



***"The investor's chief problem – even his worst enemy – is likely to be himself."
~Benjamin Graham***

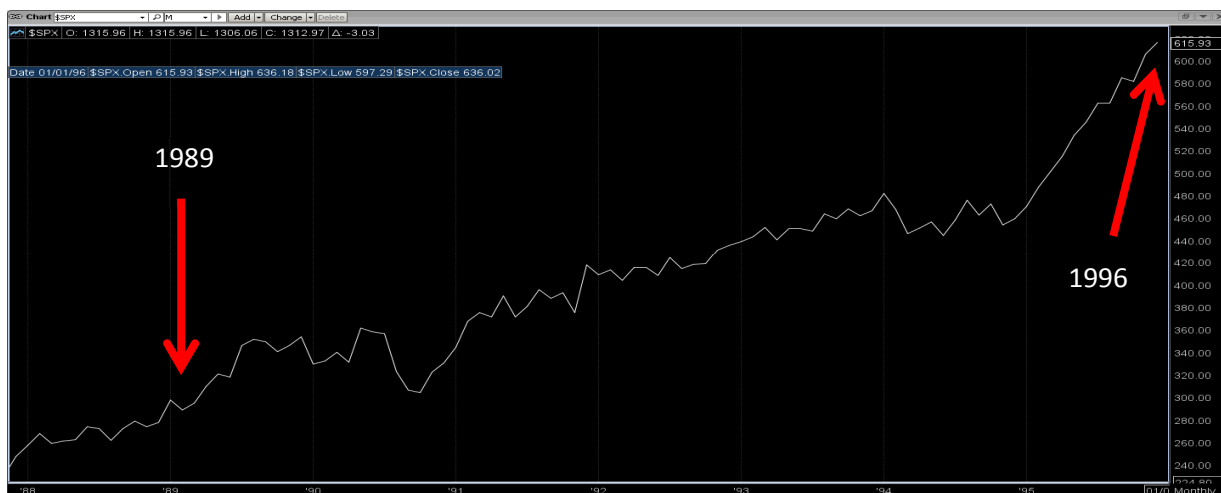
In six of the last seven months, shortly after sending out this very newsletter, I received an email or two back from subscribers asking me if my head was parked somewhere dark (to put it nicely). Apparently they did not like, or believe, my rather optimistic outlook and the economic data backing up my position.

I can appreciate their feelings as the verbal garbage being disseminated on a daily basis has investors on edge (television ratings on market related channels are up) and investor sentiment fairly low; a potentially profitable set of circumstances for investors by the way. So, let me share a historical quote with you that I feel correlates well with today's investment and economic environment.

"Money managers are unhappy because 70% of them are lagging the S&P 500. Economists are unhappy because they do not know what to believe: this month's forecast of a strong economy or last month's forecast of a weak economy. Technicians are unhappy because the market refuses to correct and gets more and more extended. Foreigners are unhappy because due to their underinvested status in the U.S. they have missed a big double play: a big currency move plus a big stock market move. The public is unhappy because they just plain missed out on the party after being scared into cash. It almost seems ungrateful for so many to be unhappy about a market that has done so well. Unhappy people would prefer the market to correct to allow them to buy and feel happy, which is just the reason for a further rise? Frustrating the majority is the market's primary goal."

~ Bob Farrell of Merrill Lynch, 1989.

For those of you that cannot remember 1989 all that well (myself included) let me share with you how the market (S&P 500 index) performed during that period. *Source: Market-Q*



The S&P 500 opened 1989 at the level of roughly 277.72. At the start of 1996 it had appreciated to 615.93. Not including dividends, this equates to a roughly 124% increase. This occurred during an economic recovery that also saw high levels of volatility, large market corrections, and unemployment rates above historical averages. For context the civilian unemployment rate on 6/1/92 was 7.8%*.

**Source: U.S. Department of Labor: Bureau of Labor Statistics as provided by <http://research.stlouisfed.org/fred2/data/UNRATE.txt>.*

No one (and by that I mean the vast, vast majority) wants to believe that we have turned the corner in the economy and that the stock markets trade at attractive levels. As the quote at the top of this newsletter suggests, it is often our own thinking, and emotions, that keeps us from reaping the rewards of investing.

Here are four excesses that have always existed prior to a recession that we are ***not*** seeing today; and may suggest higher equity prices over the next few years.

- 1.) In almost every period prior to a recession the U.S. population was over-employed. Today we are *vastly* under-employed. Furthermore, productivity figures have leveled off, suggesting that employers have squeezed every ounce of energy from their existing workforce. Given the recent decrease in the unemployment rate, it is fair to assume that employers are realizing that they are going to have to hire to keep up with demand.
- 2.) Typically businesses are spending the majority of their profits prior to a recession. Today we see the exact opposite, with cash balances at or near all-time highs. When, *not if*, these companies begin to spend this cash, it is fair to assume we should expect this to be an additional catalyst to the economy. We may also see additional dividend increases and shareholder friendly activity.
- 3.) Inventory levels in the late 2007, early 2008 timeframe ran around 6 months of supply in most industries. Today we see them around 1 month. Furthermore, as witnessed in the auto-sector, companies are having a difficult time keeping up with current demand, let alone actually being able to re-build inventory levels. *Source: Franklin Templeton*
- 4.) Asset prices are reasonable and compelling. The S&P has historically traded at a P/E multiple of around 17. Today we are at 13/13.5. Due mostly to elevated levels of concern regarding the potential of another recession in the near term, the market remains inexpensive relative to its historic level. Additional data points such as the E/P (inverse of the Price to Earnings ratio) go on to suggest that bonds remain expensive relative to stocks. *Source: ING Global Perspectives, 1st Quarter 2012 for period ending 12/31/2011.*
- 5.) It appears housing has bottomed; or is close to it at a minimum. Not only is home affordability at all-time levels (as reported by the Housing Affordability Index published by the St. Louis Federal Reserve Board), interest rates are low and new construction housing starts are on the rebound. Should we see any material increase in housing prices, expect consumer sentiment to rise, and spending along with it.

Now the bad news. I do agree with the consensus in a couple of regards, in that the road to recovery will be a bumpy one, volatility will remain elevated, and that growth is trending at levels lower than historical recoveries; much like that of the late 80's/early 90's. And, clearly the risks of a severe credit crisis in Europe would be an obstacle for further recovery. I do not however think Europe will let their fiscal predicament evolve to 'crisis' level, but it is fair to plan on a few negative, and potentially severe short-term set-backs/corrections.

With all that said, the reality is that I simply cannot find enough negative data points to buy into the thinking that we are either entering a recession or that we should expect a material slowdown in the growth of the economy. So while patience will continue to be required, I firmly believe the odds are stacked in the equity investors' favor looking out over the next few years.

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