Lassus Wherley ...a view from the top
Building Better Futures
Issue 25: May 11, 2010

The World Is Not Coming to an End!!!

Food for Thought

I am beginning to write this on Friday morning as we watch the continued volatility in the world markets. The great run we have had over the past 13 months seems to have abruptly ended with what I can only call the inability of Greece to face reality in its economy and the delay on the part of the European leaders in moving to deal with the crisis. As we stated in the last View from the Top in April, one of the open questions was, "How long will this fast upward trend continue?"; and I think we just answered that. We are now officially taking a few steps backward and a very deep breath.

There is so much uncertainty around Greece and the debt issue and around the UK and the political uncertainty surrounding the election. As we know from past history, financial markets and investors truly dislike uncertainty at any level. So………we are seeing many traders close out positions before going into the weekend to make sure they don't get surprised. Is this the "leg-down" that we didn't believe would occur? We don't think so. We could see a 10 to 15% correction because of both the uncertainty and the fact that the markets probably got a little ahead of themselves.

If you add the glitches or whatever you want to call the issues with the computers and the different exchanges which may have contributed to one of the fastest moves ever seen in the financial markets you have market moves that definitely took our breath away.

A few thoughts to keep in mind as we go through this period in the markets:

- Productivity continues to rise in the US
- The unemployment rate went up slightly from 9.7% to 9.9%........but only because we had a surge in the number of new job seekers. That is typically a good sign in the middle of a recovery.
- Employers added 290,000 jobs in April which was much higher than expectations

There is also other good news on the economy, so………..don't get caught up in the negative cycle on the 24-hour news stations. Remember that they are looking for headlines to get you to watch, not "just" reporting the news like they used to do.

As we get ready to send this out, we are still digesting the events of late Sunday night and the market rallies resulting from the announcements. The European Union finance ministers have agreed to a plan that will hopefully stop the Greek debt crisis from spreading and will stabilize the Euro.

The plan calls for up to €440 billion in loans from euro-zone governments and €60 billion from an EU emergency fund, in addition to €250 billion from the International Monetary Fund, according to The Wall Street Journal. The Journal also confirms that the European Central Bank has said it will buy bonds of European countries experiencing issues with their debt in order to ensure market stability. This is welcome news. We will continue to follow developments on this front as it unfolds. We don't believe that this is a panacea for all the issues in Greece and other countries but it is at least a beginning in accepting responsibility to move forward.

- - - - - - - - - - - - - - -

Thank you, as always, for the great questions you send our way. Here are some of the questions with our responses:

Question: *What does the Greek problem mean to me?* **Answer:** The US stock market has been going up for last few months, with investors continuing to bid up stocks, especially small caps and financials, in spite of the deterioration of the Greek debt crisis. This week it seems that the reality that our economy is indeed truly global finally hit home.

In return for the recently announced €110 billion ($142 billion) loan package, the EU (European Union) and the IMF (International Monetary Fund) have called for Greece to enact strict austerity measures, including huge budget cuts and tax increases. Markets initially rallied on the news of the loan package, but the relief was short-lived. As the week progressed, markets turned down as a Greek nationwide general strike turned violent.

The loan package, with €80 billion coming from other European nations and €30 billion from the IMF, was approved by Germany's parliament after the Greek parliament approved the austerity measures. Germany's approval was crucial since it will be the biggest contributor to the aid package. In theory, if all goes according to plan, the IMF, as well as Germany, France and the other nations who are contributing to the loan package, will get their money back as Greece reduces its deficit from the recent 14% of GDP to the 3% required for EU membership by 2013.

Events this week, however, have called this outcome into question. The idea that Greece will need to "restructure," which essentially means to default, has gained more and more credence. Greek debt is trading at prices that almost assume default. This situation is just an extreme example of what can happen when the size of government gets too big and fosters policies which support entitlements rather than economic growth. Unfortunately, the entire situation has been exacerbated by politics, and this week's resolution has taken far too long. Also, since politics continue to play such an important role here, it is difficult to call the eventual outcome.

Markets worldwide have been skittish all week as investors fear that the same type of situation could occur elsewhere among the other highly indebted countries in the euro zone such as Spain and Portugal. Trouble in these countries would have an even more significant negative impact on European economic growth and by extension, could begin to have some impact on our own growth rate.

Stock markets began this week balancing good news on the economic rebound with negative news on the financial viability of Greece with an eye to what this might mean for Spain and Portugal a few months down the road. All bets were off by Thursday, however, as the news out of Greece was compounded by a computer glitch which caused a wave of bad stock trades.

While the Greek debt issue works itself out, we expect to see continued pressure on the euro vs. the US dollar. A weaker euro will, in fact, bolster European exports. Exports are much more important to the European economy than to the US, and exports to the emerging markets have been growing significantly as a percent of the total. Along with a weaker European currency, we expect that markets will remain volatile perhaps for the next few months as the issue is worked out.

We believe that one way or another, the European Union will muddle through even though this year's economic growth rate may well be reduced. We would expect that the situation will stabilize over the course of the next few months. That being said, we expect that US stocks may perform better than European stock markets this year, especially as returns will not have the tailwind of the weaker dollar that they had last year. We continue to follow the meetings taking place as the leaders of the EU attempt to figure out a better solution to their deficit problems.

Question: *Why are we seeing so much more volatility "all of a sudden"?* **Answer:** "All of a sudden" the worries over the Greek debt crisis seem to have come to dominate the news. This situation has been a long time coming, however. In fact, the rating agency Fitch downgraded Greek debt back in October, 2009 to A- from A when it was revealed that the budget deficit would reach 12.5% of GDP.

If we look at the trading of the VIX, the most common market gauge of volatility, we see that volatility, while in a downtrend, has spiked up several times over the past year to the $30 level. During the turbulent session on May 6, with the market dealing with the Greek debt issue as well as the erroneous trade issue, the VIX closed at $32.80 up from $20.19 at the beginning of the week and a recent low of $15.23 reached on April 12, 2010. The VIX, so known as the "fear gauge," has been in a downtrend almost continuously since reaching its peak of just over $80 back in November, 2008.

Investors had become complacent in recent months with the stock market having been in a pretty steady uptrend since hitting bottom in March, 2009. As noted in last month's View from the Top, we have been waiting for the news that would cause stocks to pause in their upward march, and this week we seem to have found it with the Greek situation, the BP oil spill and the terrorist attack in New York all causing investors to step back, at least temporarily, from riskier assets.

If you are concerned that we are about to have more than a "garden variety" 10% or so correction, please keep in mind that the global financial system is in much better shape than it was two years ago and there is plenty of liquidity in the system. We would also note that we made several specific changes in portfolios over the past couple of years to make them more defensive. These changes included increasing our exposure to hedge strategy funds and fixed income and reducing exposure to small caps both in the US and internationally. We feel that these changes will help our portfolios weather the current storm and enable them to grow over the long term.

Question: *Is the US economy really doing better?* **Answer:** We do believe that the US economy is doing better and will continue to improve. This week we have had several encouraging economic releases, and these had been supporting stock prices until the trading glitch occurred on May 6.

For one, the consumer is coming back and actually spending money. In March, personal income grew 3% year over year and consumer spending was up 2.9% on the same basis. The personal savings rate fell below 3% in spite of recent expectations that the era of spending was over. These are not huge improvements in comparison to past recoveries but are good to see given how important the consumer is to the overall economy.

The ISM Manufacturing Index for April came in at 60.4, the strongest report in 6 years, confirming other recent reports of a strong rebound in manufacturing. Readings above 50 on this index indicate that the economy is expanding while readings below 50 indicate that the economy is contracting. Importantly, this report also indicated that workers were being hired in the manufacturing sector, which is great news.

Finally, on Friday May 7, we had the jobs report which brought us news of 290,000 new jobs added in April. The market had been expecting 200,000 new jobs to be added. Most importantly, 230,000 out of the 290,000 jobs added were in the private sector. The report also showed solid increases in jobs in manufacturing and construction.

All of these reports are evidence that the US economy is indeed recovering. We expect that we will continue to see other indications of this recovery in spite of the events in Europe over the next few weeks.

Stocks lost more than 5% last week and this is, in fact, a healthy development. The markets had gone too long without a correction. It is good to have a bit more fear return to investor sentiment as it helps to establish more reasonable prices. This process is never pleasant to go through, and we would prefer to see the market always move up, but we know this isn't possible.

Looking Forward

Keep those questions coming in. If you are wondering about something, the odds are pretty good someone else may also be thinking about the same topic. When you ask—we get the chance to share our thoughts on the topic with others.

Please let us know if you have any questions or concerns. We are definitely looking forward to a continued recovery in the markets and the economy. Enjoy a wonderful Spring!

Diahann

Investment Committee:

Diahann W. Lassus, CFP®, CPA/PFS, Chair
Anne L. Kehl, Investment Officer
Betty S. Thomas, Investment Analyst
Chadderdon W. O'Brien, Investment Analyst
J. Charles Pawlik , CFP®, Associate Financial Planner