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Quarterly Newsletter

Contact Us

24901 Dana Point Harbor Drive
Suite 230
Dana Point, California 92629
949-363-8686

or visit our website:
www.optivestinc.com

Third Quarter 2012

US & World Economy - Weak second quarter job growth and earnings have dominated recent headlines. After a healthy 226,000 per month average job growth in the first quarter of 2012, a measly 80,000 jobs per month were added in the second quarter of 2012 - stalling the decline in the unemployment rate (currently 8.2%).
Corporate earnings growth is also slowing. Combined with the start of a recession in Europe, this resulted in a strengthening dollar and weak commodities. The price of oil dropped, despite the continued rumbling from Iran. Add the continuing drama from Greece and Spain and you end up with heightened volatility in the financial markets and lack of confidence from investors.

World-wide growth has also slowed, yet continues to be lead by the BRIC and growth countries. These countries' percentage of the world's GDP has now grown to 20% and 25% respectively, yet their shares of global market values are only 12% and 15%. This has created one of the widest under-valued gaps since 2003 and at some point soon, the stage for a large catch-up rally.

US Stock Markets - As I write this update, the S&P 500 is at 1350, right in between early April's high of 1420 and early June's low of 1278. We expect the stock market to continue to straddle this 65-day moving average level until the fall - pushed and pulled by Europe, China and jobs - killing time until the election. Interestingly, the S&P 500 closed up 9.5% at the 6 month mark, exactly halfway to the 19% increase we forecasted in January for the year-end gain. Over the next 12-36 months we are optimistic as market valuations (prices) have lagged while earnings continue to make new highs. This is the third major displacement since 1950 and corresponds to similar poor consumer confidence and cloudy outlook as in the 1950's and 1970's. Fortunately, these past periods were followed by long periods of above average stock performance. Let's hope history repeats itself.

Fixed Income - It is a good year to collect income from bonds, as interest rates have gone lower still (keeping prices up) and high-yield debt has remained positive (yet volatile). With the Fed's "twist" extended until year end and talk of QE3 (Quantitative Easing Round 3), we expect interest rates to stay low well into next year. This is good news for mortgage borrowers, bad news for CD holders. One negative by-product of ultra low interest rates is increased volatility; an interest rate move from 1% up to 1.5% may only be a half percent move nominally, but it is a 50% increase in the relative rate. Thus, even small swings in interest rates magnify change in price and borrowing/lending costs.

Real Estate – The one bright spot in commercial real estate today is apartments. Rental rates have hit an all time high in 74 of 82 national markets tracked by REIS, Inc. (a real estate data firm). The report further states that the nation's apartment vacancy rate has fallen to 4.7%, the lowest since the end of 2001. Apartment building prices are at all time highs in some cities with new developments trying to catch up. Many families are now renting instead of owning due to tighter lending standards, higher down payments, unstable jobs and soured views on single family home appreciation. We expect this trend to continue for a few more years.

Jobs, Taxes and the Election - Every national election seems to be important, yet it is hard to remember an election with more economic ramifications on the line. GDP, job creation, income taxes, estate taxes, deficit spending, long-term debt and healthcare are all intertwined and are at critical points for our country. For us, 2013 investment tax rates are at the front of this line, with top Federal capital gains rate to go from 15% up to 23.8% and dividends from 15% up to 43.4%. Surely this cannot be good for new business investments, which in turn create jobs, earnings and demand for real estate. There will be talk of a 1-2 year extension of the current tax rates but little chance that Republicans and Democrats will budge on the exclusion of the $250,000+ wage earners who run the businesses. We don't expect any significant changes on the 2013 "fiscal cliff" until the American people decide to either raise taxes and let the Federal Government "help" the economy, or lower taxes so that the people can do it themselves. Until November, expect a "go nowhere" economy and a polarized political environment.

Summary - We are stuck in a stubbornly slow economy with weak jobs growth, but we are not headed for a recession unless taxes are raised significantly next year. Low interest rates and modest returns are the result. God bless and have a wonderful summer.

Mark Van Mourick
CEO