

Economic Update Oct. 1, 2011

By Terence L. Reed, CFP

Uncertain Times

In these uncertain times it is easy to carry with us an attitude of negativity, not to mention feelings of doom and gloom. Hearing about the continued falling of home prices and the European debt crises adds to our burden of worry.

Furthermore, noting the faltering recovery and the lack of real jobs being produced only adds to this feeling of malaise. So, during these troubled times what do we get? You guessed it; another downturn in the markets.

Recent Turmoil

Note, that this may be a temporary downturn, which would then be referred to as a panic, or it could be a normal part of the business cycle for equity markets, which is called a correction. Only time will tell. A sign of a panic is when almost every asset class drops in value including the more conservative assets. This has occurred during the third quarter of this year, which ran from July through September. We should know for sure very soon, perhaps by November or December of this year if, in fact, it is a panic. My personal view is that it is a little of both; mostly a panic underlined by a normal bearish quarter.

A Positive Note

On the plus side for the balance of the year, noting the work and research of Jerry Minton, PhD, and his study of market cycles and something he refers to as seasonality. Seasonality is a system of using historical returns for the market and figuring out why the market moves certain ways at various points in time. Typically seasonality involves what the Federal Government may be doing (especially the Federal Reserve), what interest rates may be doing, what congress may be doing, how corporate earnings are doing, or even how people's behavior changes around holidays.

He researched and commented on a phenomena that was noticed in regards to equity markets in general here in the USA dealing with the compromises that typically takes place during the normal four year election cycle. This is based on how politicians generally compromise more during the third year of the cycle to get things done and to get reelected. The third year of the four year presidential cycle has not been down since 1931 and generally shows a strong fourth quarter of this third year leading into the fourth year. So based on history we are keeping our fingers crossed that this time will be no different. Only time will tell if this indicator will hold any value for people's portfolios.

However

Unfortunately, this time the presidential cycle may prove disappointing since we have a political house that is so divided, a rolling European debt crises, and a tapped out U.S. consumer market. In fact, according to a recent U.S.A. Today article by Karina Frayter, who also writes for CNBC.com, She writes, *“Consumer spending, once the driving force of the U.S. economy, is likely to remain stagnant for years as households struggle to cut debt and build up savings, economists say.”* Karina Frayter goes on to report a finding from the Blackrock Investment Institute, that *“While some progress in consumer debt reduction has been made, the heavy lifting of meaningful deleveraging still lies ahead.”*

Karina goes on to note a very important point, “Until consumers repair their balance sheets, they are unlikely to increase spending or take on new debt even with interest rates close to zero. That could continue to hamper the recovery, because consumer demand makes up more than 70% of the U.S. economy.”

I feel this is well said and I could not agree more. The average American consumer is not only tapped out, but they are trying to pay bills, build retirement savings, set up college funds, pay off debt, and make

investments. Not an easy task in today’s environment. Many people are not in the mood to spend money easily.

The really sad fact is that many Americans are so strapped they simply do not have any excess funds at all. According to A. Lusardi at George Washington University School of Business, *“Almost half of all households say they wouldn’t be able to come up with funds to deal with a financial shock of \$2,000.00.”* That’s correct folks, more than half of American families could not quickly come up with \$2,000.00 in cash. We have a problem if that is true.

The Problem and Potential Solution

So while some consumers are holding back because they are working on their long term financial goals, many consumers are simply out of money. Ouch, that doesn’t bode well for any economic recovery that the government keeps telling us is on the way. Those of you that have spoken with me know my views on the recovery, not to mention the lack of real wage paying jobs being created lately here in this country. First, we need fair trade and not free trade. Second, I feel we can only have a real recovery of any notable size if we start making more stuff here and exporting it. The government needs to get out of the way of small to medium size businesses and let them do their

thing. Ironically, at the same time they need to get big business to start doing their civic duty and bring many of the jobs back to this country. The government needs to govern in this instance by using the carrot & stick method. Give big business a tax break on foreign earnings if they wish to bring those funds back into this country for business development purposes, i.e., the carrot. The stick being, the withdrawal of protection of the U.S. Government for any company that employs more than half of their workers overseas, has their headquarters overseas, or sets up their offices in a tax haven to avoid U.S. taxes. This is not difficult stuff to implement but as many of you know, U.S. politics has too many corporate influences via high paid lobbyists. We need to get their oversized influence out of U.S. politics so the government can get on with the business of dealing with the real problems facing us as a people and a nation.

European Debt Crisis

In regards to the European debt crisis, we all have been told of the gravity of the situation. Nobody wants to see countries default on their debt obligations. But I have to tell you, I don't think it has to end up as a financial disaster as many people would have us believe.

I mean a default is not always the worst thing to have happen. Remember a default can mean many different things. In the most obvious case, it means that a person, company, or government had

failed to carry out the terms of the debt obligations. Perhaps they are late on interest payments, or they fail to pay the stated interest rate and instead pay a lower rate, or perhaps they extend the terms of that debt obligation to a longer time frame. Does that really sound so horrible? I mean the ones that would really be affected are the bond holders. They did their due diligence before buying these debt obligations so they should deal with the consequences. They took on the risk factors involved here for a potential reward so let the cards fall where they may.

A default is not the end of the world, but if done correctly by a few targeted countries, it could signal the end of the rolling debt crisis. Note, technically Greece is already in default. Let them negotiate the restructuring of their debt obligations with the people they owe money to, the bond holders. As in any debt situation, simply having people work out their problems with their creditors would be the best course of action. Greece would get a poorer credit rating and would certainly have to pay more interest on its future debt, but in exchange, it could get more room to maneuver in paying off its current debt on a friendlier schedule.

The rest of the economies do not have to get behind Greece and pledge their funds to back up a Greek promise that they Greece cannot carry out. To do so would favor the bondholders but not the citizens of these other countries. Keep in mind that Argentina defaulted on their debt obligations back in the last great recession between 1999 and 2002. It was painful but it seems to have worked out. Also, who can forget those Brady Bonds issued by taking debts owed by small Latin American

countries to banks and reissuing those to others under more favorable terms that could be met. That actually worked out quite well for most parties concerned. Something along these lines could be worked out.

Note, each European country is different than the other. The problems Iceland faced (their banks were too large for such a small country) were completely different than what Ireland faced (their banks let real estate values get too inflated), with Greece having its own unique set of problems (too many people working for the government and lackluster tax collection). They are not related to each other in that sense. So there is not the huge danger of a rolling domino effect if Greece strategically defaults on their debt. In my view, this may be much healthier in the long run than other countries trying to constantly prop Greece up every month or so. After all, why should other European countries throw good money after bad?

Our Conclusion

The conclusion, times are indeed tough and they don't look like they will radically improve anytime soon.

If you have a loved one or friend that is concerned about the management of their portfolio or unsure of how to handle these troubled times please have them contact us. I thank you for holding the course and staying with us in these volatile times. Please call us if you wish a full review of your portfolio.



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