



## Quarterly Economic Update

3rd Quarter 2009

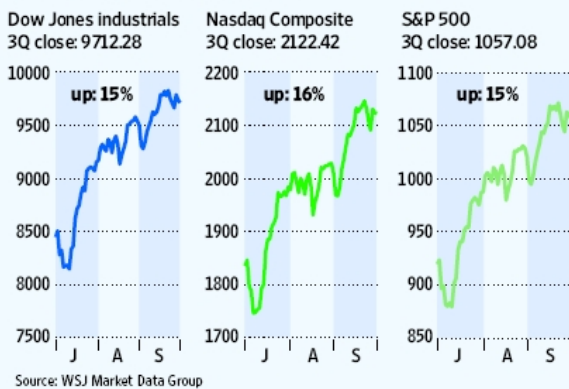
Dear Valued Client,

We apologize for the delay of this Quarterly Economic Report which was due to the milestone event of the Dow hitting the 10,000 point level on October 14<sup>th</sup>. We wanted to make sure that this report included information on this important event.

Wow – the Dow hitting 10,000! The stock market continued its upward trend and has confused many investors who believe that now the market may be overpriced. In fact, the market rebounded so quickly it feels that it went from a bear to a bull overnight! The rally that began in early spring gained steam over the summer. In many cases, the market's leaders were stocks that investors had abandoned earlier in the year, many of which were financial stocks.

### Full Gallop

Third-quarter performance, daily closes



Let's look at the numbers.

The Dow Jones Industrial Average rose 15%, its best 3<sup>rd</sup> quarter since 1939; the Dow is up 48% from its March 9<sup>th</sup> low and up 11% for the first 9 months of 2009, although it is still down 31% from its October 2007 record high. Its 28% gain over the past six months was its best performance since the two quarters ended in March 1987. (Source: WSJ, October 1<sup>st</sup>, 2009)

The S&P 500 stock index also increased 15% in the third quarter, leaving it up 17% through September 30<sup>th</sup>, 2009 and up 56% from its March low; however, it is still off 32% from its October 2007 high. (Source: WSJ, October 1<sup>st</sup>, 2009)

The NASDAQ Composite also had a great third quarter, increasing 16%, and is up 71% from its low on March 9<sup>th</sup> to October 19<sup>th</sup>. Unfortunately, it still is down 24% from its October 2007 record high.

These numbers are amazing; there are "times" when the markets defy any rational explanation and we might be in one of these "times". The rally has continued its upward journey in October and the Dow has now climbed past the 10,000 mark. Wow! The Dow closed at – 10,000? Wait a minute, can you believe it? It was only about seven months ago when the Dow reached its low (gulp, at least for now), on March 9<sup>th</sup>, 2009.

Think about it – did any of you think that the Dow would go from 6,547 to over 10,000 in 2009? "The last time I saw 10,000 it was going the wrong way", was stated by Doreen Mogavero of Mogavero Lee & Co.,

which shows her perspective on the Dow Jones Average again hitting five figures. (Source: Newsweek, October 26<sup>th</sup>, 2009)

After seven months of big gains for stocks, many investors are concerned about the underlying strength of different companies and about the uncertainty of what will drive the market as the Federal Reserve starts to peel back its layers of support.

Although many investors are concerned that the market has now increased to such a high number that it is very likely to start going down again. As you can see from the chart below, however, we are nowhere near the major indicators when they hit their past all-time highs, and therefore many investors believe that the market is more likely go higher than to go down.

Indicator	High	Date
Dow Jones Industrials	14,164.53	October 9, 2007
S&P 500 Index	1,565.15	October 9, 2007
NASDAQ Composite	5,048.62	March 10, 2000

There are a number of reasons to be optimistic at this time:

- The latest rally has come as the economy shows signs of stabilization.
- Corporate profits of many companies have come in above expectations, in large part due to cost cutting.

Unfortunately, a significant number of problems in our economy remain, including consumers with high levels of debt, high unemployment reflecting a weak job market, and depressed home prices.

Many investors are asking the same questions – is the economy improving? Is the economy worsening? What is happening?

The best response may be shuffling all of this financial data into one big pot and stirring it: take 307 million people in the U.S.; add \$14 trillion in GDP (how much is that?); \$2 trillion in expected federal deficits this year and \$300 billion in trade deficit. Now add in another 6 billion or so people on the planet, and the fact that the U.S. is the world's largest importer of oil and the world's largest borrower of other people's money. Add to these all of the political, cultural and social ingredients to the pot, too. Put all of this in a blender and what have you got? You can call it whatever you like, but it doesn't provide those quick and simple answers that most investors would love to hear. It also doesn't fit into the 15-second comment during the evening news either. (Source: Bob LeClair's Finance & Markets Newsletter, August 22<sup>nd</sup>, 2009)

Let's look at some important data to see where we should go from here.

## **GLOBAL ECONOMIC UPDATE**

Most global stocks also continued to climb for the third quarter. The Dow Jones Global Index, excluding the U.S. Total Stock Market Index, increased 19% in the third quarter. The Dow Jones Stoxx 600 index of large European companies rose 18% for the quarter in "anticipation of a full-blown economic recovery" aided by low interest rates and plentiful liquidity, said Sarah Ketterer, chief executive at Causeway Capital Management in Los Angeles. (Source: WSJ, October 1<sup>st</sup>, 2009) However, despite the signs that the global economy is improving, various risks remain, including the possibility of higher interest rates and inflation.

The MSCI emerging-markets index was up 20% in the latest quarter. However, percentage gains slowed in some markets, such as India, which "only" increased 18%, compared with almost 50% in the second quarter. In fact, China's Shanghai Composite Index was one of the few that fell in the third quarter, down 6.1% after soaring almost 63% in the first half of the year. (Source: WSJ, October 1<sup>st</sup>, 2009) Many investors

were concerned during the summer months that bank lending had slowed and raised the possibility that the Chinese recovery was unsustainable at its current pace. However, these fears have been easing recently because the Chinese government has just announced a number of new economic policies that will be implemented in the near future to address these concerns.

Some investors are worried about the huge run-up in the prices of emerging market stocks and are warning that rapid capital inflows and rising domestic spending in developing economies are signaling a bubble. The herd instinct that has investors going into emerging markets “should make anyone nervous, because once the party is over, it is hard to get out the door”, according to Frances Scotland, director of global macro research at Brandywine Global Investment Management, LLC. (Source: Investment News, October 12<sup>th</sup>, 2009) However, many investors still feel emerging markets offer good long-term value since many of their governments learned important lessons recently about debt-induced disasters, and believe that various economic packages passed by these governments may hopefully help avoid these problems .

## **UPDATE ON THE FINANCIAL CRISIS – ONE YEAR LATER**

It is hard to believe that it has now been a full year since the financial markets had an economic meltdown and devastated the major capital markets – many countries around the world took drastic measures and implemented new economic policies to fight back against this crisis. The good news is that it is estimated the world’s major stock markets have recovered about two-thirds of their losses. Unfortunately, many economies around the world are still in one type of recession or another, most of which were triggered by the disaster.

Even as we pass the first anniversary of this historic event, there is no one cause of the recession that all of the economists can agree on. It appears as though a combination of reasons became the catalyst. In fact, many economists and investment bankers are still researching the details to determine where the flaws in operations of our economy occurred and what steps need to be taken to prevent this from happening again. Therefore, let’s take a look at some of the possible causes of this fiasco.

## **MORTGAGE-BACKED SECURITIES**

One thing most economists agree contributed to the crisis was the issue and misuse of mortgage-backed securities, which in turn was one of the primary causes of the housing bubble. (We’ll talk about that in a moment.) When mortgage-backed securities were first introduced, most banks were very strict in their guidelines about who could get a mortgage and who couldn’t. Pooling those mortgages resulted in fairly low-risk securities, because the mortgage holders had proven to the banks that they were able to make their monthly mortgage payments on a timely basis. Over time, however, as Wall Street bought all the mortgages from the banks to create more of these securities, many banks weren’t as picky about who they lent the money to anymore, since the bank usually wouldn’t hold the mortgage but instead sell it off to Wall Street to eventually be sold to investors.

As these mortgages (sometimes referred to as sub-prime mortgages) grew riskier, ratings agencies didn’t factor that into their ratings, which they kept at the highest triple-A level based on previous default levels. When mortgage defaults increased and housing prices dropped, many investors wanted to get out of their mortgage-backed securities, which unfortunately ended up going into a financial spiral. The collapse of this market greatly damaged the operations of banking systems and also hampered the economic recovery.

The easing of leverage limits for many investment banks contributed to the failure of The Bear Stearns Cos. Inc. and Lehman Brothers Holding Inc., and the near collapse of many others.

## **HOUSING BUBBLE**

Many economists believe that one of the primary causes of the financial meltdown was the bursting of the U.S. housing bubble, which was produced by the Federal Reserve's lax lending policies.

As mentioned earlier, many of the banks changed their lending policies and reduced their requirements for someone to qualify for a loan; housing prices started to go up because many investors qualified for mortgages they would not previously have been able to acquire. Interest rates were very low and more investors could afford the lower payments. When people saw house prices rising, many Americans decided that houses were great investments, and so demand for houses kept prices rising.

This significant increase in the price of houses concerned investors and many were unsure of the "real" value of a property. Many investors believed that as long as they compared prices of similar houses, they could determine if the price was competitive. Unfortunately, this says nothing about whether the home prices in general are justified. This has been referred to as "Ketchup Economics"; if a two-quart bottle of ketchup costs twice as much as a one-quart bottle, the price of ketchup must be right.

The housing bubble helped drive up consumer debt and pushed the national savings rate down to almost zero by encouraging many homeowners to look at their home equity like a savings account. Many consumers borrowed against that equity, and consequently savings fell even further, and debt increased. Look at the numbers – household debt grew from \$7.4 trillion at the end of 2000 to \$14.5 trillion in midyear 2008. (Source: Investment News, October 5<sup>th</sup>, 2009)

The Federal Reserve started worrying that the dramatic increase of these housing prices could affect inflation. When the Fed began pushing interest rates up in 2005, the bubble began leaking and eventually burst. It carried the banking industry down with it because many banks were so heavily invested in financing houses. Many housing prices – artificially inflated by low interest rates and high demand – fell in value, credit tightened and people felt (and were!) poor. Many people reduced their spending and allocated more of their income to precautionary savings, including cash, government securities and money market accounts.

The Fed tried to encourage lending once again by pushing interest rates down even further. Unfortunately, that didn't work because many banks decided to increase their requirements for someone to borrow and many investors decided they didn't want to take on any more debt, and in turn the demand for loans also dropped significantly.

During a normal recession, the Fed usually responds by buying Treasury bills from banks. It drives interest rates on the government debt down, causing many investors seeking a higher rate of return to move into other asset, which drives other interest rates down as well. Historically, these low interest rates have eventually led to an economic rebound. For example, the Fed dealt with the recession that began in 1990 by driving short-term interest rates from 9% down to 3%. Another example is when the Fed addressed the recession that began in 2001 by reducing rates from 6.5% down to 1%. And, it tried to handle the current recession by driving rates down from 5.25% to zero.

With all of this uncertainty, many financial institutions decided not to extend their existing lines of credit to even some of their most credit-worthy customers. As a result, this also caused a liquidity shortage that in turn contributed to the price of many investments to drop significantly.

Unfortunately, zero percent interest wasn't low enough in this recession! As the recession continued to deepen, this conventional monetary policy lost all its traction. You can reduce interest rates all you want, but if there is no money to be lent out, interest rates don't have much of an impact!

The Fed took many actions to fight this financial instability and these proved highly relevant to economic policy—a focus on the depleted capital of financial institutions guided all of the Fed's actions after the fall of Lehman, and it appears that these actions helped successfully head off an even bigger financial collapse.

This is the second time (the first being the Great Depression) when America has been up against the problem of zero percent interest rates that did not affect the economy. Many economists believe that the monetary policy is ineffective and the private sector can't be persuaded to spend more; instead, many believe that the answer to the depression-type economic situation we are currently in (or just left!) is through "fiscal stimulus"; which believes that the public sector must take its place and perform its proper role in supporting the economy. This thinking underlies the Obama administration's economic policies. While some economists think that this is a viable solution, many do not believe that the government should be managing the economy.

## **OTHER CAUSES FOR THIS CRISIS**

Many economists believe that changes in a couple different rules in the securities arena contributed to the recession. One of these was the Mark-to-Market accounting rules, which the government imposed in 2007, forcing banks and life insurance companies to reduce the value of their "regulatory capital" (or investments) as if they were day-trading accounts. In the past, capital was usually assessed at book value for regulatory purposes, which is the price that the institution paid for an investment. Thus, much of the hundreds of billions of dollars of losses these financial institutions reported were not actual cash losses, but artificial book losses.

There was a significant uproar by these various financial institutions and earlier this spring these accounting rules were revised to almost where they were prior to the crash. It's no coincidence that when this modification occurred, profits increased significantly, especially by financial companies, as these *paper* losses were reinstated back into *paper* gains. Think about it – if the Mark-to-Market accounting rules had not been changed, the paper losses would most likely not have occurred, and the significant gains this year probably would not have happened either!

The second change that had a significant impact on our financial crisis was the SEC's removal in 2007 of the "Uptick Rule", which held that a stock could not be shorted unless it had gone up in price first. The argument was that without this rule in place, investors could sell their stock positions, short the stock again and again, which could reduce the price of the stock even further, which could cause the prices of other stocks to go down and create a vicious downward pricing spiral. Although this is currently being disputed, many economists believe that this was a major contributor to our financial problems. (Source: Forbes, October 19, 2009)

## **HOW DID ECONOMISTS GET IT SO WRONG?**

The subject of economics is quite complex. There is no one theory or monetary policy that all economists agree. Instead, there are a variety of theories and policies that have been used for a long time to help manage our economy – and the global economy, too!

As was just demonstrated in the latest recession, these theories can change – sometimes immediately! Most economists did not see this coming and research is now being conducted on how to prevent these problems from happening in the future. However, it appears as though the answer to this question is simple – no one knows for sure! All we know is that recessions will still continue to happen.

It appears that many economists' theories were "shot down" and put to the side by this "Great Recession". Why? Probably because many real-world investors bear little resemblance to the rational, relaxed, cool calculators of efficient-market theory and other prevailing economic models, making the economy subject to bouts of irrational exuberance and unwarranted panic. Even those who try to make informed decisions in a calm, cool manner, keeping their attention on the problems at hand, often find that problems of trust, credibility and limited collateral force them to run with the herd. This, in turn, only magnifies the problem, especially when you take away access to liquid assets, such as lines of credit. Panic only increased when investors realized these available sources of cash weren't available to them anymore.

Few economists saw our current crisis coming, but what is more important is most had not even *considered* the possibility of catastrophic failures in a market economy. Over the past few decades, many financial economists came to believe that the markets were inherently stable – that stocks and other assets were priced right due to the supply and demand theory. Unfortunately, there was nothing in that model that suggested the possibility of the kind of collapse that happened last year.

We have theory and then we have the real world! There are limitations of human rationality that often lead to bubbles and busts; the problems of institutions that run amok; the imperfections of the markets – especially financial markets – that can cause the economy's operating system to undergo sudden unpredictable crashes. Economists will have to acknowledge the importance of irrational and unpredictable behavior and face up to the imperfections of markets. In short, the *belief in efficient financial markets* may have been a contributor to the emergence of one of the biggest financial bubbles in history.

## **SO – WHO IS TO BLAME?**

It is only fair to place the blame on many different sources. Many tried to put the blame on bankers who are not responsible for ensuring economic stability, but on the government officials who had that responsibility and failed to discharge it. They failed even to develop contingency plans to deal with what everyone knew could happen if housing prices escalate at the rate that they did (it had happened in Japan in the late 1980s and the 1990s).

Some of the blame should be shared by the influential economists who assured us that there could never be another severe recession like we just encountered. They argued that in the face of recession the Federal Reserve only had to reduce interest rates and flood the banks with money and all would be well. Everyone wishes it would be that simple!

As mentioned earlier, the Fed has taken many actions that appear to have been successful. However, it is too soon to tell which of these policies, alone or in combination, would be the most effective to resolve our financial crisis. Let us hope that the financial problems we are having today (or just finalized recently) won't occur again anytime soon (or if they do occur, let's hope they're not as severe).

Unfortunately, these implemented policies increased the national debt by a wide margin and this in turn has also caused many economists and investors to worry about the long-term consequences of these recently enacted solutions. (Source: New York Times, September 6<sup>th</sup>, 2009)

## **REACT, READJUST, AND REBOUND**

We hear of so many different arguments about the economy, both pros and cons – the stock market is overvalued, undervalued, slow growth, inflation – but it is important to take a look at things from a long-term perspective because the show will go on! Remember, one of the most common attributes among great investors is patience.

How you respond in uncertain times such as these makes a big difference in your finances. We look at things from a longer-term perspective and not just a short-term investment philosophy. The market historically moves in cycles of gains and losses, and in most cases, gains again. There are many sources that cause market fluctuation; whether it be political, economic, or financial, the market reacts to a particular event in different ways. Historically, this can best be summed up in three stages:

**React:** An event or series of events that creates a downswing in the market.

**Readjust:** The downside momentum slows as many investors reconsider and reevaluate their reaction based on the values of the market's financial fundamentals at that time.

**Rebound:** The market begins moving forward, cautiously but eventually gaining momentum, until the next event. As you know, past performance is no guarantee of future results, but it is important whenever possible to try to step back and watch the stages that we are going through – even today! However, as we try to watch this journey that we are going through at this time, it is important to remember:

“It’s tough to watch the movie when you are in it!”

Let’s first take a look at some of the crisis events the market has faced in the past, particularly those of a financial nature. Please look at the table below and see how long it has taken the market to recover from the downturn in the past. Note also that the market has historically recovered – even from significant events.

**Crises and recoveries in the Dow Jones**

	Reaction dates		Reaction dates loss (%)	DJIA Gain %- Months after reaction dates				DJIA recovery
				1 mo.	3 mo.	6 mo.	12 mo.	
Panic of 1907	2/15/1907	11/20/1907	-42.90	6.90	14.70	29.90	48.30	6/24/09
Market Crash of 1929	10/11/1929	11/13/1929	-43.70	27.30	34.10	46.00	11.80	9/17/54
JFK Assassinated	11/21/1963	11/22/1963	-2.90	7.20	12.40	15.10	24.00	11/29/63
Penn Central Bankruptcy	6/19/1970	7/7/1970	-7.10	8.00	16.00	24.90	33.80	7/16/70
Arab Oil Embargo	10/16/1973	12/5/1973	-18.50	9.30	10.20	7.20	-25.50	1/29/76
Hunt Silver Crash	2/13/1980	3/27/1980	-15.90	6.70	16.20	25.80	30.60	7/14/80
Continental Illinois Bailout	5/8/1984	5/27/1984	-6.40	2.30	11.50	10.10	18.30	8/31/84
Financial Panic '87	10/2/1987	10/19/1987	-34.20	11.50	11.40	15.00	24.20	7/31/89
Asian Stock Market Crisis	10/7/1997	10/27/1997	-12.40	8.80	10.50	25.00	16.90	2/6/98
September 11	9/11/2001	9/21/2001	-14.30	13.40	21.20	24.80	-6.70	11/9/01
<b>Average</b>			<b>-19.83</b>	<b>10.14</b>	<b>15.82</b>	<b>22.38</b>	<b>17.57</b>	

Data Source: Ned Davis Research 1/09

What the table doesn’t tell you is *when* the current market will recover. Many officials -- even Ben Bernanke -- have announced that it appears that the recession is over.

**UP, DOWN, OR SIDEWAYS – WHERE IS THE ECONOMY HEADED TODAY?**

The cover of August 3<sup>rd</sup>, 2009 Newsweek magazine declares “The recession is over!” If our recession did end on that date, then it officially lasted 19 months, the Nation’s longest since 1933. (Source: Newsweek, August 3<sup>rd</sup>, 2009)

Treasury Secretary Tim Geithner and Federal Reserve Chairman Ben Bernanke have recently announced that the recession is officially over. Unfortunately, the credit markets are in much worse shape. The volume of overall bank lending has not returned to pre-crisis levels. Many banks have had to cut off the flow of credit to their clients, even the most credit worthy clients. This can cause many small and medium sized businesses who continue to lay off their employees without access to capital.

The first reason for the slowdown in lending is that underwriting standards have risen across the board, making it much more difficult for businesses to obtain loans. A year after the height of the panic, banks continued to tighten lending standards for mortgages, and the popular press routinely decries the lack of rebound in consumer credit despite government intervention to stimulate borrowing. The credit has been scaled back dramatically due to other new requirements imposed by the Fed since the correction.

According to the reports issued by the major rating agencies, in 2007 \$700 billion of asset-backed securities were underwritten; only \$10 billion has been issued in 2009! Whoa, what a change! (Source: WSJ, October 16<sup>th</sup>, 2009) Many economists agree that unless the credit lending systems are fixed, the road to recovery could take a lot longer and could be more painful.

So – is the recession really over?

Unfortunately, it doesn't feel like much of a recovery because it has not generated enough jobs to make a dent in the unemployment rate. The other important question is: Will the upturn last?

This question arises because the early stage of the recovery is being production-led, not demand-led. Business output is so far below the level of overall spending that increased production will be needed just to slow the overly rapid depletion of inventories. To keep the production rebound – and the recovery – going into 2010, overall spending will have to pick up and that is a big uncertainty given the problems still facing consumers. (Source: BusinessWeek, July 23<sup>rd</sup>, 2009)

Enormous government support to household incomes in the first half of 2009 is expected to decrease even as labor markets remain weak. However, any economic recovery will be fragile until the labor markets can offer U.S. households a sustainable source of income growth.

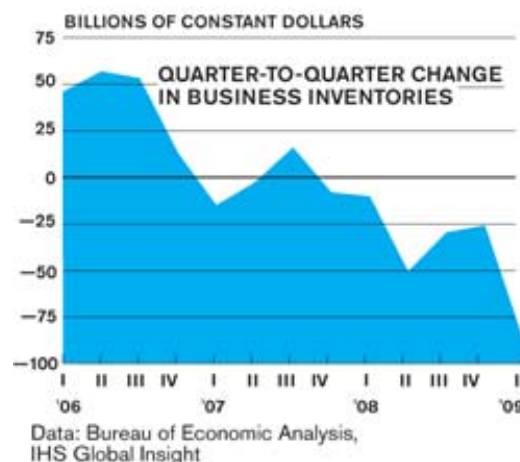
There have been signs of stabilization in both the United States and global economies, but a great deal of uncertainty remains. There are clear indications that some economic “green shoots” are emerging, but these green shoots have been brought up in an environment that is still largely barren. The negatives are getting smaller, the positives are getting bigger, but it is very possible “sideways” is a likely candidate. Famous economist Yogi Berra, said “It ain't over till it's over”!

It is important to remember that there is a stark difference between the end of a recession and a return to “normal” levels of economic activity. The labor market remains under tremendous strain and the massive amount of wealth destruction brought about by the severe Bear market will continue to weigh on confidence levels to the point where both consumers and businesses may be unwilling to spend or take on more debt. The reality is that, for many people, the environment will continue to feel like a recession even after it is technically over.

Should we celebrate now and feel that our problems are behind us? Of course not! When the market goes up 50% in such a short period of time, this can influence investors to sell and take their profits. This profit taking can also be triggered by emotional reasons, as well as financial.

Let's take a look at some interesting observations. The market bottomed on March 9<sup>th</sup>, 2009. Since then it has increased significantly, and if you look back, many investors bailed out of the market in or around that time of its low when in fact, looking at it from a rearview mirror approach, that would have been the best time to invest. Well, hindsight is 20/20! You never know whether we are experiencing the height or the bottom until sometime in the future. However, if you look at the historical data, most of the profits come in the beginning of most Bull markets, usually well before most investors have even realized that the market has turned from a Bear market into a Bull market. Remember – this can happen at any time without notice, so be prepared. Therefore, the question is “Are we at the top of the Bull market and is it about to go down, or is the Bull market going to continue its upward trend at this point?” Only history will tell us that. We have to base our decisions today on common fundamentals and interpretation of the economic data. Again, as

## PLUNGING INVENTORIES NOW WILL BOOST GROWTH LATER



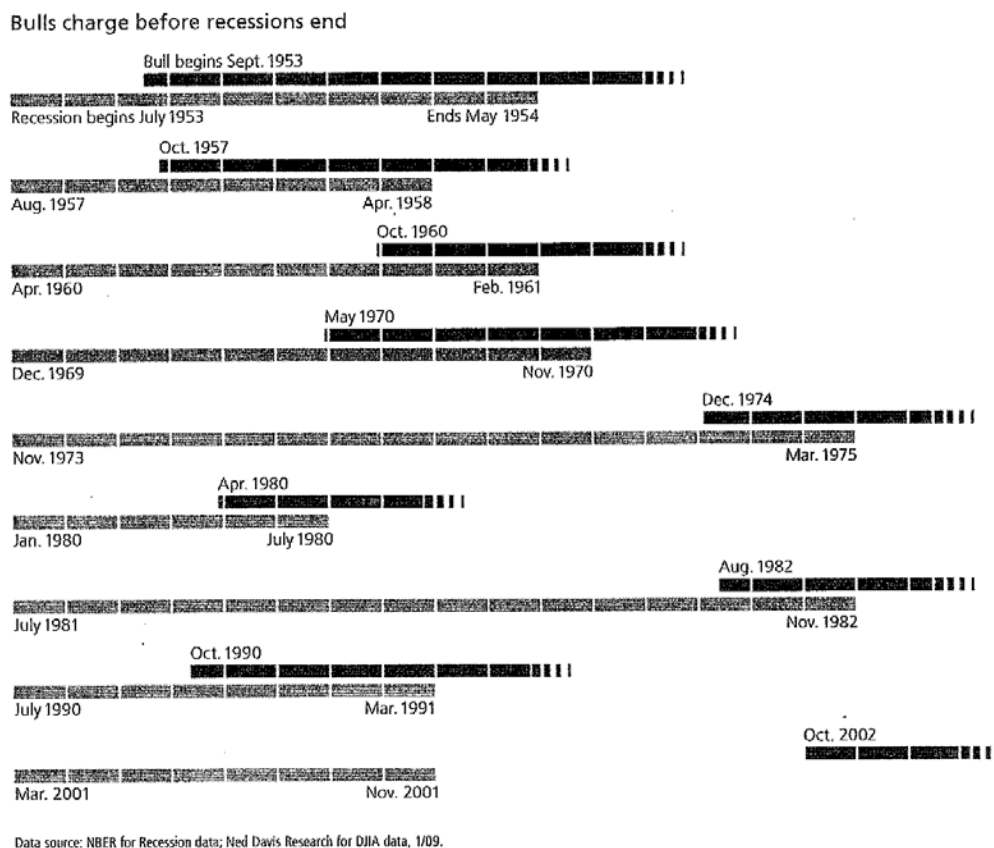
you know, financial ingredients are not the only items on the Wall Street menu; other major issues, such as political, can also be a factor in market fluctuations.

Unfortunately, many investors often make decisions based on gut feelings that have nothing to do with economics. One problem is that economic indicators that appear to contradict each other can cause confusion and misunderstandings for investors. For example, many people are confused today at how the stock market can continue to go up very high despite such ongoing problems as the housing market and unemployment. In order to explain this parody, we must first ask the question:

“Which comes first, the economy or the stock market?”

In past recessions, one of the reasons people remained absolutely convinced that the recession was still raging on was that unemployment was still going up. The media often refers to unemployment as a coincidence indicator of the economy; journalism often implies that economic activity and employment trends do the same things at the same time, rising and falling together. During the last 12 months with unemployment rising to the 10% level, many headlines stated “Job losses stack up as recession deepens.”

Employment historically has been a lagging indicator of the economy. Either way you look at it, the equity market has usually been a leading indicator of the economy and particularly of unemployment. The fact is that in all seven of the previous recessions over the past 50 years, the market turned up on average, 9 months before unemployment peaked, and as you can see from the chart, the recession was still ongoing.



Contrary to popular belief, the market and the economy do not move in tandem, although they can certainly have an impact on each other. The market usually recovers before the economy; therefore, if investors wait for the economy to improve before getting back into the market, they are likely to miss part of the rebound. Please note the chart above illustrates this interesting sequence, at least from a historical perspective. Let’s hope this time it is the same as the ones we have experienced in the past.

Does that mean that the market will continue to increase from this point on? No one knows for sure.

## **INFLATION VS. DEFLATION**

Inflation occurs in periods of rapid economic growth and prices are increasing. Deflation happens when growth stagnates or goes in reverse and prices are falling. Inflation favors the debtor and punishes the creditor. For example, the people who borrow and take long-term, fixed-rate loans at today's low interest rates are likely to benefit, while many bond holders are likely to lose money because bond prices fall when interest rates rise. Creditors to the U.S. government are particularly at risk due to the low interest rates that are being offered at this time.

While inflation is bad for stocks in general, some industries usually do better than others. For example, industries with low fixed costs and the ability to raise prices quickly, such as basic consumer goods, historically do relatively well.

It appears that the economic recovery has done little to increase prices, minimizing the risk of inflation for the time being. In the U.S., Fed officials are still debating whether their policies could breed inflation for the long run. Many officials believe there is so much slack in the economy that inflation could keep slowing in the months ahead which would justify keeping interest rates in their current range of 0 to 0.25% for a long time. (Source: WSJ, October 16<sup>th</sup>, 2009) If inflation doesn't fall, or if it starts to rise, policy makers could be forced to revise that view about interest rates.

Still, many investors are worried about the threat of inflation; however, many economists are not worried since the consumer-price index (CPI) was down 1.5% for the 12 months ending August 31<sup>st</sup>, 2009. (Source: WSJ, October 5<sup>th</sup>, 2009) What these financial professionals are concerned about is the vast amount of stimulus money and credit that governments are pouring into economies throughout the world. Their fear is that at some point, this might result in rising prices for goods and services.

Many investors have gravitated toward tangible assets like gold, commodities, and Treasury Inflation-Protected Securities (TIPS) as a way to fight against this possible problem. However, many of these investments have never been tested during a bout of meaningful inflation. The last time inflation went up significantly was 3 decades ago. TIPS have only been around since the late 1990s.

The price of commodities, including gold, is subject to substantial price fluctuations of short periods of time and may be affected by unpredictable international monetary and political policies. The market for commodities is widely unregulated and concentrated investing may lead to higher price volatility.

## **GOLD**

Another investment often heralded as a hedge against inflation is gold. However, gold hasn't always increased when U.S. consumer prices went up. According to Ibbotson Associates research and consulting, the correlation of spot gold prices to an Ibbotson-tracked inflation benchmark is only 0.096. (Correlation is perfect at 1; the closer to 0, the less the correlation). (Source: WSJ, October 5<sup>th</sup>, 2009)

In English, this means that if the correlation of an investment is 0.9, then the investment has gone up and down 90% of the time the same as compared to what it is tracking. However, at 0.096, let's round this number up to 0.1 and therefore the correlation of gold to the CPI is only about 10% of the time.

Gold has certainly done well in some inflationary periods, like the late 1970s, when the metal spiked above \$800 per ounce. Still, according to some economists, investors would do better to view gold as an international currency that hedges against weakening paper currencies, particularly the U.S. dollar. One of the reasons for the current rally in gold prices is growing worries about a weakening dollar tied to the expanding U.S. budget deficit and the outsized obligations that the U.S. has in its Medicare and Social

Security systems. For example, the U.S. dollar index has slipped more than 13% as of October 4, 2009, against other currencies since March, when its index hit its peak so far for this year. Gold prices, meanwhile, are up more than 14% so far this year, as of October 4, 2009. (Source: WSJ, October 5<sup>th</sup>, 2009)

However, this trend could reverse, particularly if investors perceive that political leaders and economic policy makers have a grasp on these problems. If that should happen, the dollar could strengthen and push down the price of gold even if inflation goes up.

## **U.S. DOLLAR**

The dollar's slump worsened in the third quarter as many economies improved and investors moved their cash into riskier investments in search of higher returns. In fact, it may stumble further if investors bet that other countries will raise interest rates before the Federal Reserve raises ours.

The U.S. Government's efforts to put money back into the economy have made the dollar unusually cheap to borrow. Some investors worry that a significant increase in the U.S. debt could undermine faith in the dollar by sparking inflation. The amount of debt the United States has amassed and the growing size of our budget deficits could potentially have a negative effect on inflation and the U.S. dollar. Although many economists now believe that this will occur sometime in the future, it is no less real and the impact on the capital markets could be quite detrimental.

It is very possible that the various policymakers in Asia and Europe may start complaining that a weak dollar hurts their ability to export goods to the United States. In addition, the dollar slide is also prompting questions about how long the world's largest central banks will continue to consider it the best currency for their reserve holdings. Some critics, especially in Russia and China, have officially called for an alternative to the dollar or for switching to a system of multiple currencies.

All of these uncertainties warrant caution at this time.

## **INTEREST RATES**

Another issue is interest rates. As interest rates have been reduced in the U.S., the demand for the U.S. dollar has gone down because investors can usually find higher interest rates when they purchase other currencies from other countries. Think about it – if you could earn, for example, 1% in one investment and 3% in another you probably wouldn't be as interested in the 1% investment, assuming all other things remain the same.

With interest rates currently low, many investors have been stampeding out of cash equivalents and into corporate, government, and municipal bonds. The rates on these bonds dwarf the returns that investors are earning with short-term investments like money market accounts. However, these gains could quickly turn into big losses if interest rates start rising.

Under ordinary circumstances, rising interest rates send bond prices moving in the opposite direction, hurting investors who depend on fixed income holdings for some of their income. As investors rush out of lower-gain bonds into the higher – paying ones, prices overall fall. In fact, for every one-point rise in the Federal funds and other interest rates, the price of a 10-year Treasury decreases 8.5%; it rises 2 percentage points with the same bond's value by 17%, using figures from Barclays Capital. (Source: WSJ, October 14<sup>th</sup>, 2009)

The demand for U.S. treasuries is high because many investors have the stability and guarantees of the U.S. government. Although many people think that a Treasury note is stable, the yield on a 10-year Treasury note peaked at 15.84% on September 30<sup>th</sup>, 1981 or about 28 years ago. The yield on a 10-year

Treasury note closed on September 23<sup>rd</sup>, 2009, at 3.48%. Let's put this into perspective. If someone had invested \$100,000 in September 1981 versus \$100,000 in September 2009, their income would be about \$15,800 in 1981 dropping down to about \$3,500 this year. Take inflation into account, the return looks pretty dismal especially if you are looking for stability in your portfolio.

## **THE U.S. DEFICIT**

The Treasury said the U.S. ran its biggest budget deficit since World War II and reported that the deficit for the 2009 fiscal year end September 30<sup>th</sup> came in at about \$1.4 trillion, or about 10% of the U.S.'s Gross Domestic Product.

A significant part of this deficit was a result of the \$787 billion stimulus package that was pushed through Congress last winter. On Friday, administration officials defended the stimulus as necessary to pull the economy back from the brink.

The deficit concerns are having an effect on the health-care overhaul and the next steps to take on the Afghanistan war. Still, future projections have remained higher than many economists believe are sustainable. Treasury Secretary Tim Geithner, in a CNBC interview, recently stated that the time for addressing deficits will come "when we've got an economy [that's] growing again". (Source: WSJ, October 17<sup>th</sup>, 2009)

## **CREDIT MARKETS**

Unfortunately, on the short end of the yield curve, interest rates are still stuck near zero. Treasury bills are yielding only 18 basis points (.18%) and interest rates on many money market accounts and financial institutions are only half that. If we use the "Rule of 72", it would take about 7,200 years to double your money with current money market rates! (The rule of 72 is an approximation of the impact a targeted rate of return would have. Investments are subject to fluctuating returns and there can never be a guarantee that any investment will double in value.) In order to help reduce the possibility of spending your principal, many investors are looking to other types of investments besides Treasuries in order to help generate income, but most are trying not to take on too much risk and cause them to lose sleep at night.

However, income portfolio investing encompasses more than just building a static ladder of bonds. It is necessary to take an active approach and manage the yield curve, and monitor many different inefficient credit markets. Unfortunately, many investors lack the knowledge and expertise to perform these functions well and it is often a good policy to be sure that these functions get performed by specialists.

There are many different types of bonds ranging from short-term to long-term, high-quality versus low-quality, taxable versus tax-free, just to name a few differences. (Dividends are not guaranteed and companies may reduce or eliminate the payment of dividends at any given time for traditional corporate stock.) Another alternative besides bonds is to invest in high-dividend paying equities and preferred stocks. These instruments offer the upside potential of equity markets, but still generate a high income stream that in some cases limits the downside risk during a market correction. However, these equity investments are not without risk themselves and can experience painful down drafts as what happened last year. As always, it is necessary to make sure the allocations within a portfolio are appropriate to the investor's time horizon, liquidity needs and risk profile. There are other investments that often generate above average cash flow such as real estate and other real estate related investments. Unfortunately, some of these can be quite complex and often experience higher volatility than higher producing stocks due to various risks associated with real estate investing such as lack of liquidity and regulatory changes.

There are many risks associated with dividend producing investments and due diligence is critical during the time like these that we are experiencing today may cause a company to reduce their dividend and instead

hoard cash in a competitive landscape. These investments must to carefully monitored and not be purchased with merely a buy-and-hold mentality.

Perhaps the greatest long-term risks to an income-oriented investor are raising interest rates and inflation, which erode the relative value of the income stream. As much as the Fed insists the monetary policy remains the same, inflation is not currently a concern right now, this pressure on interest rates will likely continue especially in light of the growing Federal deficit and accompanying inflation fears.

It is possible that if the CPI starts to go up, the Federal Reserve might increase interest rates in the U.S. in order to prevent inflation from getting out of hand. Should that happen, demand for U.S. Treasuries would probably go up (because the higher interest rates would be more competitive with the interest rates other countries are offering), which could strengthen the dollar and push down the price of gold, even if inflation is heating up.

So – what is an investor to do in order to help offset this potential liability? Although there are a number of different strategies we can use to address this problem, there is no one “solution”, just a variety of actions to try to make this as painless as possible. We will review these alternatives with you during our next meeting since they will vary depending on your situation.

## **THE IMPACT OF “DELEVERAGING”**

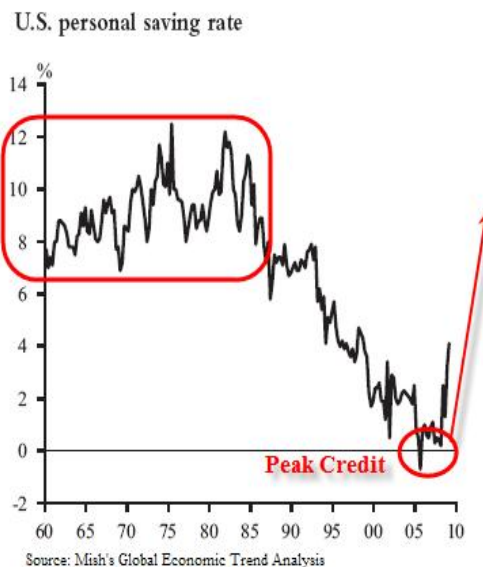
A good sign is that the trend of increasing debt appears to have been reversed, with many consumers “deleveraging”, increasing the national savings rate to 6.9%, which is its highest level in 15 years, according to the U.S. Department of Commerce. This eventually should help make the U.S. less dependent on foreign capital inflows to finance the government’s borrowing. Please see the chart to the right, which shows a significant decline in the U.S. personal savings rate, since the mid-70’s until it bottomed in 2005, which illustrates a “negative” savings rate; it has rebounded over the last three years, a sign that many investors are concerned about their retirement and the economy. (Source: Trend Letter, November 2009)

Consumer credit fell to just \$12 billion in August and it was the seventh consecutive month of decline and the longest stretch since 1991 that Americans have reduced their borrowing. Yeah! The increase in savings over the last several months is good for many consumers’ balance sheets, but does not do much to stimulate economic recovery. (Source: Bloomberg, October 7<sup>th</sup>, 2009)

## **SUMMARY**

Wise investing isn’t simply about your brain power; you also need a sense of how strong your stomach is – how much market turbulence you can actually take before you start selling in a panic. Unfortunately, many investors are clueless about what their tolerance really is.

Now that the market has rebounded much since its low in March, some investors might get a little more lax in their worry about the stock market. Now is not the time to do that! This tolerance isn’t about how much risk you *ought* to take when you invest; it’s about how much you *can* before you start to lose it. When economic times are good, many investors think they have a high risk tolerance, and when things start going bad, this often turns into a zero risk tolerance.



Now that the stock market has shot up more than 50% since early March, here comes the hard part: rebalancing your portfolio to reduce your risk to the level that it should be. You probably have a higher proportion allocated to stocks now and it is often difficult to make a decision what specific securities to sell.

One investor could argue not to sell their winners because they've gone up too much in value and instead sell the losers, which have not gone up in value or may have gone down. Think about it – isn't that a bit opposite of the old investment rule of buy low, sell high!

Now is the time to make sure to take an objective approach while the market is still at a level that we should be more comfortable to make these decisions. We look forward to seeing you soon.

Yours Truly,

Davis Wealth Management Group

P.S. "If economists could manage to get themselves thought of as humble, competent people, on a level with dentists, that would be splendid!" – John Maynard Keynes

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*There is no guarantee that a diversified portfolio will outperform a non-diversified portfolio in any given market environment. Rebalancing a non-retirement account may create taxable events that may increase your tax liability.*

*This optimism about the future does not minimize the fact that we have gone through one of the worst economic periods in market history. Remember that equity markets are volatile and an investor may lose money and there is no guarantee that securities will appreciate.*

*The price of commodities is subject to substantial price fluctuations of short periods of time and may be affected by unpredictable international monetary and political policies. The market for commodities is widely unregulated and concentrated investing may lead to higher price volatility.*

*In general, bond market is volatile, bond prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. The investor should note that funds that invest in lower-rated debt securities (commonly referred to as junk bonds) involve additional risks because of the lower credit quality of the securities in the portfolio. The investor should be aware of the possible higher level of volatility, and increased risk of default.*

Sources: Wall Street Journal (10/1/09, 10/5/09, 10/13/09, 10/14/09, 10/15/09, 10/16/09, 10/17/09), Newsweek (3-23-09, 8-3-09, 10-26-09), American Spectator (October 2009), Money (November 2009), Investment News (10-5-09, 10-12-09), Forbes (10-19-09), BusinessWeek (7-23-09), BlackRock (3<sup>rd</sup> Quarter Global Market Views), The Week Magazine (8-14-09), Research Magazine (October 2009), New York Times (9-6-09), Bob LeClair's Newsletter (8-22-09), By The Numbers (8-3-09), Nick Murray Interactive (February 2009). ©MDP, Inc.

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