Lassus Wherley ...a view from the top
Building Better Futures
Issue 28: August 27, 2010

Two Steps Forward and One and a Half Back = Very Slow Progress

Food for Thought

The stock market has continued to be pretty much a roller coaster ride this year as investors deal with the uncertainties surrounding the housing market and the not-so-great jobs picture here at home, as well as sovereign debt, high levels of government deficits around the world, and the global economic outlook.

We saw the market peak in late April after the first round of quarterly earnings was released. At that point results looked pretty good and convinced investors that the recovery was doing well and that stocks would continue to move upward based on strong earnings growth.

Since that time, we have experienced the impact of the BP oil spill and been brought back down to earth by the reality of the debt/deficit issues, discussions about health care reform, financial regulatory reform and the continued less than great news on jobs. Volatility has become a regular feature of investing in the stock market, and it is likely to remain so for quite some time.

There are many different views of both where we are in the economy and what is happening with the financial markets. Some believe we are looking at news that can only get worse while those of us in the other camp believe we are continuing to move forward but at a slower pace than we expected.

We have received many very timely questions recently and decided to dedicate this issue to answering your questions. Please let us know if there is anything else you are wondering about. We appreciate the opportunity to help you make informed choices in an increasingly complex world.

Question: *Do you see a double-dip recession occurring?* **Answer:** As we said in our last issue, we don't expect the US economy to fall into a double-dip recession in spite of the slow rate of growth we are experiencing. The spreads which investors are demanding in order to own high-yield bonds or debt currently indicate about a 1 in 4 chance of a double-dip recession. This seems like a reasonable assessment of the chances of this occurring.

We have had more negative than positive economic releases in the past few weeks, and this has fueled the recent downturn in the market. In the week of August 9th, we saw an increase in the US Trade deficit caused by a drop in exports. This release was followed immediately by news that the growth rate of Chinese imports was slowing. The global financial markets reacted to both of these bits of news by heading south.

In the week of August 16th, the markets reacted in a similar way to the release of the prior week's report on initial jobless claims. Initial claims came in at 500,000 in the week ended August 14th. This was the largest total

since November. This report is not the end of the world, but it is another indication that businesses don't yet have enough confidence in the outlook to spend their cash reserves or to begin increased hiring.

Economists are expecting US GDP (Gross Domestic Product) to grow at a 2.9% annual rate in both 2010 and 2011 according to the latest WSJ (Wall Street Journal) survey. The economists at this point are more optimistic than the general public, but they are also revising their growth and jobs forecasts lower. The unemployment rate is not expected to fall below 9% through at least June, 2011. The economists surveyed said that "far and away, the biggest risk to growth is too few jobs, too little wage income, too little consumer spending."

A large part of our concern is that small business has not yet made the turn to begin hiring. Since small business is so vital to our economic growth, this factor alone has had a significant impact on the pace of increased employment and economic growth. Small business continues to have difficulty borrowing since banks have raised the standards for business loans.

Investors' concerns about the possibility of a double-dip recession have increased due to the weak economic releases of recent weeks, the move down in long-term US Treasuries and the comments after the recent FOMC meeting by the Fed. The Fed's announcement that they will engage in some new quantitative easing (they will buy US Treasuries with the proceeds of maturing mortgages in order to keep the size of their balance sheet constant) in light of the slowing in the economy made many investors uneasy. The Fed also indicated that they will keep interest rates where they are and this could continue well into 2011.

Our reason for believing that growth will stay positive, although very slow, is based partially on the fact that interest rates are very low and likely to stay low for an extended period of time. Another factor is that it is normal for the economy to soften after the initial snapback in economic growth that occurs coming out of a recession. The last factor is that double-dip recessions are both extremely rare and very unlikely in a recovery which has been as mild as this one.

The last time there was a double-dip recession (defined as the economy experiencing 2 quarters of negative growth after coming out of a recession) was in 1981-1982 when Paul Volcker, then the head of the Federal Reserve, made a pre-emptive strike against inflation by dramatically increasing short-term interest rates. Finally, US productivity remains at a record level which is a big positive for corporate earnings and should support moderate job growth going forward.

One factor that we continue to watch is the increased buying of US Treasuries by investors who are afraid of a double-dip, indicating that they are more concerned about deflation than inflation.

Question: *How concerned should we be about deflation?* **Answer:** Investors who fear that economic growth will go negative also fear that this will cause an overall decline in prices in the economy. Deflation is a concern because it is hard to fight. There is no easy way to stop it, such as raising interest rates to combat inflation. A declining level of prices causes businesses and consumers to hold off on spending and could lead to further slowing in the economy. Deflation is a concern in a soft economy because the lack of pressure on wages, and the slack in industrial capacity dampens prices.

We continue to monitor the data on price changes in the economy closely. The annual rate of inflation as expressed by the Core (excluding food and energy) CPI is currently running at about 0.9%, indicating that inflation at the consumer level continues to be positive but very low. The Core PPI (Producer Price Index) in July rose to 1.5% from 1% in June as food prices surged. We are not expecting an increase in inflation of any consequence for at least another 2 years or more. Much depends on how quickly the economy firms.

The decline in yields on Treasuries does bear close watching. The 10-year US Treasury was at 4% in April and is now at 2.47%. This cannot represent good value if the economic expansion continues, as we believe will happen. It is an indication of very high uncertainty about what is happening with the economy when bond investors buy long-term Treasuries at such an expensive price level. They are buying them because if there were to be a period of deflation over the near term, long Treasuries would be hurt less than some other asset classes.

Just as we don't expect a double-dip recession, we don't expect that the US economy will experience more than a brief period of deflation, although the risk has increased based on recent numbers. We believe that the recent sprinkling of buy-out deals in the stock market indicates that not only do corporations have cash, but they are seeing good values and are willing to spend it. Consumer demand remains slow and we don't see anything in the cards that will kick start consumer spending.

Question: *Why are high levels of government debt so bad?* **Answer:** Many nations in the developed world are very heavily indebted. This debt will need to be reduced over time as it is weighing down the economic growth rate of these countries. Both households and countries are in the process of deleveraging or paying down debt after having taken on too much debt over the past decade. This process is likely to continue for the next several years and will lower the rate of economic growth. In a recent report on their long-term outlook, Vanguard cites government debt as "the major investment issue of the next decade." Many nations in the developed world have ratios of Federal Government Debt/GDP that are reaching unsustainable levels. In their recent white paper, "Growth in a Time of Debt", Kenneth S. Rogoff and Carmen M. Reinhardt point out that "the median growth of the 20 advanced nations … fell by half as their debt levels moved from less than 30% of GDP to 90% or more." US Federal Debt has recently hit an estimated 93% of GDP.

Developed nations, including the US, need to find a way to cut back on this debt while managing tax increases to limit the impact on consumption. They also need to actively manage issuance of new debt to prevent a rapid rise in interest rates. The problem is that a lot of federal government debt is related to social entitlement programs which are more likely to grow than shrink over the next several years as the baby boomers retire. The eventual solution in each developed nation will involve some combination of reduced spending and higher taxes, with the mix varying from country to country. The risks are that some developed nations will choose other alternatives, such as inflating their way out of the debt or else restructuring the debt (defaulting).

The danger of carrying these high debt balances in the US is reduced by the current very low interest rates. This brings down the cost of servicing the debt. Also, as we discussed earlier, both foreign and domestic investors are currently buying US Treasuries as a hedge against deflation. If the domestic

savings rate continues to stay where it is (around 6%) or move higher, then rates on long US Treasuries may not in fact move up as much as is presently feared. This is another area where we will need to monitor what is happening both in the US and abroad.

Question: *What is the issue with confidence?* **Answer: Investor** confidence is being hurt by the continued volatility in the stock market. We would all sleep a lot better with less volatility in the markets. It is human nature to prefer that the markets move up slowly and steadily rather than take what seems like two steps forward and one and a half back.

Consumer confidence is another issue. We don't need the monthly reports from the University of Michigan or the Conference Board to tell us that consumer confidence has taken a hit. The underlying problem here relates to the job situation. We all have been impacted by the high level of unemployment either personally or in our families or circle of friends. It is wearing and does not inspire consumers to spend with abandon. That is the good news hidden in the bad news. Consumers are doing a better job of managing their spending and savings which is good news for the long-term financial health of the US.

One other positive point on the jobs front which was recently made by Liz Ann Sonders of Schwab is that we may have some catch-up coming in terms of hiring. Many firms laid off even more people than they needed to in late 2008 – early 2009 as they were anticipating an even worse recession than we ended up having. These firms may be close to starting to rehire.

Finally, **confidence in the future** is key for business leaders of both large and small businesses. There are so many unknowns right now that, particularly in the case of small businesses, it just seems safer somehow for many of them to just sit on their hands rather than to spend on equipment or to hire. The issues cited by business leaders are taxes, healthcare, regulations, the cost of regulations and access to credit.

PricewaterhouseCoopers regularly asks business leaders how they feel about the prospects for the US economy. The percent of respondents who indicated they were optimistic grew from 19% to 51% from Q1 2009 to Q1 2010. The percent that indicated they were uncertain, however, essentially stayed the same from Q1 2009 (40%) to Q1 2010 (38%).

Question: *How do you feel about stocks given all these gloomy issues you have talked about?* **Answer:** You may be surprised to hear that we remain relatively positive about stocks. Keep in mind that excessive pessimism is actually good for stocks. Remember the old saw about stocks climbing a wall of worry? Well, it is true. Stocks may well remain in a choppy pattern for some time while some of the issues we have discussed are worked out (double-dip recession or not, deflation or not, onerous government debt burdens and issues of confidence). Investors may well feel better, as we mentioned before, with a slower and more consistent rate of capital appreciation. The fact is that the market usually declines after the initial uptrend coming out of a recession. It is just that this time the initial uptrend was a bit of a moon-shot, and so we need to expect more backing and filling for that reason alone.

We would just point out two things which we feel are important to keep in mind. One is that the primary driver of stocks is really valuation and not the level of economic growth. Stocks do not need a strong economy to post positive returns. Two is that with interest rates as low as they are, we believe that

this is a good time for long-term investors to buy stocks. We continue to buy bonds also, as they provide benefits in terms of income and stability to a portfolio, but we think that returns on stocks should trump returns on bonds over the next several years.

Question: *What changes are you considering making in portfolios?* **Answer:** At this point in time, we are content to leave our portfolios just about where they are. We continue to assess the mix in portfolios on an on-going basis. We have been considering reducing the exposure to Hedge Strategy funds and may act on this later in the year. Given the uncertainties in the market and the tendency for September and October to be very volatile months in the stock market, we feel better leaving things as they are for now.

Much Food for Thought

The challenges in 2010 have been constant but we continue to see glimmers of hope. Some of the good news is that mortgage rates continue to stay at very low levels. Those in the market for a home or refinancing are definitely going to reduce their overall cost in this environment.

If you are into that new media stuff like Twitter and blogging—stay tuned. We are working on starting a blog and I am already on Twitter and doing some postings there. You can follow me @diahannlassus. We continue to look for better ways to communicate with you and keep you up to date on our thoughts and the important articles and other information we want to share with you.

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 restarting the recovery in the markets soon. Enjoy the nicer weather (hopefully)!

Diahann

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