

Planning Resources

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The Economy

The Eye of the Storm?

On the eve of the two-year anniversary of the global banking crisis, the IMF calculates the cost of rescuing the financial system has come to \$12-trillion, a staggering total equivalent to around a fifth of the entire globe's annual economic output.

According to the Bureau of Labor Statistics Employment Situation Summary August 7, 2009, Nonfarm payroll continued to decline in July (-247,000), and the unemployment rate was at 9.4%. This leaves unemployment little unchanged month over month.

This data is an example given that "less bad" is now good. The stock market has reacted to fewer job losses, for example, and rallied on it, basing its claim that the data beat estimates.

Another recent driver of this rally is the observation that many S&P 500 companies have beaten low-ball earnings and revenue estimates. Firm's cost cutting measures easily allowed them to beat these lowball estimates, which helped propel the market higher. There have been very few examples of top line growth which leaves open the obvious question how companies will continue to grow earnings (even against low ball estimates) if the global economy continues to shrink in real terms.

Another very worrisome trouble spot is the chronically weak housing market. The S&P Home Price Index July futures contract, traded on the Chicago Mercantile Exchange is still buried at the \$147,500 per average home, in its 20-city index from \$186,000 in May 2008.

Also, banks still hold a large amount of commercial real estate and consumer credit card losses, and illiquid asset backed securities. However, Congress bailed-out the banks (for the third time in my 20 year career) by pressuring for a change of FASB Rule 157. Banks can now estimate the fair market value of their illiquid assets on what I call a mark-to-make-believe accounting, instead of relying on market prices. Banks have cooked their balance sheets into looking healthier than they actually are.

This problem may be further compounded when the banks finally get around to unloading these “assets”. When a sell side transaction does take place it will be at market value, presumably at much lower than the current mark-to-make-believe values (otherwise why change Rule 157) recognizing a potential huge future loss for the banks.

Home foreclosure filings in the U.S. housing market climbed to a record in July as falling home prices and the recession left more homeowners unable to keep up payments or refinance. A total of 360,000 properties received a default or auction notice or were seized in July. Almost one-quarter of U.S. mortgage holders are underwater (according to Zillow.com, an online real estate service).

There are some positive indicators that things may be improving in the housing market. For example, existing home sales did jump in July to the highest level in almost two years, boosted by lower prices, tax credits for first-time buyers, and near-record-low borrowing cost. It’s a start.

On August 12th, the Fed said it plans to phase out its purchases of U.S. Treasury notes, signaling that its \$300 billion money printing program will end in late October. The Fed has bought \$253-billion of longer term Treasuries since mid March.

We believe the recent Fed announcement is an accommodation to Beijing, who demanded the scrapping of Quantitative Easing (QE), or face the onslaught of Chinese sales of T-bonds, or a buyers strike in the future. The Fed’s announcement that there is a limit to how much Treasury debt it would print stabilized the U.S.-dollar.

One of the results of this change in policy could result in lower bond prices. We are very concerned that many investors are seeking the “safe” haven of bond funds and if bond prices fall (yields go up-as we suspect will be the case) investors could suffer heavy losses.

The good news is that with individual bonds, unless there is a default, when the bond matures or is called, your principal is returned. However, that is not true with bond funds. Bond funds have no obligation to return your principal. In addition, because the “income” from bond funds will fluctuate with changes to the underlying bond portfolio, systematic, predictable income from bond funds is impossible to predict.

It seems to us that central bankers are resorting to the same tactics which brought about the financial crisis in the first place, attempting to hop-up the stock market and other financial assets, through massive injections of cheap money.

“There are two ways to be fooled, - One is to believe what isn’t so; the other is to refuse to believe what is so,”
– *Soren Koerkegaard 19th century Danish philosopher and theologian*

Our Outlook

It is hard to expect a sustained recovery in debt-financed gross investment in an economy under strong deleveraging pressure. That's particularly true since the U.S. itself has not financed a penny of the growth domestic investment in more than a decade – all of the growth has been financed by foreign capital inflows via a massive current deficit. With government spending now drawing on those foreign savings to defend banks and bondholders from losses, gross domestic investment is likely to be squeezed.

There is no doubt that bull markets (of any variety) ignore any bad news. Whether you believe the Fed and their cohorts have saved the world from financial disaster, or simply think we are in a brand new bull market, it does seem that speculation is back in vogue. And that raises a yellow flag.

Speculation is not necessarily a bad thing, but what has popped up recently seems that stocks left for dead such as AIG and Fannie Mae have suddenly become the momentum stars that internet stocks were back in the late 1990's. Indeed, Fannie Mae is technically insolvent, making its recent quadrupling in price pure speculation. The speculative juices are back, which is typical to see near the end of an up cycle.

The Federal Reserve has spent the past year cleaning up after a housing bubble it helped create. But along the way it may have pumped up another bubble, this time in industrial commodities and stock markets. To head off the worst downturn since the Great Depression, the Fed slashed interest rates to zero percent, while funneling \$1.75 trillion into the coffers of Oligarchic banks, which in turn, have plowed the excess cash into corporate bonds and stocks. If given free money, an investor's appetite for risk shoots higher.

In our opinion, this is not the recipe for a sustained economic or stock market recovery.

As we pointed out in our last piece, while we are pessimistic about the economy and the stock market, we are very bullish on our portfolios which are structured as follows:

- 20% International, Infrastructure and Technology stocks - fully hedged
- 20% Long short-term U.S. Government and Foreign Government Bonds indexed to inflation
- 10% Short long-term U.S. Government Bonds
- 10% Long/Short Commodity Futures
- 10% Gold
- 10% Mergers, Acquisitions, and Event Arbitrage
- 20% Cash

We continue to look for short side opportunities in what we consider to be overbought equity indexes.

We also like many of the protected value accounts available and non-publicly traded Class A Real Estate for a well balanced portfolio with income.

Note: These are target levels and each individual portfolio may be overweight or underweight an asset class depending on a number of factors including individual risk profile, account inception date, and any highly concentrated holdings the client may already own.

Summary

We remain defensive, but continue to believe that we will see outstanding investing opportunities as a result of excessive speculation and willingness on the part of many investors and their advisors to Buy-Hold-Hope.

If you would like to schedule a complementary portfolio review or meet with any other of our specialists in Estate Planning or Risk Management, please feel free to give me a call.

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