FirstMerit Market Message

A QUARTERLY NEWSLETTER FOR FIRSTMERIT WEALTH MANAGEMENT CLIENTS
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Fundamentals Falter... But Fears Fade

Robert Leggett, CFA
Senior Investment Strategist
Robert.Leggett@firstmerit.com

We've focused on the battle for the hearts and minds of investors between Fears and Fundamentals all year, but the true partisans from both sides have been disappointed by the outcomes thus far. The Bulls were sorry to see slowing fundamentals such as GDP and earnings growth; and the Bears were disappointed by the absence of their fears coming to fruition. Given our stance as moderately bullish investment managers, we were happily surprised by the one outcome that matters most to our clients -- growth of their investment portfolios -- while the Bears have been doubly disappointed.

For the past year, we have been harping on the need to downplay fears and focus on fundamentals. Our point was that fundamentals were at least okay and might actually surprise the consensus to the upside. The fears were not unreasonable, but appeared to us to have low probabilities of occurring within our tactical time horizon. Thus, a total focus on the downside risks of fearsome outcomes (such as a U.S. recession, the Fiscal Cliff, the European crisis, or a China hard landing) could -- and did -- cause many investors to miss the opportunity to participate in a bull market.

Market returns were very good through Q3 and the S&P 500 led the way with a 16.4% total return. Midsized and smaller stocks were up about 14% and despite U.S. Dollar strength and European leadership's determination to shoot themselves in the foot, EAFE was +10% and Emerging Markets +12%. Fixed Income returns weren't bad either (although Treasury returns were only low single-digits), as "spread product" such as Corporates (+7.1%) and High Yield (+12.1%) continued to do well. Somewhat ominously, TIPS did much better than non-inflation protected Treasuries.

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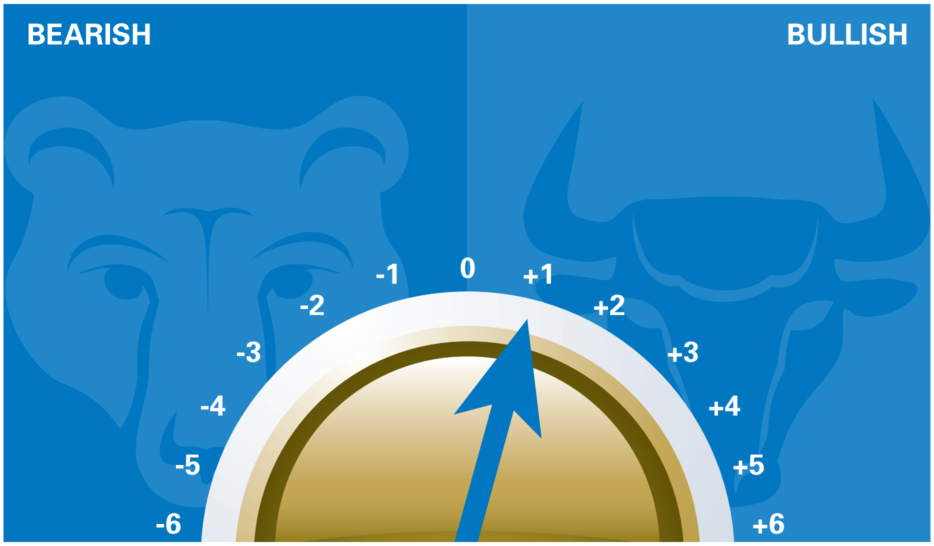
MARKET METER FALL 2012



0 MAJOR TREND
+ Nominal new highs
– "Real" new lows

0 FUNDAMENTALS
= GDP at stall speed
= Reasonable P/E, slow EPS

+1 FEDERAL RESERVE
+ Open Ended QE

0 TECHNICAL
+ Higher Highs / Lower Lows
- Slowed Momentum & Breadth

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Earnings (EPS) were the key to the low-to-mid-teens equity market returns, as reported EPS continued to exceed expectations. And it is no surprise that U.S. stocks led the way, because the major fear that consistently cast a shadow was the collapse of European banks, European sovereign debt and the Euro currency itself. The primary reason the largest companies (particularly those with safe dividends and steady growth prospects) outperformed was that they tend to beat smaller, more cyclical companies when growth slows and forward estimates are trimmed, which is what we have seen this year. With another key fundamental – valuation – at undemanding levels, the stage was set for our focus on fundamentals to pay off.

However, we will admit to disappointment over two key fundamentals: GDP and EPS growth. Both slowed dramatically and current data trends don't point toward improvement. As it became clear that 2012 would be the third consecutive year with a spring/summer economic slowdown we modified our message, recognizing that GDP was sliding to a "stall-speed" pace below 2% and that EPS had flattened.

Many disappointed bears are now pointing out that the stock market has disconnected from the underlying economic fundamentals. We agree that "disconnected" bull markets do not end happily, so this is indeed a crucial topic. So, with equities rising steadily in spite of disappointing fundamentals, what are we going to do now? We won't downplay fundamentals and simply count on upside momentum continuing!

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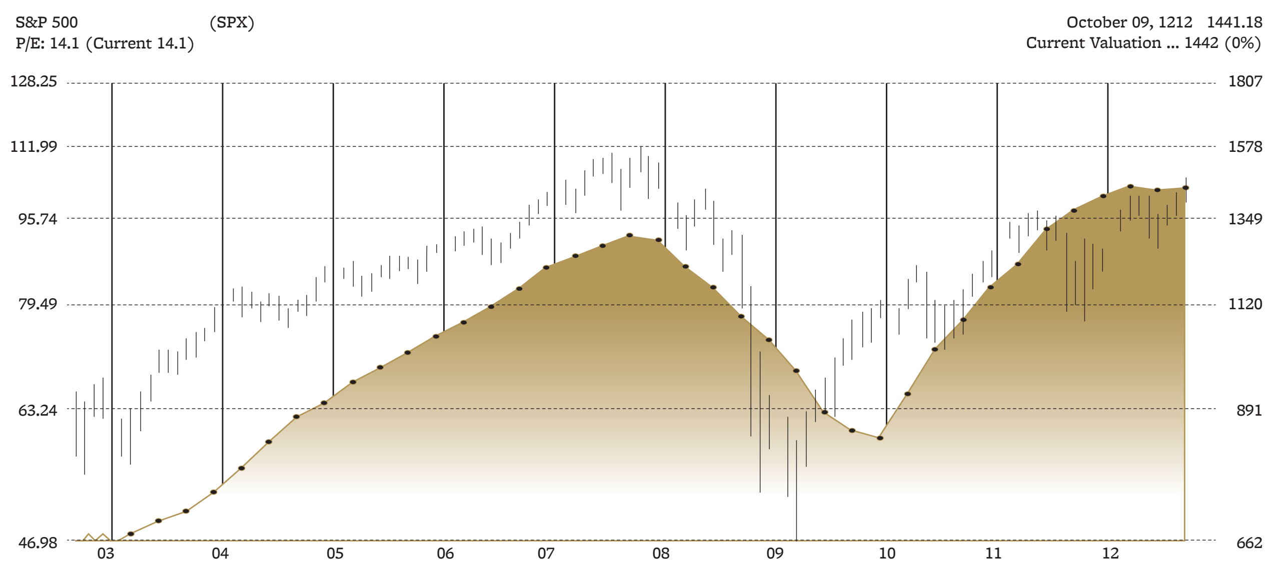
What we will do is turn to our Strategic & Tactical Asset Allocation methodology. It's based on analyzing Fundamental data and trends, paying attention to the Fed and understanding investor sentiment.

While the key to the financial markets in the near term may well be the U.S. Elections or surprising news on any of the Fears we listed, the key to investment strategy over the next several quarters will be the outcome

Earnings at all time highs, but stocks are not.



The vertical lines show the S&P 500 has not yet surpassed the all-time high reached in 2007. S&P EPS (solid line with shading) did hit a new high, but has now flattened, as we note in the text.

of the slowdown in Fundamentals. The Fed (Quantitative Easing) and investor sentiment (fears vs. greed) will help shape the trajectory of fundamental data.

Starting with economic data trends, our early perspective on 2013 is they WILL be slow and for one very good reason: the Fiscal Cliff is shifting from a Fear to a Fundamental. The Fiscal Cliff is a mix of expiring tax cuts (Bush tax cuts, Alternative Minimum Tax inflation patch, and the payroll tax cut) and spending cuts (the "sequestration" which chops 10% from defense and 8% from all discretionary spending; Medicare doctor payments; and extended unemployment benefits). If nothing at all is addressed, falling off the Cliff in January 2013 would result in a 4%+ hit to the U.S. economy. Although many of the Fiscal Cliff issues will be addressed by early 2013, some issues such as the payroll tax cut seem likely to expire and that would mean a 2% decrease in take-home pay for millions of consumers. Not good for consumer spending. In addition, recent survey data indicates that businesses are already cancelling spending decisions based on uncertainty about the Fiscal Cliff and regulatory activity.

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The basic arithmetic is daunting. The third quarter consensus estimate for nominal (i.e., before inflation) GDP is +3.0% to +3.5%. If the surveys are correct and businesses are becoming more cautious, Q4 GDP may be even slower. Looking to 2013, preliminary forecasts are for a modest improvement to roughly +4%. Subtracting 2% for expected inflation would mean a continuation of the current stall-speed, sub-par, disappointing expansion. Some key sectors such as housing and energy production are improving, but that's not enough to reaccelerate the economy.

Of course, American fundamentals aren't all that matter. Europe is in recession, albeit more moderate than was expected. The European Central Bank (ECB) finally took a page from our Fed and has stated they will do whatever it takes to support the Eurozone, but if infighting flares up again, the impact on one of the world's largest economies could be disastrous. Our point all along has been that the ECB would be forced to do exactly what it is now talking about doing. That should allow the "Euro Crisis Can" to be kicked down the road while they figure out how to create stronger fiscal and banking unions to support the thin currency strands that bind them together now.

Expectations are generally the key to whether one is disappointed by reality. Entering 2012, expectations were low and fears were at extreme highs as if the Great Recession had never ended.

China has also managed to grab its share of headlines as it struggles with the impact of slowing world trade and its upcoming leadership changes. Chinese imports are an important factor in low U.S. inflation rates and Chinese buying is very important to the pricing of many commodities. We will watch this closely, as China's great wealth makes it capable of making a large impact on global growth.

The Federal Reserve extended its Quantitative Easing program (bond buying) and stated they intend to suppress interest rates into 2015 or even longer. If the Fed follows through on its intentions, bond yields are not likely to rise much over that timeframe, but one worry is that the Fed changes its plan or that something "goes wrong" and the yield curve steepens. The other worry is that business, consumer and investor sentiment improve and a positive feedback loop develops as fear is displaced by greed. With trillions of Dollars available for bank lending, a new credit-fueled spending spree could develop. Could the Fed nimbly reverse direction, raise interest rates just enough

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to support the Dollar, keep the economy growing and avert an inflationary spiral? That will be difficult! And that's why inflation remains a risk, although probably not in the near term.

These uncertainties are likely to persist beyond the November elections, so we are taking additional defensive steps in client portfolios.

Expectations are generally the key to whether one is disappointed by reality. Entering 2012, expectations were low and fears were at extreme highs as if the Great Recession had never ended. Those low expectations were reflected in low stock market valuations. We are now later in the earnings cycle and it appears EPS estimates may be too high. Valuations based on current estimates are reasonable, but if EPS begin to decline, valuations won't provide immediate support.

We have maintained a fully invested equity position all year, but always with a defensive tilt which has allowed our portfolios to participate in the financial market gains. Unless the Fiscal Cliff and longer term deficit issues are addressed early in the next Administration, we may find ourselves watching our Recession Checklist gain points (that's bad) and the Market Meter lose points (also bad). These uncertainties are likely to persist beyond the November elections, so we are taking additional defensive steps in client portfolios.

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I have been tweeting on behalf of FirstMerit Wealth Management Services since late 2011. In a mere 140 characters or less, I strive to keep you informed on the economy and financial markets, point out the significance of current events to your financial lives and link you to additional resources for more in-depth analysis. I try to be interesting and sometimes I even succeed at being humorous! Joining Twitter is easy (and non-invasive) and I hope if you are not already a "follower" of mine @firstmerit_mkt that you will become one soon.

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For more information:

AKRON: Leigh Gerstenberger – (330) 384-7104
ASHTABULA/MENTOR: Ellen Forbus – (440) 953-3617
CANTON: Bob Stark – (330) 498-1551
CHICAGO: Dave Taylor – (312) 775-4909
CLEVELAND: Tom Anderson – (216) 694-5678
COLUMBUS: Curt Ramkissoon – (614) 570-7570
ELYRIA: Dan Munro – (440) 329-3269
MEDINA: Don Miksch – (330) 764-7263
TOLEDO: Mickey Cooper – (419) 720-1521
WOOSTER: Linda Litman – (330) 263-3208

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