Lawrence I. Grossman, CFP®, MBA, AIF™, MA
Registered Investment Advisor * Accredited Investment Fiduciary™
Grossman Financial Management
tel: 707/745-8756 * fax: 707/745-8723 * E-mail: lawrence@grossmanfinancial.com * Website: www.grossmanfinancial.com
940 Adams St. #L, Benicia, CA 94510

Market Update – July 2011

Despite continued economic stresses around the world, the first half of 2011 was marked by reasonable market returns. Stocks were up 6% and bonds rose almost 3%. While maintaining a defensive posture, our clients' portfolios showed results in line with the markets, even as they were exposed to less risk.

It is our view that the stock market reflects far too much optimism. It seems to ignore fundamental imbalances in our nation's fiscal condition which present significant speed-bumps to the growth of businesses that the stock market reflects. The economy continues to suffer high unemployment (9.2% and recently trending up) and anemic growth (below post-recession norms). The graphs in Figures 1 and 2, attached, present the sobering realities.

Contrasting these graphs with financial market returns suggests a disconnect between market logic and the economy. In fact, the stock market, both domestically and around the world, is up 30% from a year ago. To place a finer point on this, consider Figure 3, which indicates that, by two widely respected valuation methods, the stock market is overvalued by more than 50%. Figure 4 looks at the price of the stock market relative to the entire economy; this metric also reinforces the sense that the market is very high.

The current federal debt ceiling negotiations portend years of difficult politics on the road to greater stability in public finances. Resolution of the debt crisis is necessary for long-term economic growth at normal levels. But, in the short and intermediate terms, the corrective steps being considered – primarily budget cuts and revenue increases – most probably will dampen growth.

The main macroeconomic public sector response to the financial crisis remains the Fed's monetary policy actions. The Fed has tripled the size of the money supply to keep interest rates extremely low with the goal of stimulating the economy. While this strategy has had a positive impact, it also raises concerns about inflation. And, by itself, monetary policy is insufficient to return the economy to normal growth.

If economic growth does not accelerate – and it is unclear what would achieve that – it will take many years for unemployment to decline to normal levels and, consequently, the economy will continue to perform far below its capacity. Figures 5 and 6 show job losses during this recession (and compared to earlier ones) and initial unemployment claims; both figures show conditions more consistent with an economy in recession than one in recovery.

Though the stock market doubled since the low in 2009 and is high relative to economic fundamentals, it remains below its peaks of 2007 and even 2000. In fact, over the past twelve years the stock market has averaged only a 1.7% annualized total return. This underscores the real nature of stock market risk; it is not just a short-term phenomenon.

Most of what we wrote about financial and economic conditions eighteen months ago remains true today:

- Stocks are overpriced.

- Bond returns are at risk as bond prices will fall when interest rates return to normal levels.
- The housing market is still losing value (though we are close to the trough).
- Households remain deeply in debt, limiting spending.
- Unemployment is stubbornly high.
- Economic recovery is proceeding very slowly.
- Economic fragility remains high; most financial sector “systemic” risks have not been fixed.
- The withdrawal of monetary and fiscal stimuli have potentially negative short-term economic impacts.
- The federal government fiscal deficit is dangerously high and is currently growing at about $1.3 trillion a year, or about 10% of GDP. If the federal budget was somehow balanced at the level of current revenues, the required spending cuts would plunge the economy into another major recession.

In light of all this, we continue to recommend a relatively defensive investment posture with both stock and bond positions. To further mitigate risks, we are also maintaining our policy of very broad and careful investment diversification.

Figure 1

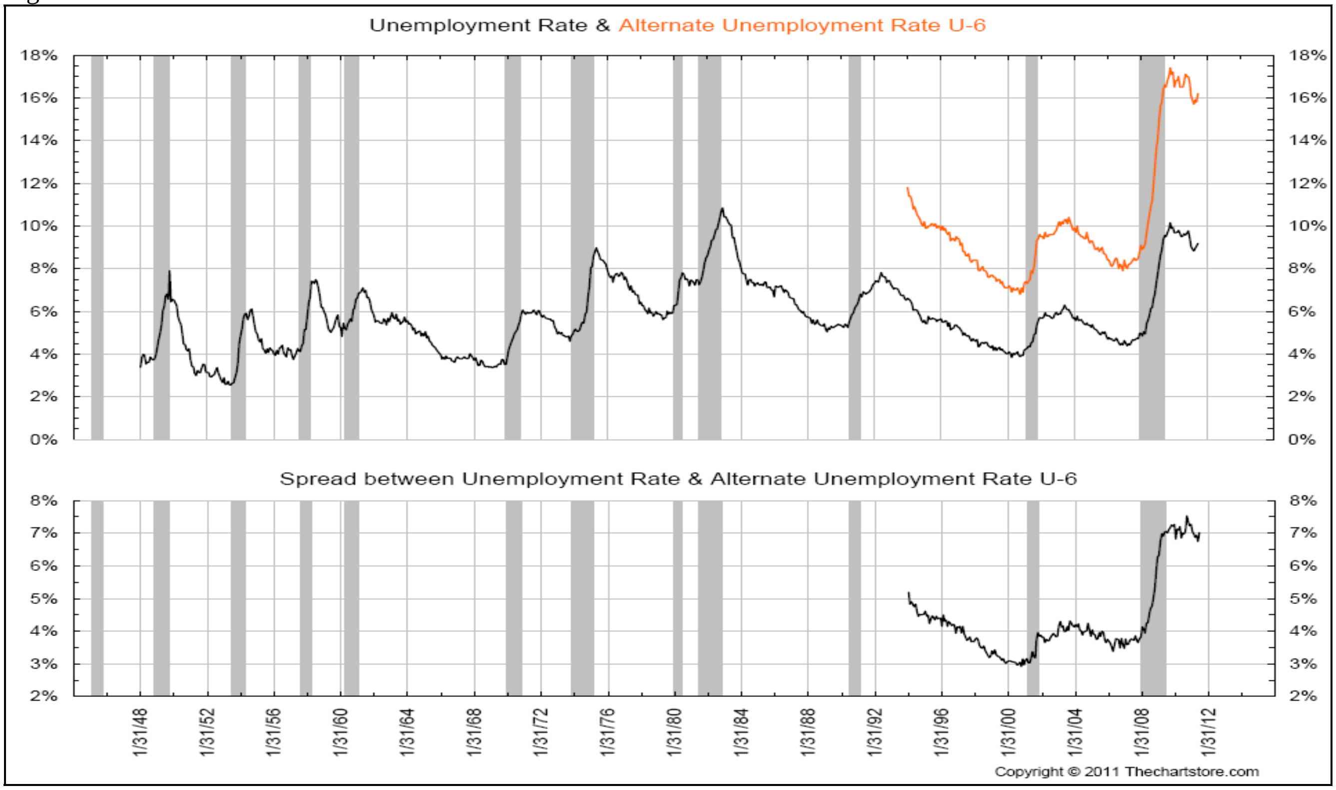

Figure 2

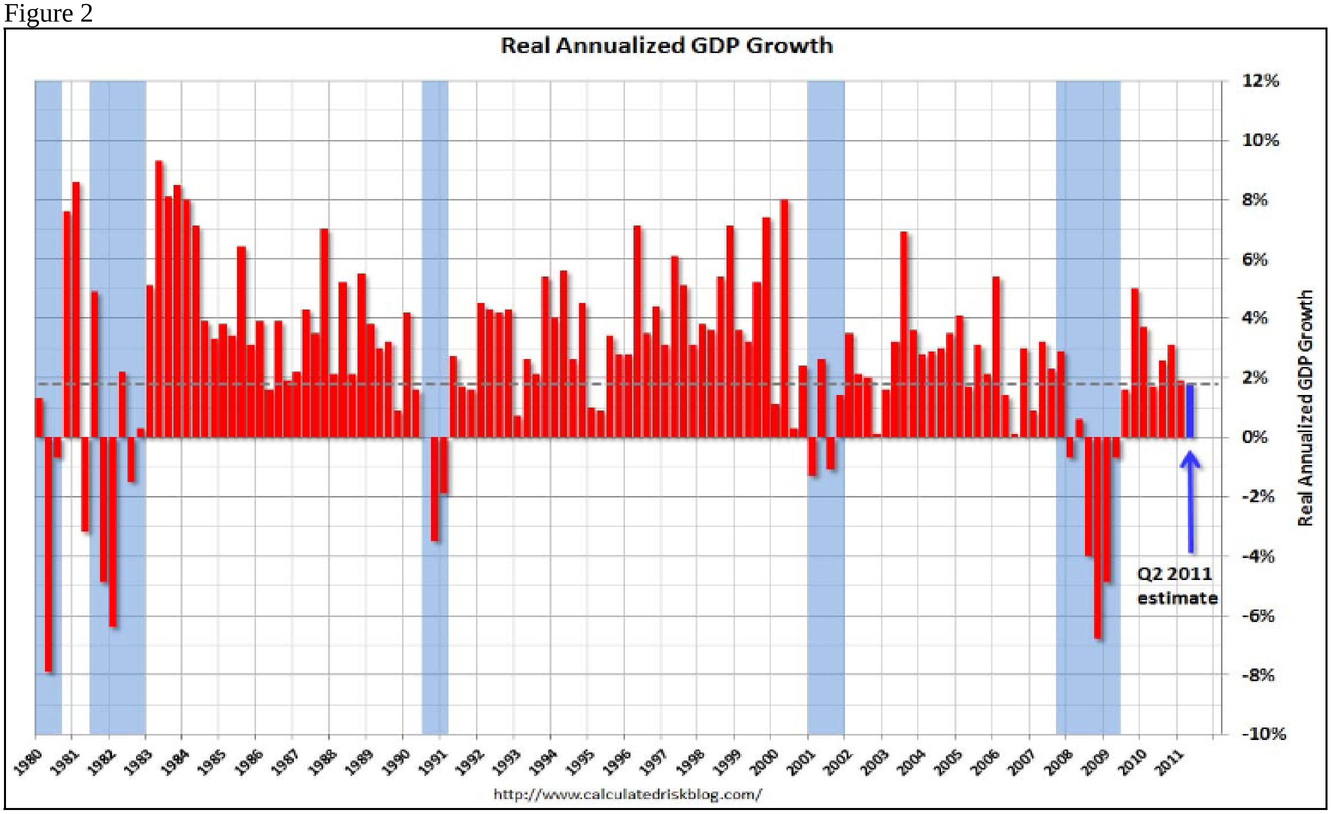

Figure 3

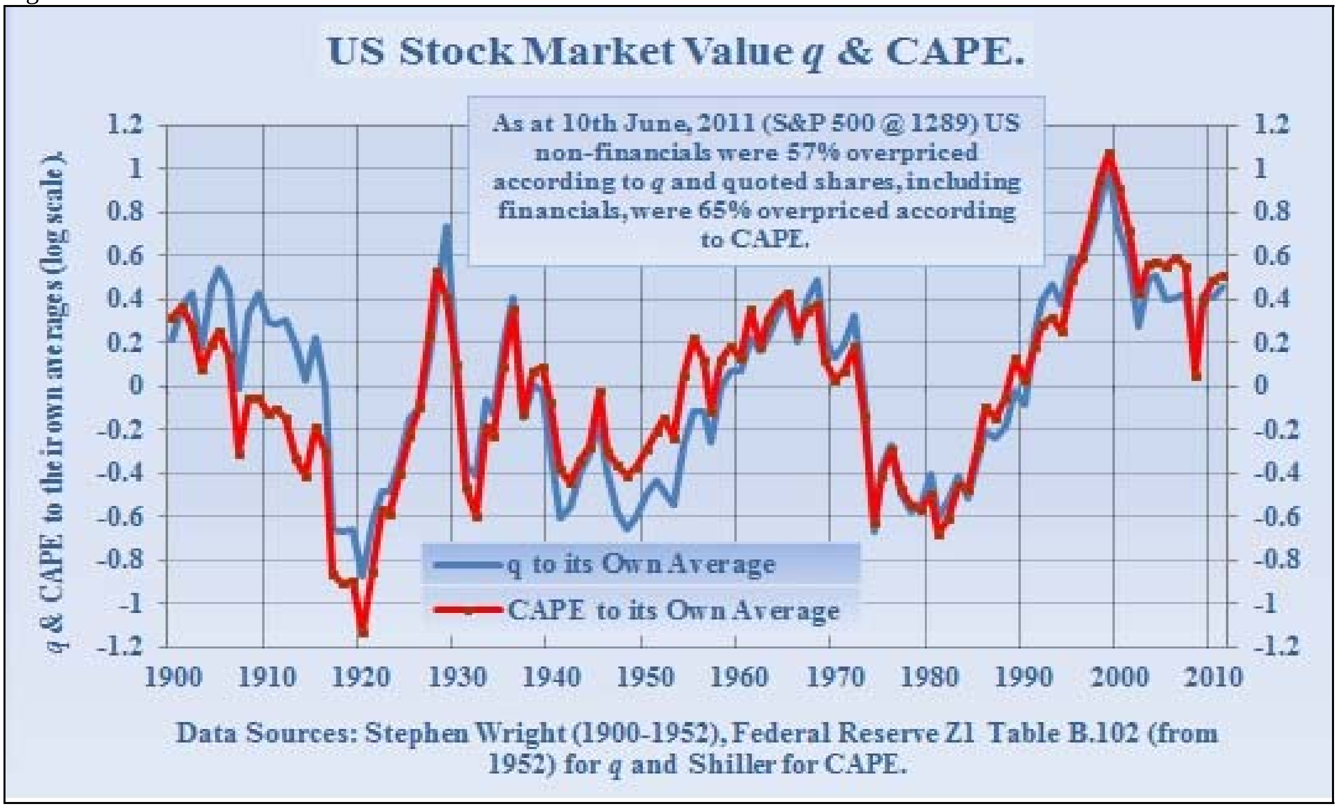

Figure 4

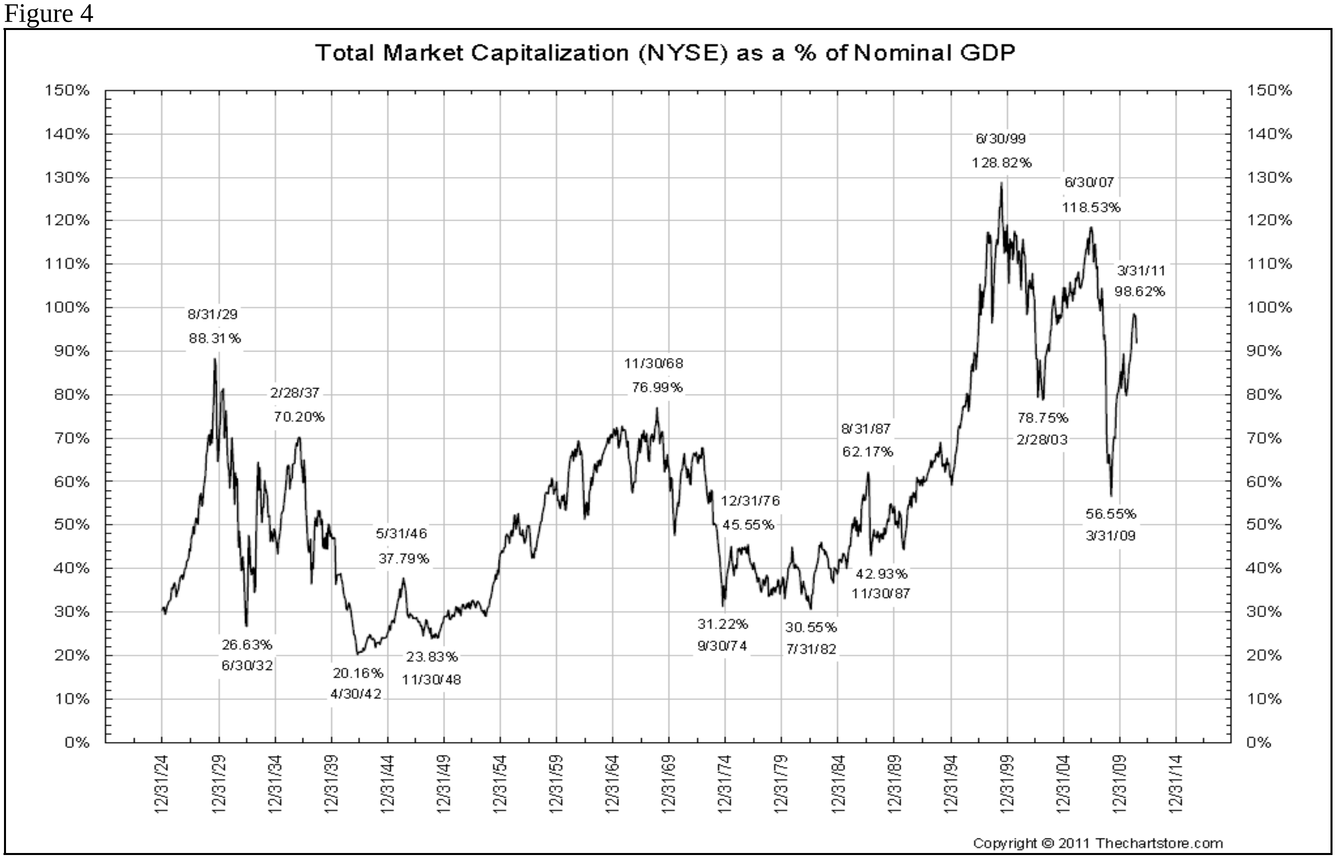

Figure 5

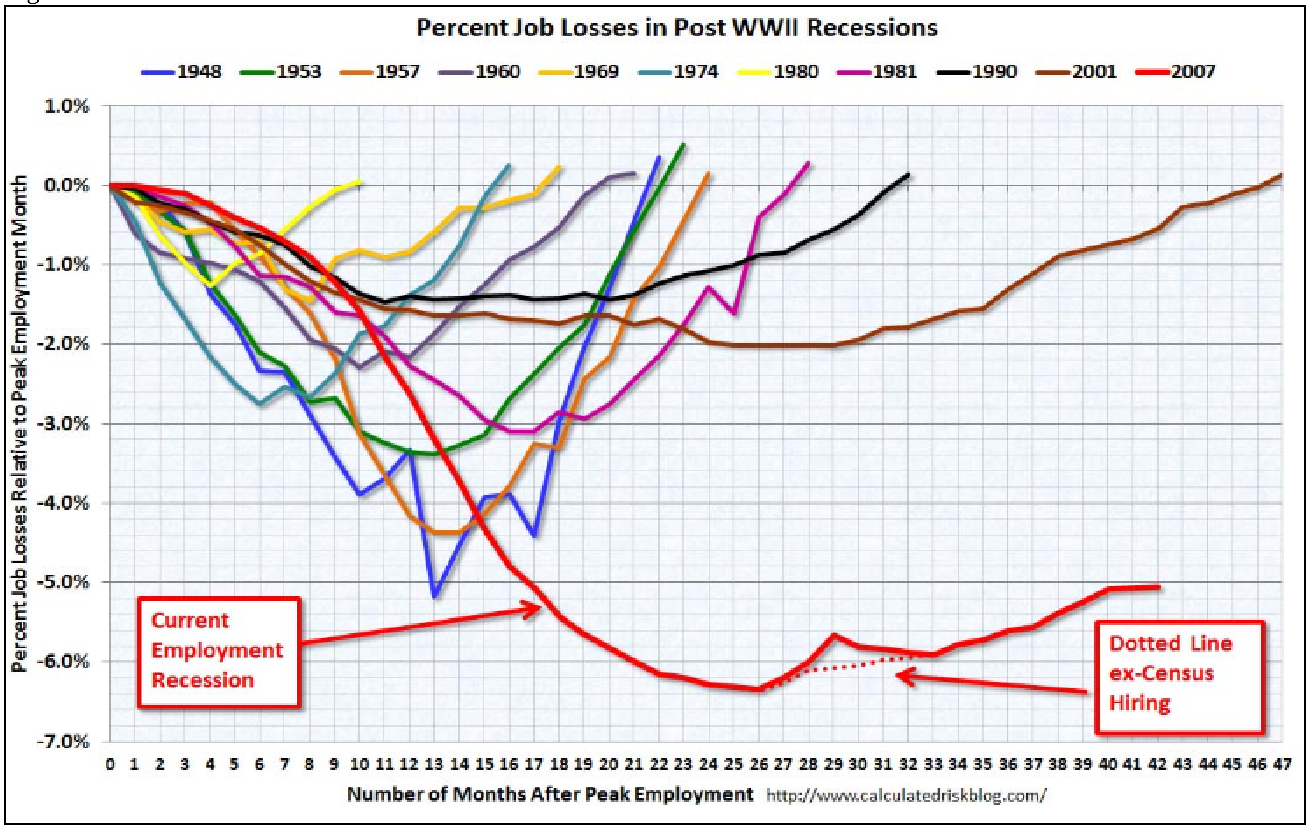

Figure 6