahoo Finance



Source: Sage Advisory Services, Bloomberg

Negative market returns in May and June erased early-year gains and put the indices back in the red for the year-to-date period. This latest correction, which followed a strong market rally, is consistent with patterns seen in previous cycles. According to Chart of the Day, "…*since the Dow's inception in 1896,* *there have been only three bear markets whereby the Dow declined more than 50% (early 1930s, late 1930s until early 1940s, and during the very recent financial crisis). Today's chart also adds the rally that followed the dot-com bust during which the NASDAQ declined 78%. The current Dow rally has followed a path that is fairly similar to that of the NASDAQ rally that began in late 2002 as well as the Dow rally that began in 1942."*



Source: Chart of the Day

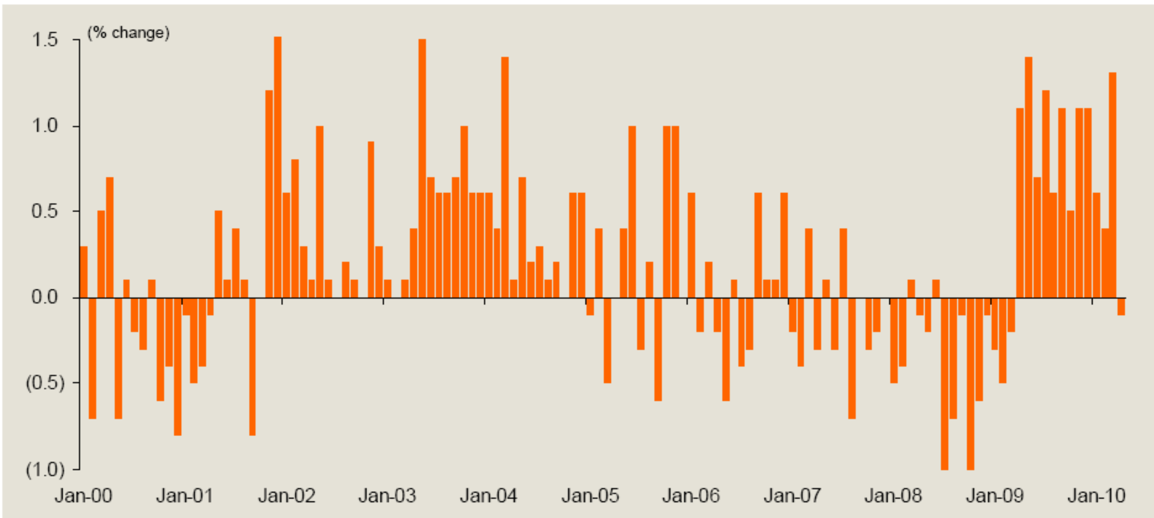
Confidence in the global recovery has waned, with many questioning the validity of various indicators showing several quarters of improvements in industrial production, consumer spending, corporate earnings, and – ultimately – GDP growth. When an economy bounces back from the depths of a severe recession, it is not unusual to see a strong initial surge, followed by a stabilization, or even partial retracement of the gains. However, financial markets can interpret this transition as the start of a new recession. In addition, an ever-expanding government involvement infinitely complicates matters and increases the level of uncertainty. Accordingly, worries of a double-dip have resurfaced and investors are wondering "what if":

- What if we have a double-dip recession?
- What if the challenges faced by Greece and the Eurozone worsen and spread to the U.S.?
- What if "cap and trade" passes? What if the Bush tax cuts expire?
- What if we have deflation?
- What if we have <u>in</u>flation?

So many possible scenarios, so many unknowns… It is as difficult to know how the next 2-3 years will play out for the world's financial markets as it is to predict the World Cup Champion at the start of the tournament. We do know that the world's economies are facing serious challenges and that pessimism has once again reached an extreme point. To help clients make sense of these challenges, we discuss some of them below in further detail. As always, however, we remain focused on understanding our clients' long-term goals and on devising the most prudent strategies to achieve those goals.

As a sign that the economy may be losing some steam, April saw the first dip in the U.S. Leading Indicators gauge after 12 consecutive months of strong gains. (May followed with a positive LEI reading, not reflected in the chart below.) New home sales reached a new record low as the government's homebuyers' tax credit program expired. Retail sales declined in May as well. And finally, consumer confidence tumbled 10 points in June on renewed worries about the job market, the oil spill, and the sovereign debt crisis.

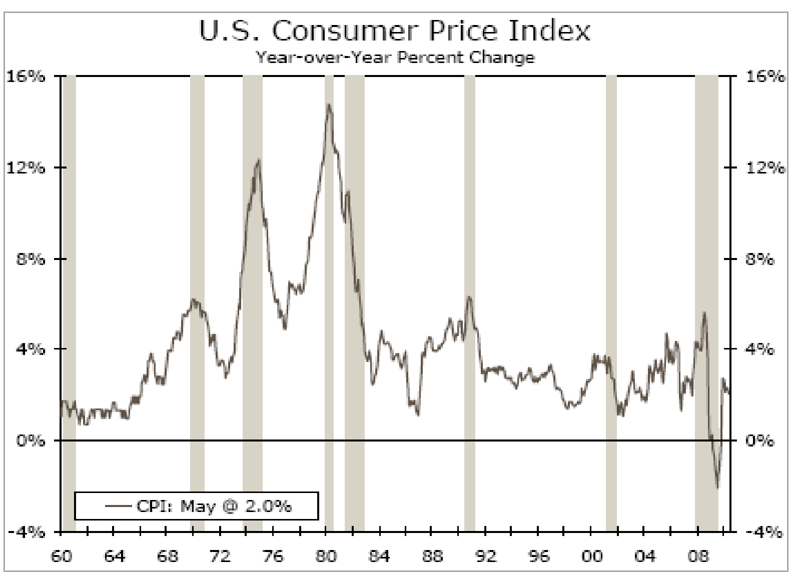
U.S. Leading Indicators



U.S. leading indicators failed to meet expectations in April, dropping 0.1%, the first decline since March 2009, following a 1.3% increase in March.

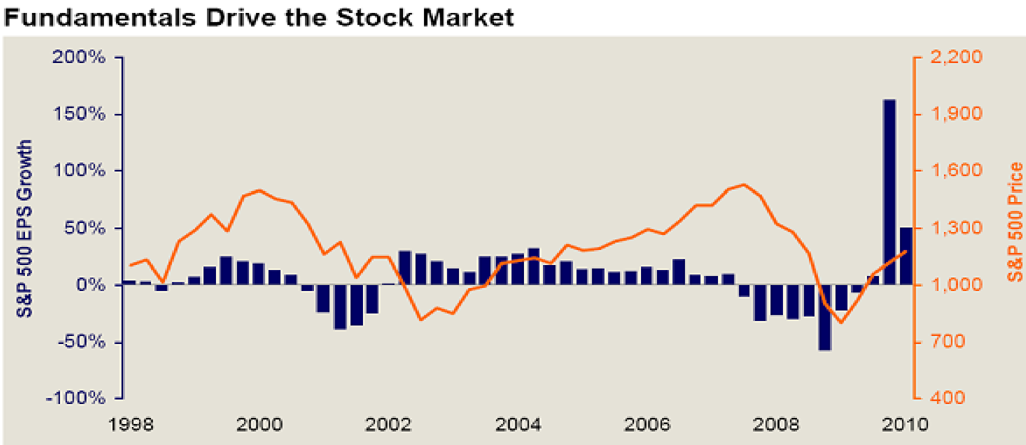
Source: ING Global Perspectives

On the flip side, industrial production and durable goods orders (excluding the volatile commercial aircraft industry) stayed in recovery mode in May, corporate profit margins are expanding, and earnings growth – at least for now – reflects both top line expansion and cost cutting benefits. Inflation remains tame, with the May readings at 2.0% for CPI and 0.9% for Core CPI.



Source: Wells Fargo Economics Group

The direction of equity prices going forward can be driven by either company-specific fundamentals (which on balance seem to be positive) or headline risk (which is decidedly negative). In an environment of low inflation, low interest rates, and ongoing cyclical tailwinds, corporate America is in a good position to continue to post solid earnings growth. Valuations, especially for high-quality companies, are reasonable. As the following chart illustrates, the correlation between fundamentals and the stock market direction is significant: accelerating and positive earnings generally drive markets up, while decelerating and negative earnings drag markets down, although sometimes with a lag.



Source: ING Global Perspectives

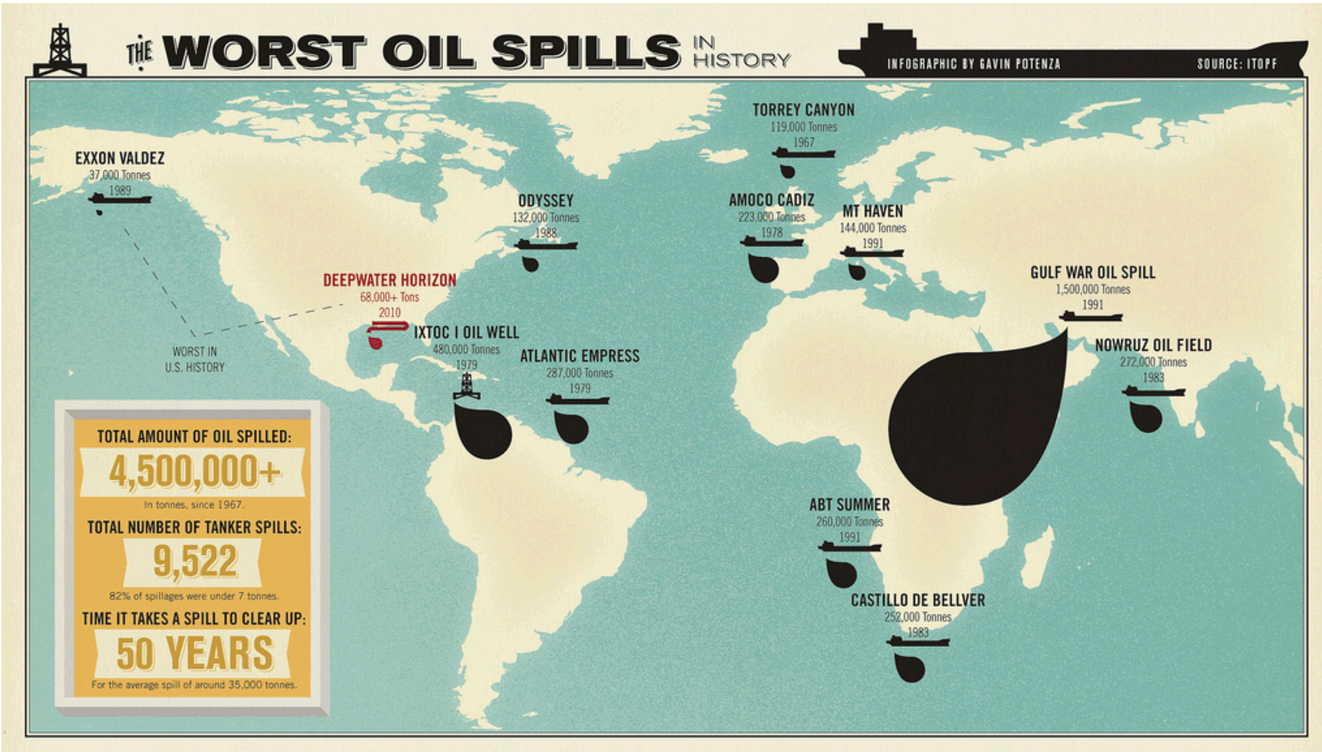
Asset prices will also benefit from a U.S. Fed committed to maintaining low rates for as long as necessary, the likelihood of a more pro-business Congress after the mid-term elections coming up in November, as well as the enduring power of technology to drive innovation, productivity growth, and new industry creation.

Countering these tailwinds are numerous sources of headline risk. The one closest to home is the BP disaster off the Gulf Coast, the largest offshore oil spill in U.S. history. It resulted from the April 20, 2010 Deepwater Horizon drilling rig explosion, which killed 11 platform workers and injured 17 others. Efforts to contain the spill have so far proven unsuccessful and, more than two months after the tragedy, the flow rate is still an astounding 35,000 to 60,000 barrels per day. The latest cleanup cost estimate, according to BP, is $2.35 billion. The ultimate economic, environmental, and human cost of the spill is as of yet unknown.

The oil slick as seen from space by NASA's Terra satellite on May 24, 2010

Oil slicks surrounding the Chandeleur Islands, Louisiana

(Source: Wikipedia)

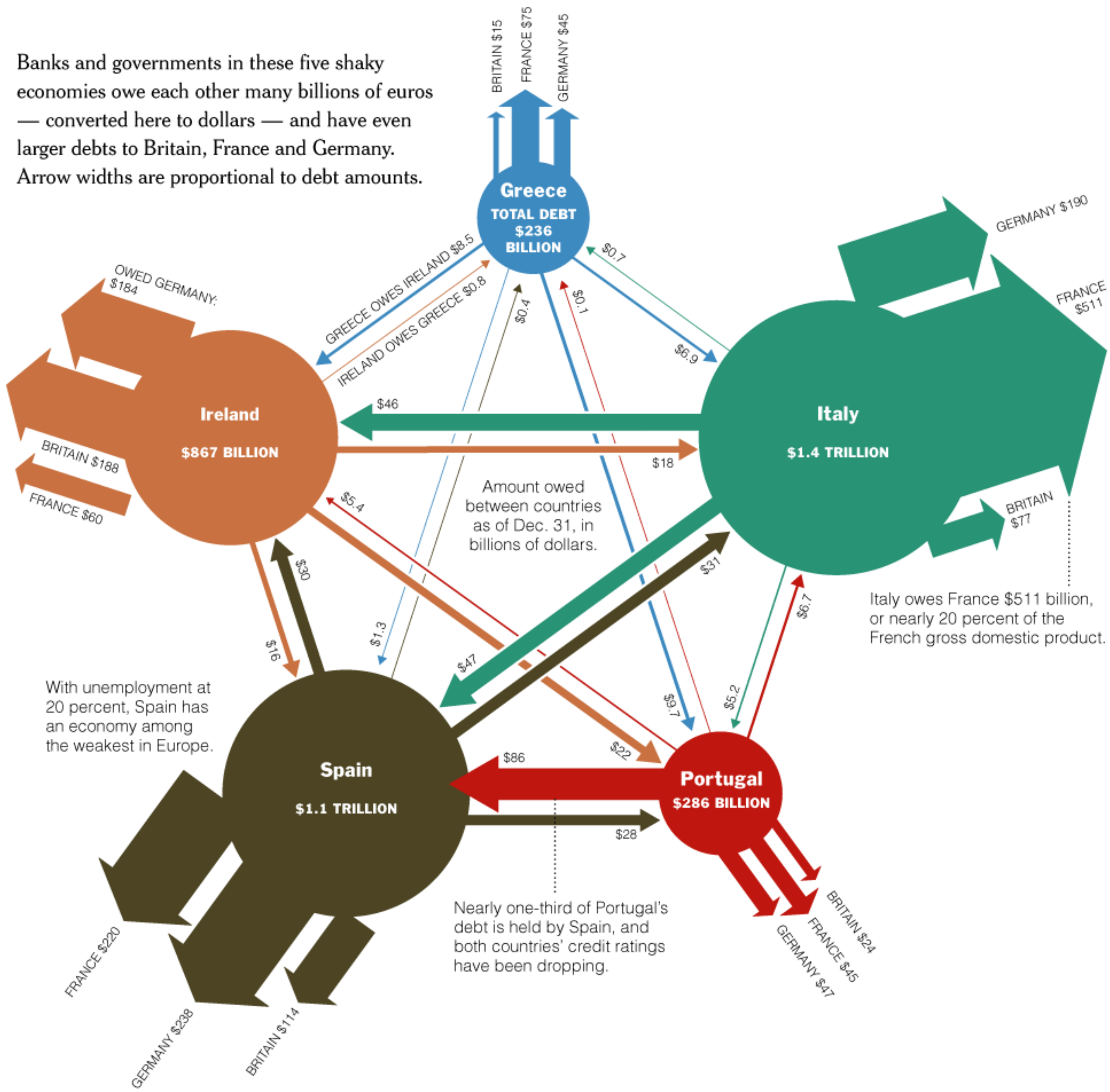


Source: The International Tanker Owners Pollution Federation, Gavin Potenza

Regulation and the growing importance of politics in all matters related to the economy and financial markets create uncertainty. For starters, Congress could soon be voting on the financial reform bill. The latest version is the result of more than a year's work and two weeks of negotiations. It includes a number of key provisions related to issues such as consumer protection, financial institutions that are too big to fail, and risky bets by banks and Wall Street firms. In addition, climate legislation and carbon cap-and-trade seem to be back on the government's agenda. However, after barely passing the House of Representatives last year, the bill has stalled in the Senate. Chances are the final version, if and when it reaches the Senate floor for a vote, would be a significantly scaled down effort to cap greenhouse gases across the U.S. economy. Immigration reform is also fighting for position on the summer/fall legislative calendar with the mid-term elections looming in November. And finally, the potential expiration of the Bush tax cuts at the end of this year has an effect on present-day spending by both businesses and individuals, who know that they may have to pay higher taxes in the future.

Across the pond, Europe is facing its own set of challenges. The Aegean Contagion, which started as a problem specific to the Union's weaker members – Greece, Spain, and Portugal – led to a crisis of confidence as well as the widening of bond yield spreads and risk insurance on credit default swaps between these countries and other EU members. *"Concern about rising government deficits and debt levels across the globe together with a wave of downgrading of European Government debt has created alarm in financial markets. The debt crisis has been mostly centered on recent events in Greece, where there is concern about the rising cost of financing government debt. On 2 May 2010, the Eurozone countries and the International Monetary Fund agreed to a €110 billion loan for Greece, conditional on the implementation of harsh Greek austerity measures. On 9 May 2010, Europe's Finance Ministers approved a comprehensive rescue package worth almost a trillion dollars aimed at ensuring financial stability across Europe by creating the European Financial Stability Facility." (Source: Wikipedia)*

What turned a local crisis into a global one is the interconnectedness of European economies, as the following chart from the New York Times illustrates.



Source: The New York Times

The central concern is that the crisis could spread beyond Greece. In an effort to stop the bleeding, Spain swiftly announced austerity measures, Ireland successfully came to market with an oversubscribed €1.5 billion issue, and European Union leaders began working on proposals for ensuring the region's fiscal stability in the long term. From a U.S. perspective, the sovereign debt crisis in Europe resulted in dollar strength and jittery investors. Without underestimating the seriousness and size of the problems in Europe, it is worth pointing out that the size of the U.S. economy at the end of 2009 ($14.3 trillion) was larger than the combined size of the 3 countries ranked 2-3-4 in the world (source: International Monetary Fund). Greece was a distant 27th and smaller than the economy of the state of Massachusetts. The following table provides a comparison of the world's major economies, their contribution to global GDP, and their estimated 2010 growth rates.

Cyclical Recovery – Global GDP

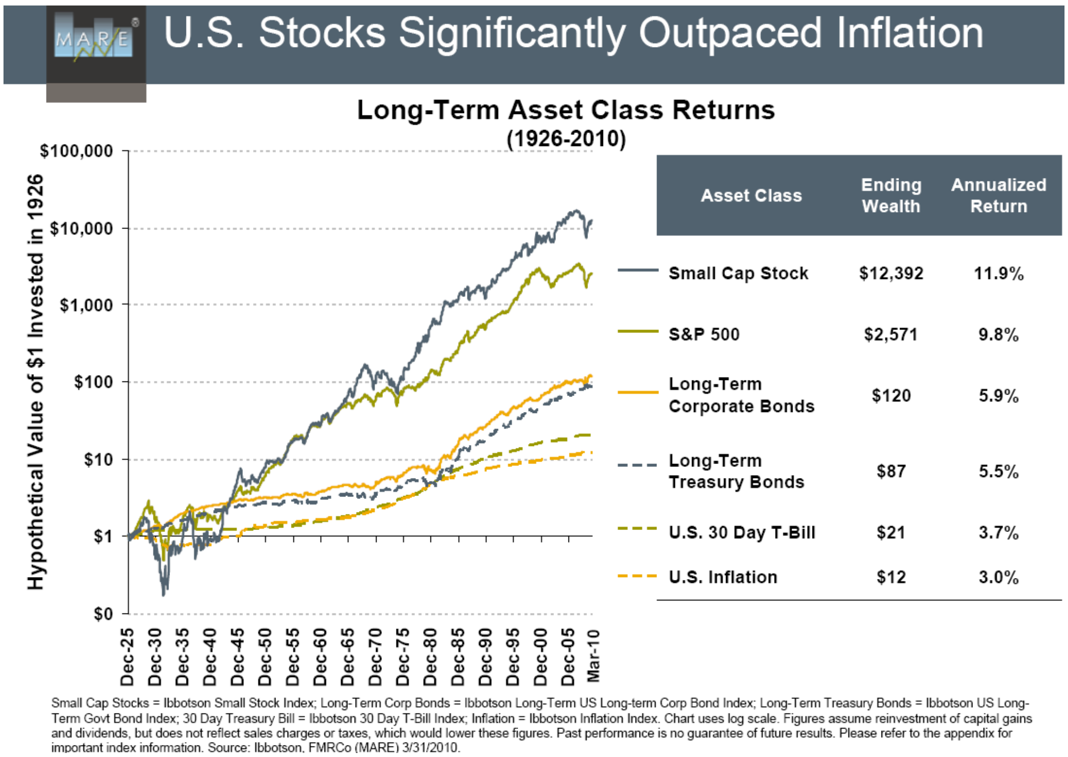
Rank	Country	GDP (billions)	% of Global GDP	2010 GDP Est.
1	UNITED STATES	14,204.32	23.44%	3.1%
2	JAPAN	4,909.27	8.10%	1.9%
3	CHINA	4,326.19	7.14%	10.0%
4	GERMANY	3,652.82	6.03%	1.2%
5	FRANCE	2,853.06	4.71%	1.5%
6	UK	2,645.59	4.37%	1.3%
7	ITALY	2,293.01	3.78%	0.8%
8	BRAZIL	1,612.54	2.66%	5.5%
9	RUSSIA	1,607.82	2.65%	4.0%
10	SPAIN	1,604.17	2.65%	-0.4%
27	GREECE	356.80	0.59%	
32	IRELAND	281.78	0.47%	
47	HUNGARY	154.67	0.26%	
	Massachusetts	364.99	0.60%	
	Maryland	273.33	0.45%	
	Iowa	135.70	0.22%	

Source: Sage Advisory Group, Bloomberg, BEA, IMF

The next few rounds – of both the World Cup and the story of financial markets in the new decade – will be anything but boring. As we ponder all the challenges we face today, we cannot predict which "what if" scenarios will come to pass. But we are aware of the issues as are the investment managers we work with. Being closest to the frontlines of investing, these managers are in the best position to adjust client portfolios to protect them from the negative impact of a potential double-dip recession, harmful legislation, geo-political risk, or escalating inflation. Beacon Pointe's equity managers tend to invest in high-quality businesses with strong balance sheets, which are likely to outperform in difficult market environments. Furthermore, these are often companies with pricing power and brand loyalty, which allows them to preserve their margins in inflationary times. Beacon Pointe's fixed income managers are first and foremost focused on capital preservation, building portfolios of safe, liquid, and conservative bonds, adjusting duration prudently in accordance with their interest rate forecasts, and providing an income cushion to the client's overall portfolio.

In addition to diligent manager selection, Beacon Pointe's asset allocation strategy serves as a safe harbor for client portfolios in turbulent times. As a matter of principle, we recommend diversification among asset classes (i.e. equities, fixed income, and – where appropriate – alternatives) as well as investment styles (i.e. value vs. growth, large cap vs. small cap, domestic vs. international) to create the most attractive risk/return profile for the aggregate portfolio regardless of the market environment du jour. Sticking with the asset allocation strategy throughout the cycle and rebalancing periodically gives clients the best chance of attaining their investment goals over the long term. History shows that points of massive uncertainty have occurred many times in the past – remember "The Death of Equities" magazine cover by Business Week in 1979 – and each time investors who persevered with their discipline and remained focused on the long-term were rewarded.

The final chart today, courtesy of Fidelity Investments, provides a reminder of what the very long-term looks like and how those who have successfully navigated the emotions of short terms market fluctuations have benefited from the long term upward path of the markets. Over the past 85 years stocks and bonds have outperformed cash and inflation by a significant margin. Surely, no asset class goes up in a straight line and periodically, during times of great pessimism and uncertainty, our faith in equity markets can be challenged. But times of great fear such as bear markets, financial crises, wars, political adversity, and natural disasters, are simply temporary breaks of the market's upward trajectory. A single goal in your own net doesn't have to lead to a lost match. It is the end result that determines the winner. While uncertainty and pessimism may lead to a bumpy summer, you can be sure that Beacon Pointe and our underlying investment managers stay focused on the game at hand and through prudent patient play we believe an ultimate victory will be achieved.



Source: Fidelity Management

Please feel free to call Beacon Pointe at 949-718-1600 should you need additional information or have any questions.