Lassus Wherley ...a view from the top
Building Better Futures
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Two Steps Forward and …….

Food for Thought

As many of you know, I am a big fan of headlines. That is primarily because I think many writers spend a lot of time coming up with catchy and meaningful headlines to get our attention. We are all challenged with how to get people to read what we write. Headlines can really tell a story when you are watching them on an ongoing basis. Here's one that ran in Business Insider on June 7, 2011: "6 Reasons Housing Prices Aren't Rising," written by Bearemy Glaser.

The 6 reasons the article highlights are: unemployment, household formation, shadow inventory, underwater mortgages, more stringent mortgage requirements, and a rising interest rate environment. It was a good look at the different factors. High unemployment has certainly impacted home purchases both for those who are unemployed and can't afford to buy a home and those who are afraid of being unemployed.

We aren't seeing high numbers in household formations due to many factors, including young people staying home longer or returning home. The shadow inventory represents homes where the owners want to sell them but don't believe they can get the right price, so they don't put them on the market. We are not quite sure how they estimate this but it makes sense that there are many people out there who fall into this category.

The next three items are related to mortgages. First there are many folks who are still underwater or who owe more than their homes are worth. In Florida we refer to them as "upside down" since the house is worth less than the mortgage owed. Then you have the fact that it is more difficult to get a mortgage today or even refinance the mortgage you have. And last you have an environment where we expect mortgage interest rates to rise sometime in the near future.

What we know is that home prices have come down a very long way in some parts of the country. What we believe is that they are beginning to stabilize even in those areas where there have been record foreclosures. However, it is probably going to be some time before we see prices begin to move up again. So………..if you are getting ready to sell a home, you have to recognize that this market is different. There are opportunities for those who are looking to buy but remember that the caution light is still on.

I am sure you have also noticed that the financial markets have given back a lot of the gain from this year. It is always difficult to look at statements that have those minus signs on them. So……..as you review them, please focus on the 12-month numbers rather than that 1-month number. The numbers for the year still look good in spite of June's negative returns.

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

Question: *How is the US economy doing?* **Answer:** The US economy has been weakening since posting 3% growth in the 4th quarter of 2010. Real GDP (Gross Domestic Product) growth was 1.8% in the first quarter of 2011, and estimates for the second quarter are being lowered to about 2.3%.

Manufacturing has been growing at a slower rate than in previous quarters. This may reflect a drop in auto production caused at least partially by the disruptions in parts from Japan following the earthquake and nuclear power plant problems. This trend will probably reverse in the second half of the year as auto production increases.

As mentioned in the opening discussion, many homeowners are reluctant to sell their home at a loss. This means they may not be willing to move to get a new job in a different geographic location. (S&P/Case–Shiller National Index showed that prices fell 4.2% in the first quarter of 2011 after falling 3.6% in the fourth quarter of 2010.) The economy is also not getting the benefit of growth in housing-related consumer spending.

The Federal Reserve acknowledges that the US economy is growing more slowly than it had projected but still expects improvement later in the year. It notes that the current soft patch is related to transitory factors like weather and the events in Japan.

There are many reasons to look for a stronger economy:

Near-term increase in vehicle production.

Consumer spending will be supported by a decline in gas prices.

Capital spending will increase as we near the end of the 100% depreciation bonus for equipment placed in service by December 31, 2011.

Expect significant boost from exports in fourth quarter 2011.

As of the latest WSJ survey of economists (June 3-8), GDP forecasts were lowered slightly for this year. At that point in time, economists were still expecting growth to rebound from the 1.8% level of the first quarter. Estimates were calling for growth of 2.7% in 2011 and 3.0% in 2012.

In spite of the recent increases in jobless claims and the disappointing jobs report for May which showed fewer jobs added than expected, the US economy is creating about 200,000 new jobs per month. This seems agonizingly slow, but we have to remember that over 8 million jobs were lost in the Great Recession and the process of whittling away at unemployment is going to take some time. It may take several more years to replace many of the jobs that were lost.

In May the unemployment rate was 9.1%. Economists polled in the WSJ Survey in June forecast that unemployment would be down to 8.6% by the end of 2011 and 7.9% by the end of 2012.

The bottom line is that job growth is key to sustainability for economic growth. We need about 150,000 new jobs per month for a sustained recovery. We will watch this number very closely since any sign that the trend is slipping below that pace would be cause for concern.

Question: *How concerned should we be about inflation?* **Answer:** This is a subject which has generated much debate. Consumers have been hit by rising prices for gasoline and food and are convinced that inflation is a real issue. Economists and the Federal Reserve, on the other hand, are telling us that inflation is not a problem.

Part of the difference in opinion relates to the fact that consumers look at the "Overall or Headline CPI" numbers which include food and energy, and economists and the Fed prefer to look at the less-volatile "Core CPI" which excludes food and energy. We can debate forever whether it makes sense to exclude these important inputs from the most-watched gauge of inflation, but the fact is that there are solid reasons to believe that inflation is not **yet** an issue.

Inflation is unlikely to be a major issue until unemployment declines further. Current high levels of unemployment are preventing wide-spread wage pressures from building up in the US economy. Average hourly earnings are growing at about 1.95%. Since this is in line with or even below the rate of inflation generally, there is no widespread pressure for wage increases in the US economy.

The move upward in the Overall CPI over recent months largely reflected the move in energy prices, including a 33% increase in the price of gasoline. Food prices were up 3.2% from a year ago, and much of the increase in food prices was weather-related. So for now, inflation still seems to be under control but remains another one of the issues we continue to monitor closely.

A positive effect of lower inflation expectations is that it gives the Fed some breathing room and allows it to keep interest rates lower for longer.

Question: *When do you expect the Federal Reserve to begin tightening monetary policy?* **Answer:** Since the Fed itself sees the recovery lagging, it seems unlikely that it will be tightening monetary policy any time soon. Most members of the FOMC (Federal Open Market Committee) believe that the Fed should continue to provide an "easy" monetary policy for some time to come. The Fed's second round of quantitative easing (buying of $600 billion in US Treasuries) is likely to end in June as scheduled, but it is unlikely that the Fed will raise the Fed funds rate for at least another year or well into 2012. This means we are probably looking at interest rates remaining low for some time.

Much has been written in the press about just what the impact of the end of QE 2 will be. Since stocks and commodities and other "riskier" assets began a dramatic rally when Fed Chairman Bernanke first announced the second round of quantitative easing (buying of US Treasuries), it might make sense that this rally could begin to fade when the Fed stops buying Treasury debt. It is this assumption which is behind much of the recent sell-off in commodities and the stock asset classes that had performed the best while the Federal Reserve was effectively pushing investors out of cash.

But the reality is the impact on the financial system should not be dramatic. There are important differences between today's environment and the one that existed in March, 2010. The labor market is moving in a positive direction with net payroll growth in each of the past 12 months. This is in comparison to an economy last year that had lost jobs on a net basis for 10 out of 12 months. Business lending has increased, which is always a good sign. And last, but certainly not least, is that corporate profit growth has outpaced share prices even though we have had a very good run in the financial markets.

Question: *What do you think is going to happen with the US deficit?* **Answer:** Perhaps the biggest issue that the market is facing right now is the US fiscal situation. The US reached the $14.294-trillion debt ceiling, and the Treasury is taking steps that enable the government to avoid default until August 2. These steps buy time for the White House and the Congress to reach a deficit-reduction agreement that would enable the debt ceiling to be raised.

We believe that the debt ceiling will be raised so as to avoid a default, but we may see this decision made closer to the eventual deadline than is necessary or prudent. A default on the debt by the US would be extremely damaging to the fiscal health of our country and cannot be allowed to happen. Taxes will need to be raised whether or not they are accompanied by spending cuts if we are to avoid this potentially disastrous scenario.

We hope that the bluffing going on in Washington comes to an end sooner rather than later and that saner heads prevail. As long as this issue remains on the table, investors will have a reason to worry. The worst case would be a default by the US government which would obviously have very negative repercussions for the markets. We remain cautiously optimistic that the issue will be faced and dealt with. Our main concern relates to how long this process will take.

Question: *What is happening in the global economy?* **Answer:** Economists expect that global economic growth will slow this year from rates seen in 2010 and then rebound somewhat in 2012. Investors are concerned that a soft patch in the global economy may result from the efforts of major emerging markets' central bankers to bring inflation down. We have previously discussed how the emerging markets have been the engine of global economic growth in recent years. As growth in China and India slows as a result of more restrictive monetary policy, then economic growth in other countries in both the emerging and developed markets will slow as well.

Most economists project that China will be generally successful in executing a soft landing for their economy as they attempt to tamp down inflation. This is always a delicate exercise, but the advantage that the Chinese central bankers have is that they are able to take measures without advising or consulting with the representatives of the people as central bankers are required to do in a democracy.

Question: *So how does all of this impact how we should be looking at the markets?* **Answer:** At the present time we are somewhat concerned that global stock markets have been too willing to ignore many of the issues discussed in this newsletter. We may find ourselves in a similar position to that of a year ago when the stock markets went down in May to August over fears of slowing growth and the fiscal problems in Greece.

On the other hand, economic growth remains positive, stock market valuations are not stretched, and companies' balance sheets are full of cash which enables them to raise dividends and to continue making deals. So……..we remain cautious but not worried.

We have recently begun to take some just-in-case actions which include taking quicker profits in those asset classes that have done very well. We are also raising cash levels to slightly above the high end of the minimum/ maximum range in accounts that have regular distributions.

It is normal, although not pleasant, to see some consolidation of stock market gains after a rally that has lasted as long as this one. We don't believe that any correction we face would be more serious than what we faced last summer, but we are watching for any signs to the contrary.

And the Beat Goes On…...

There are lots of issues and concerns this year which may cause markets to be more volatile than we have seen recently. That has certainly been true in June. We have mentioned a few of these issues here. One of the things that we pay close attention to is the rotating headlines. The reason we pay close attention is we believe that there are many more important issues out there that aren't in the headlines today.

If you monitor the headlines and note the difference between last month and this month, you will recognize that the latest issue is the new headline but the issues from last month haven't been resolved. So……..my point is that the financial markets will rotate through problems kind of like the headlines, but we need to pay attention to more than just the current headline.

There will certainly 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 great Summer!

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