Lassus Wherley ...a view from the top

Building Better Futures

Issue 31: April 8, 2011

The Wall of Worry Continues!

Food for Thought

As I finalize this issue of the View from the Top, the bad news continues to come out of Japan. Our thoughts and prayers are with the brave workers who continue to battle to get the nuclear power plants under control and make it safe for others. We will discuss the economic impact of the many events that have occurred and that continue to evolve, but I would like to take a minute to discuss the human cost of these events. The first is the loss of life in Japan. The losses have been devastating and continue to mount. We hope that the ongoing relief operations will be successful, and we applaud the Japanese people for their courage and determination in facing the series of disasters which they have encountered.

On another front there are positive events in Tunisia and Egypt with revolutions and the beginnings of democratic governments. The road will be a difficult one for each of these countries and their people, but it is truly exciting to see history being made. And, of course, the civil war in Libya continues. In the world today, there are so many moving parts that are all connected in some way. These connections make it even more challenging to look at what is happening and relate it to our longer term view of the world.

Japan, Oil and Euro-zone Debt

After several weeks of anxious moments, we are starting to hear that progress is being made in bringing the reactors at the Fukushima Dai-Ichi plant under control. While we are not nuclear experts, it is our understanding that the longer that any overheating can be prevented, the smaller the supply of the most volatile, dangerous elements becomes. Global markets have reacted positively to this news.

Since the earthquake struck, investors have been concerned with the impact of the prolonged power outage in Northeastern Japan and the disruption in global supply chains on the world economy. At this point, estimates of global growth for 2011 are being cut by about 0.25% to 3.75%-4.00%.

Prior to the earthquake, Japanese equities were looking quite attractive based on factors such as earnings, valuation and sentiment. In spite of the negative impact to be expected on earnings from the current disruptions, for long term investors, the valuation of Japanese equities has improved. Most of the major Japanese companies are exporters and thrive on the strong economic growth which is occurring in the rest of Asia. For many of these companies, a majority of revenues come from outside Japan, and it is possible for them to shift production overseas as well.

The importance of exports to the Japanese economy is the reason for the dramatic, concerted effort by global central banks to bring down the value of the yen which had

soared in the wake of the tsunami based on the expectation that investors would repatriate assets to fund the rebuilding of the damaged Japanese infrastructure. Of course, the ultimate impact of the events in Japan will depend upon the length of the disruption, which is hard to know with any certainty.

While much of the focus has been on Japan, the situation in the Middle East has shared the front page as the US and its allies decided to take steps to support the rebels including conducting air attacks against forces supporting Col. Muammar Gadhafi. This is another situation which has no clear ending at this point in time. Much will depend upon how long Col. Gadhafi decides to keep fighting. We do know that Libyan oil production is now only a quarter of what it was before the crisis and that Libyan exports could be curtailed for months.

The price of oil has continued to rise as a result of concerns that broader unrest in the Middle East may spread to other countries and disrupt fuel supplies. Recently, political unrest in Bahrain prompted Saudi Arabia to send troops into the country. This opens the possibility of a conflict between the two main oil producers in the region, Saudi Arabia and Iran.

There are many questions swirling around as we kick off the second quarter of 2011. Please let us know if we missed any that you are concerned about.

Question: *What is the impact of the chaos in the Middle East?* **Answer:** Since mid-December, markets have been dealing with the political turmoil which has spread across North Africa and into parts of the Saudi Arabian peninsula. Until the United Nations Security Council authorized military force against Gadhafi's security forces on March 18th, opening the way for airstrikes within Libya, the news had been overshadowed by the events in Japan, but it is clear that we have not seen the end of the turmoil in the Middle East.

Any expansion of the recent turmoil into either of the Middle East's largest exporters of crude oil, Saudi Arabia or Iran, would exacerbate the recent uptrend in oil prices, and be negative for the global economy. These two countries, given the size of their reserves and production, are much more important in this respect than Libya.

As in Japan, the main question is how long the disruption will last. If the disruption is temporary and fuel starts to flow freely after a brief hiatus, then the global economy will adjust and muddle through. If, on the other hand, supplies of oil from Saudi Arabia and Iran are curtailed for a significant amount of time, then the world economy will feel the impact more seriously.

We will continue to monitor the situation in the Middle East for its impact on the markets. The long-term positive that could come out of the current tumult is a move towards more liberal societies, if not outright democracy, in this part of the world. We know nothing will happen overnight, and we expect the road to freer, more democratic societies will not be a smooth one.

Question: *What is going on in Europe?* **Answer:** The European sovereign debt crisis is coming back to the fore as the debt troubles that plagued Greece in the spring of 2010 and Ireland in the fall of 2010 are now affecting Portugal. Short-term interest rates in Portugal have dramatically increased as investors become more concerned about its long-term

solvency.

Concerns about the very viability of the European Union have returned to the forefront. There are several issues here. One is the difficulty of having a single currency across 17 countries with great disparity in terms of economic health, fiscal structure and interest rate levels. Another is the fact that German taxpayers are tiring of supporting the fiscally weaker countries on the periphery of Europe such as Greece, Ireland, and Portugal.

The recently enacted Pact for the Euro was an effort to improve coordination among European countries as they deal with Europe's ongoing sovereign debt crisis. The pact increased the European rescue funds (one of the two lending facilities which were created in the depths of the European debt crisis in May 2010) but did not allow the bailout funds to buy existing European government debt. It can only purchase newly issued debt which was the position favored by Angela Merkel, the Chancellor of Germany.

Recently, Moody's downgraded the debt of Portugal, which sent rates on Portuguese debt higher. If rates continue to rise Portugal could be forced to seek some form of bailout. This could lead to worry that the contagion would travel to Spain. Spain is a much bigger economy and would have a more serious negative impact on Europe overall.

For now, Greece looks to be okay until 2013. They have a large share of their economy that is a shadow economy (consists of business activities that are not accounted for by official statistics. It includes illegal activities or what we call the black market and activities that are in themselves legal but go unreported or under-reported for purposes of tax evasion,) and are trying to move towards more fiscal and structural discipline. If Greece were to default, then the biggest loser would likely be the ECB (European Central Bank) as the biggest holder of their debt. For Ireland, the easiest solution would be to restructure the debt held by the banks. This is the solution which the Irish government would prefer, but they have been pressured by the ECB not to do so due to fears of spreading the problem.

ECB President Jean-Claude Trichet has signaled that the ECB is likely to increase interest rates as soon as tomorrow. As ECB President, Trichet is bound to act to contain inflation, but this measure would not be helpful for those EU countries which are still struggling with sovereign debt issues.

Question: *Are you still confident that the emerging markets are going to experience long-term growth?*
Answer: We believe that economic growth rates in the emerging markets will be higher over the long term than in the countries in the developed world. This growth will be driven by the industrialization of the emerging nations and their development of a middle class. Earlier this year, emerging stock markets underwent a pull-back due to worries about inflation. These problems have resulted from the easy monetary policies which have boosted growth in the emerging markets for the past few years. In March, the emerging markets turned up and actually outperformed both US and international developed stock markets.

Meanwhile, the inflation situation is being made more difficult by high food and oil prices. High prices for these commodities have more of an impact in emerging economies than they do in the developed world as the basic necessities consume a much higher percentage of household budgets in these countries. As the central banks of the emerging nations attempt to control inflation, they are raising interest rates and increasing

bank reserve requirements. These policies will slow the economies in the emerging markets over the short term.

Earnings estimates for companies in the emerging markets are being revised downward. This could be a year in which developed markets outperform emerging markets. A lot will depend on how quickly the power and supply lines come back on line in Japan, as well as what happens with the price of oil.

We have been slowly adding to emerging markets positions and will continue to do so as the year unfolds. We are glad to be able to increase the size of positions in this asset class at reduced prices since we intend to hold these positions for the long term.

Question: *I keep hearing about municipal bonds and bond funds having issues. What is really happening and are you doing anything differently to manage the risk?* **Answer:** We are trying to pick the best bond fund managers of national municipal bond funds that we can find and monitor their strategies, sector weightings, and performance. We utilize several short- and intermediate-term bond funds to provide broad diversification and manage the risk of our portfolio of bond funds.

This year prices of municipal bonds have stabilized after losing some value back in December due to passage of the tax package and concerns about the fiscal situation of some states and localities. We do not think that the situation will be as dire as what we read about in the press. Municipalities certainly have issues. Some of the concerns revolve around underfunded retirement benefits and the need to renegotiate contracts with public employee unions.

State debt and pension costs while rising are still manageable. State tax revenues are growing once again and debt service (interest expense + debt that is coming due in the year) is a reasonable 5%-10% of total expenditures. Given how important it is for states to have continued access to the credit markets, states will find a way to pay their debt service, even if this requires tough decisions around taxes and spending.

Typically, interest rates rise and bond prices fall in an improving economy. Prices of municipal bonds may be more volatile than taxable debt over the course of the next few months as new municipal bonds are issued. For this reason, we continue to dollar-cost average into municipal bond fund positions rather than to invest all at once.

As revenues increase, many of the cyclical problems faced by the states will begin to abate. On the other hand, the structural fiscal problems of both state and local governments will only be resolved by some serious long-term budget reforms. We believe that this process will be messy and contentious but are glad to see that these issues are being squarely faced for the first time. As the process works itself out, we expect that there will be ebbs and flows in the municipal market but are encouraged that these first steps are being taken to solve problems which have been building for some time.

While this process works moves forward, we will continue to monitor our muni bond fund managers. Our current positions are well-diversified funds that hold high-quality muni debt, and have short- to intermediate-term duration. These are the characteristics which should enable them to come through the stormy weather in fine shape.

Interest rates will eventually rise as the economy improves, and we expect that the bond portion of our portfolios, both taxable

and tax-exempt, will continue to serve the same role in portfolios that they have in the past. They produce income, add diversification to the portfolio, and serve as a stabilizer in difficult markets.

And the Beat Goes On……

There are lots of issues and concerns this year which may cause markets to be more volatile than they were in 2010. We have mentioned a few of these issues here. It seems to us that global growth may be more challenged by high oil prices, the ongoing sovereign debt crisis in Europe and the threat of inflation in the emerging markets than by the events taking place in Japan. We will continue to monitor each of these situations closely.

There will probably be many more challenges in 2011, including the battle of the budgets between the Democrats and Republicans. 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. Have a very happy Spring! I am definitely looking forward to very warm weather.

Diahann

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