

Parsec Financial

WEALTH MANAGEMENT

Fourth Quarter 2011

What is the Earnings Yield Telling Us?



*by Harli Palme, CFP®, CFA
Financial Advisor*

Hindsight is 20/20. Looking backward, it is easy to see if stocks went up or down. But determining their movement in advance is what investors seek. History (and an abundance of academic research) has shown that few, if any, are able to consistently determine the short-term future direction of stocks. However, that does not stop analysts, advisors, and investors from looking for indications as to when it is the time to buy stocks. The earnings yield is one of the many factors that the industry uses as a signpost for these matters.

An earnings yield is similar to a dividend yield. Just as the dividend yield tells us what a stock's dividend is as a percent of its price, the earnings yield tells us what a company's earnings are as a percent of its price. For example, if Johnson & Johnson has annual

earnings of \$4.18 and a current stock price of \$63.25, its earnings yield is 6.6% ($\$4.18/\63.25). The higher the yield, the better because either the earnings are high or the price is low. Either way, it's a buy-worthy scenario.

Aggregate S&P 500 earnings work the same way. S&P 500 top-down earnings are estimated to be \$96.22. At the current S&P 500 level (1,151 as of this writing) that indicates an earnings yield of 8.36% ($\$96.22/1,151$).

We can apply this same principle to evaluate U.S. Treasury notes. Currently, the yield on 10-year Treasuries is 2.01%. Relative to the stock market earnings yield, the Treasury yield looks paltry. The current disparity of 6.35 percentage points between the earnings yield and Treasuries is quite large.

This disparity is known as the equity risk premium. It indicates the excess return you should receive for taking on the risk of equities. There are other components of the

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Parsec's Holiday Schedule

Closed Thursday & Friday, November 24-25, 2011.

Closed Monday, December 26, 2011.

Closed Monday, January 2, 2012.

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expected return on equities, such as the risk-free rate, inflation premium, etc. Historically, the equity risk premium has been much lower than it is now. One major reason for this current large equity risk premium is that investors are highly risk averse right now. They are unwilling to accept the volatility of the stock market, even given the high earnings yield.

This risk aversion has caused investors to flock away from stocks, driving valuations extremely low. Some argue that the low valuation of stocks is warranted because future earnings may come down. But we haven't seen such a high equity risk premium for stocks since the 1950s. If the risk of recession fades, stocks could rise sharply. It

seems reasonable to us that such historic disparity between Treasury yields and stock earnings yields portends a future rise in stock prices.

If you are adding to your portfolio in this environment, you have the fortunate ability to buy at a relative low. If you are not in the position to save, or even spending from your portfolio, your best option is to wait it out. Time will tell whether stocks are undervalued at the present moment. A long-term investor benefits from the risk-reward trade-off that stocks offer, in the form of higher long-term returns.

Parsec Prize 5K Supports 2011 Recipients

Parsec has made a commitment to charitable giving by dedicating 2 percent of revenues to support non-profit organizations. Half of our charitable giving budget is devoted to the Parsec Prize. Since 2005, organizations who support education, economic development, conservation, wellness, and the arts have received over \$400,000 in Parsec Prize monies.

This year, each recipient receives \$20,000. The 2011 recipients are: **Appalachian Sustainable Agriculture Project (ASAP), Asheville Industries for the Blind, Asheville Symphony, and The Salvation Army Boys and Girls Club of Buncombe County.** The recipients will have an opportunity to

raise more funds through the first **Parsec Prize 5K on October 15, 2011.** All of the entry fees will be donated to the runner's choice of these charities. Runners can also donate more funds or solicit sponsors, if they choose.

Congratulations to these wonderful organizations! We really appreciate the work they do for our community.

Parsec Newsletter Year in Review



*by Neal Nolan, CFP®
Financial Advisor*

Over the course of this year, we have had the privilege to offer our suggestions, recommendations, and advice in this newsletter. 2011 has brought us a myriad of information, to say the least. As we begin to bring this year to a close, we offer this opportunity to look back on our thoughts and recommendations.

We discussed a lot of topics this year. Roger James introduced us to Parsec Trust, a division of National Advisors Trust. We reviewed funding requirements for Roth IRA contributions as well as a permanent repeal of the income limitation of the North Carolina 529 plan.

The deficit situation was not far from our thoughts. Little did any of us know that Rick Manske's comments in the first newsletter about the Federal deficit debate would later prove to be one of the hot button issues of the year.

We post the newsletters on our website. If you would like to review this year's newsletters, go to the "News" section at www.parsecfinancial.com. You can also read issues dating back to 2008.

We at Parsec are honored to serve our clients. We hope you find our newsletter useful and informative. As we begin to draw 2011 to a close, we wish you the very best this holiday season has to offer!

Parsec Buzz

Our founder **Bart Boyer** and his wife Elaine will have a new son (in law) at the Thanksgiving table this year. Their youngest daughter Tracy married Clark in June.

Have you heard a new voice answering the phones in our Charlotte office? Then, you have met our new colleague, **Aaron Combs**. Aaron is a recent graduate of Winthrop University where he studied financial planning and personal finance.

Sarah DerGarabedian and **Harli Palme** successfully completed the final level of the CFA examination and are now CFA

charterholders. We now have three colleagues at Parsec who hold the Chartered Financial Analyst® designation.

Samantha Williams and her husband Danny welcomed their daughter Candace on July 6, 2011. Twins Charity and Cheyenne look forward to enjoying the holidays with their new sister.

Consumers Will Keep the U.S. Economy Growing



by Dr. Jim Smith,
Chief Economist

Among all the doom-and-gloom talk (so bad it probably should be called *sturm und drang*) that has been saturating the air waves, magazines, and newspapers for the past several months, consumers have been steadily spending money. The consumer sector is the least analyzed part of the economy and yet by far the most important.

As the chart shows, real (adjusted for price changes over time) personal consumption expenditures (PCE) now make up more than 70 percent of real gross domestic product (GDP). That means that all the rest of the economy (business fixed investment; residential investment; government spending on goods and services; and net exports) make up less than 30 percent of real GDP.

Net exports have subtracted from real GDP for over 30 years now. No one expects exports to exceed imports in the foreseeable future.

Real PCE set a record in April 2008 at a seasonally adjusted annual rate of \$9,289.3 billion. That total was not exceeded until October 2010. Every month since then has been higher than the old record.

On August 29, the Bureau of Economic Analysis (BEA) of the U.S. Department of Commerce gave us wonderful news on real PCE for July 2011 (<http://bea.gov>; click on “Personal Income”). It set a

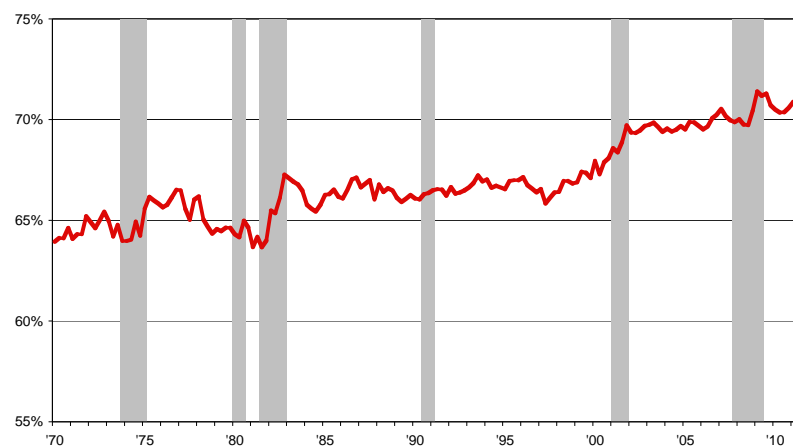
new record of \$9,428.2 billion at a seasonally adjusted annual rate. That was up 2.3 percent from July 2010, led by a 7.0 percent increase in durable goods. That category includes vehicles, appliances, electronic goods, furniture, tools, kitchen equipment, bicycles, and other products that usually last 3 years or longer. Spending on services was only up 1.6 percent from a year earlier. That held down the overall total increase as services makes up the biggest component of PCE (about 2/3).

The increase was 0.5 percent from June 2011. That was the biggest month-to-month increase since December 2009.

On September 15, the Census Bureau gave us more good news on consumer spending in its monthly report on retail and food services sales (<http://www.census.gov>; click on “Monthly Sales for Retail and Food Services”).

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Real Personal Consumption Expenditures
as a Share of Real Gross Domestic Product



Shaded vertical bars are official NBER recession dates.

Source: Bureau of Economic Analysis

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They reported that total retail and food services sales in August hit a new monthly record of \$389.5 billion, adjusted for seasonal variation and holiday and trading day differences, but not for price changes.

That total was 7.2 percent above August 2010. The retail sales segment alone was also a new monthly record in August at \$348.8 billion. That was up 0.1 percent from July and 7.5 percent from August 2010.

Retail and food services sales make up over 40 percent of PCE. For the first 8 months of 2011, total retail and food services sales were \$3.06 trillion. That was an increase of 7.9 percent from the same period in 2010.

Real PCE growth only contributed 0.3 percentage points to the paltry 1.0 percent growth in GDP at a seasonally adjusted annual rate in the second quarter of 2011. The contribution was 1.47 percentage points to the miserable 0.4 percent real GDP growth at a seasonally adjusted annual rate in the first quarter. That obviously implies, without the good contribution from consumers in the first quarter of 2011, real GDP would have declined.

That would have set the “Chicken Littles” to screaming: “We’re in a recession! We’re in a recession!” We are not in one now and really cannot be so long as consumers keep increasing their spending.

When we get our first report of third quarter real GDP from the BEA on October 27, we should see the best performance so far this year, which won’t take much. The contribution from real PCE growth should be a big part of that.

There is seriously good news that has not been widely reported coming from the forecasting fraternity. The National Association for Business Economics (NABE) released its latest forecast on September 12, and the consensus forecast is actually pretty good. (See <http://www.nabe.com>; click on “NABE Outlook.”)

Our consensus view for the 52 of us in the survey is that real GDP will grow 1.7 percent in 2011 and 2.3 percent in 2012 on a year-over-year basis. Real PCE is forecast to grow 2.1 percent both this year and next. Admittedly, both predictions are well below the 2.8 percent historical average annual growth in real PCE over the 1990-2010 periods and were re-adjusted downward from the previous survey in light of the large downward revisions to 2003-2010 data we received from the BEA on July 29. Still, less-than-exceptional growth does not a recession make.

We should see the second consecutive record holiday shopping season this year. That assumes you’ll do your part and keep retailers and mall owners happy in November and December wherever you live. The economic outlook is much better than most of what you hear, read or view.

Grow with us.

Parsec Spotlight: Mary Shanahan



Mary came to Parsec in 2005 after learning about a part-time position that was available here. Her role has evolved from filing documents and doing odd tasks to assisting clients and training staff as the senior client service specialist.

Her road to Parsec was circuitous. She graduated from Dominican College in Blauvelt, New York with a Bachelor of Science degree in nursing. She worked as a registered nurse while traveling up and down the East Coast with her husband. They finally settled in Asheville in June 2002.

Mary has two children: Kristen, who lives in Asheville, and Robert, who lives in Chapel Hill. She enjoys spending time with Tess, a dog she adopted from Brother Wolf Animal Rescue. She loves riding her horse Comma and gardening.

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