Dunn Warren Investment Advisors, LLC

The Portfolio Reporter

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Beware of Greeks Bearing Gifts

The discussion about how the economy is doing is at a high roar. Deciding for yourself is difficult if you are listening to the pundits on television. However, there is an easy way you can calculate where things stand. Do you think twice before buying a large item, or an item you do not need in everyday life? Has a home sold for less in your neighborhood? Are homes being foreclosed on in your neighborhood? Do you have a friend or family member that has been laid off recently?

If you can answer yes to any of these questions, this gives you a good idea as to the state of the economy.

At Dunn Warren it is important for us to have a plan and stick to that plan. It is easy to get caught up in emotion. Rather than get caught up in the rollercoaster of fear and doubt that emotion brings, we are methodical about how we invest a portfolio.

We have a three factor methodology for managing our investments: 1. measure risk, 2. invest using relative strength, and 3. monitor the economy. This month we will discuss the process of monitoring the current economic environment. Specifically, we will examine why it is important to understand the difference between leading, coincident and lagging economic indicators. Leading indicators tend to decrease prior to a stock market downturn and increase prior to a stock market upturn. Coincident indicators turn down and then go negative just as the press declares a decline in the economy. Lagging indicators begin their decline once we are well into a recession.

The mutual fund company, MFS Investment Management, recently published their "Strategist Corner", in which James Swanson, CFA, stated that the U.S. and emerging market economies continue to expand. He sighted the following:

• U.S. industrial production is rising; in the third quarter it was up 5.1%.

• Capacity utilization in the United States is edging higher. It was most recently at 77.4%.

• U.S. corporate profits, as measured by Standard & Poor's 500 Stock Index companies reporting, are stronger.

• Corporate revenues in the United States, all through the troubled third quarter of 2011, have gained at a pace that is three times the pace of nominal U.S. gross domestic product growth.

• U.S. consumers, written off for dead, seem to be alive. Retail sales are running 4% higher than at this time in 2010.

Swanson is looking at the wrong indicators. Industrial production, capacity utilization and retail sales are *coincident* indicators. They turn down at the same time the press and the arbiters of recession, National Bureau of Economic Research, recognize a recession. Looking at the growth of corporate profit and revenues as a percentage change year over year, we find that they are growing, but at a *slower rate* than a year ago.

What are the indicators to be looking at? Right now we need to look at leading indicators: job advertisements, unemployment claims, ISM, and consumer confidence. Leading indicators show a sickening econ-

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omy. In 2001 and 2008 they showed weakening ahead of the stock market decline.

The Conference Board reports that in the last 6 months, job advertisements have declined by 9%. Unemployment claims have been at a constant high level of about 400,000, although the recent report from the U.S. Department of Labor came in lower at 397,000. The ISM index (Institute of Supply Management) is currently at 50.8, down 10.6 points from its high in February 2011. An ISM index reading below 50 indicates that the manufacturing sector is in a decline. Consumer confidence, as measured by the Index of Consumer Expectations, is down 16.3% in the past 12 months (Thomson Reuters – University of Michigan).

Once the leading indicators turn down, and then go negative, this signifies that the economy is in a *fragile* state. This means that any disruption to the economy has a greater impact. Think of this like a "spinning top"- a toy that children play with. When a child first spins the top, the high speed enables the top to keep spinning even if you touch it or it touches another object. However, once the top begins to slow down, if you touch the top or it hits something, the stop becomes inevitable. This would be the equivalent of Greece and the European Debt crisis. Even though the amount of debt and the size of Greece are small, because the U.S. economy is already moving more slowly, we are in a fragile state so that the impact could be greater. *Beware of Greeks bearing gifts.*

Having a definitive process that you stick to is what we believe brings long-term investment success. Despite the market increase in October, our definitive process tells us to stay with our current portfolio holdings, rather than try to chase returns. Although the stock market is not currently recognizing the slow-down in the economy, it does not mean the risk is gone. Risk is ever present as shown by our leading indicators. Dunn Warren will continue to monitor this risk using our defined methodology.

Please feel free to pass "The Portfolio Reporter" to interested friends and family members. For more information about your investments, please contact your financial professional.

MONTHLY CONFERENCE CALL

Our next monthly conference call will occur Thursday, November 17th at 11 a.m. Mountain Time (1 p.m. EST).

Phone Number: 866-740-1260

Access Code: 4682824

To view slides on the internet during the call, go to www.readytalk.com and enter 4682824 under "Join a Meeting".