Quarterly Newsletter,
2nd Quarter 2009
7/17/09

A conference call is scheduled for Friday, August 28, at both noon and 4:30 PM. If you have topics you'd like discussed, please let us know. We can't promise to cover everything, but we will do our best.

For Clients and Friends of Financial Connections

It is a pleasure to say that the investment returns for the markets finally had a positive quarter. Domestic equities, international equities, and bonds were all up this quarter. In fact, stocks had their best quarter in more than 10 years.

The question most people are asking is, will this be the beginning of a new bull market? The second-quarter market increase seems to be more a reaction to the slowing of the economic decline rather than the beginning of a recovery. In fact, while April and May had positive returns, June was essentially flat.

Uncertainty Remains

As usual, the economic indicators are conflicting. The overall environment improved, but many problems remain.

- The potential for a financial system meltdown seems to have waned, yet the world economies are still fragile.
- Economic activity continues to decline, but at a slower rate, which suggests we are closer to an economic bottom.
- Consumers and businesses are expected to spend less, as the economy in effect resets itself following the artificial boost from the credit bubble.
- There are some positive signs for housing, including stronger demand and more affordability.
- Additional foreclosures are anticipated as adjustable mortgages reset.
- High unemployment may worsen foreclosures.
- Inflationary pressure will occur, but its timing is unclear.
- Loss of jobs continues.
- Federal deficit increases significantly.

Opportunities

With so many conflicting signals, there is no way to determine how the coming years will unfold. Many analysts predict a mediocre rate of return over the next 3 to 5 years for both stocks and bonds. Yet other analysts say after periods we've just experienced, equities will do extremely well.

Since we do not know which opinion is more accurate, we will continue to diversify our portfolios, with exposure to cash, bonds, stocks, tangible assets, and alternative strategies.

We continue to see opportunities in high-yield bonds. Emerging markets also offer potential gain although they come with higher volatility. It is anticipated that future economic growth will come outside the United States as the middle classes in the emerging markets gain economic traction. The hope is that an increase in their spending will offset the decrease by American consumers and spur global growth.

While inflation continues to be a concern for the future, we do not see an immediate problem (see related article).

WHERE DID THE INFLATION GO?

There has been much written about anticipated inflation. A closer look at the statistics suggests that the financial press is too eager to cry "Wolf." None of the indicators show inflation is on the horizon. Here are signals to watch for:

Signals to Watch

Tight Labor market: Since World War II, sustained inflation has occurred only when the labor market is tight (low unemployment, many jobs unfilled). Currently, national unemployment is the worst in the last 25 years.

Consumer Spending: If demand for goods is high and supply is low, inflation can take place. But consumers are spending less, earning less, saving more, and repaying debt.

Velocity of Money: The number of times a dollar changes hands as it moves through the economy in the course of a year is called the velocity of money. It needs to be fairly high for inflation to take place.

Example:
- ♦ The bank lends money to Company A,
- ♦ Company A buys supplies to create inventory,
- ♦ The supplier spends money to pay its employees' wages,
- ♦ The employees spend money on groceries,
- ♦ The grocery store pays the farmer for produce, and
- ♦ The farmer buys more seeds.

This is an abbreviated, simplistic example of how $1 lent by the bank and spent by others makes its way through the economy. When money moves at a high velocity, it can be inflationary. At a low velocity it usually isn't.

The flow of money in the economy is now at a very low velocity. The banks have increased their reserves but are not lending in large quantities.

Wages: Usually, inflationary times bring wage increases. That is not occurring today—in fact, wages are declining as people take pay cuts in order to keep their jobs.

Debt Repayment: By repaying debt, American consumers partially offset the potential for inflationary activity by the Fed. But if they repay debt without spending money on other goods, a lower demand for goods keeps prices low. Rising prices are inflationary.

Capacity: When inventories are low and manufacturing is at or near capacity, inflation can occur. Right now, we have excess capacity.

So, while inflation may be just over the horizon, we do not anticipate it occurring in the near term.

WHAT LETTER WILL OUR RECOVERY EMULATE?

Recessions tend to recover in four styles: V, W, U or L.

V = A rapid decline followed by a rapid market increase

Michael Mussa of the Peterson Institute for International Economics says, "Deep recessions are almost always followed by steep recoveries."

After the deep 1973-75 recession, the economy rose at a fast pace (6%) and even faster (7.75%) after the deep 1980-82 decline.

Mild recessions such as those in the early 1990s and early 2000s led to mild recoveries.

W = Two V-shape declines and recoveries

This type of decline/recovery is a double-dip. We have the decline since fourth quarter 2007, we experienced a recovery the second quarter 2009. This equals a "V" shape. If we have another decline then recovery – it will add a second "V" to make a W style recession.

U = A prolonged recession before recovery takes place

Nouriel Roubini, known as the glum economist, predicts a recession lasting 24 months before an upturn.

L = A decline and then a market primarily flat—trading within a small range

In this scenario the economy and market stagnate for an extended period after a decline. Japan is a good example of an L-shape recovery.

Only in hindsight will we know which shape our recovery will take.
As he reviews the different types of recovery, Roger Gibson, a financial planner well known in our industry for his asset allocation research, suggests that we will have

double- digit returns over the next 10 years but periods of severe declines in the process.

One of the reasons we are asking you to review and update us on your cash requirements is that we suggest you keep funds in cash and cash equivalents for 3 to 5 years. Hence if the market does have severe declines, though temporary, you will still have enough money to meet your expected withdrawals while the rest of your portfolio recovers.

Please contact us to set up an appointment or set up a conference call to discuss your withdrawal requirements.

BEHIND THE UNEMPLOYMENT NUMBERS

The unemployment numbers seem grimmer every week. When we hear that 500,000 people lost their jobs, should we assume that no one was hired and 500,000 people were terminated? Not at all.

In February, the Bureau of Labor Statistics announced that 4.8 million workers were laid off or chose to leave their jobs while 4.3 million workers were hired. So the number of unemployed we hear about is the net difference between jobs gained and lost.

One segment of the population is actually gaining jobs: people in the 55+ age category. In May 2009 they filled 224,000 new jobs, while the balance of the population lost 661,000 jobs.

Oddly enough, a mismatch between workers' skills and employers' needs means that there are 3 million jobs available that employers still cannot fill. People laid off from construction, finance, or retail lack the training for the new openings in education, accounting, healthcare, and government.

The housing market also makes it difficult to sell a house and relocate for a new job. The Census Bureau found that renters, not surprisingly, are more likely to move for a job than homeowners.

We hope that between the government and private employers, retraining can take place to keep up with the new job opportunities.