FINANCIAL CONNECTIONS
GROUP INCORPORATED

For Clients and Friends of Financial Connections

Quarterly Newsletter, 3rd Quarter 2012
10/17/2012

We will be offering a webinar (seminar via the web) on **Monday, November 12** at 4:00 PM conducted by our long-term care consultant, Allen Hamm.

He will discuss: the four options for paying for care, and his new Genetic Analysis algorithm which can help you determine the likelihood of needing long-term care services.

Please let us know if you are interested in attending.

Risk-on was a theme for the third quarter as investor buying resulted in meaningful increases across most global indexes. Yet the bulk of the news this quarter was not positive. Europe hasn't solved its structural problems, China's economy continues to slow, and the U.S. economy stumbles along.

The Fed's QE3 might offer some assistance to grow the economy and reduce unemployment here at home (see related article) and the European Central Bank plans to assist European countries by buying distressed debt. Already sovereign debt interest rates have declined in Spain.

Europe

Europe's austerity approach, led by Germany, doesn't appear to be a solution. There needs to be fiscal stimulation for growth. According to Dr. David Kelly, chief strategist for JP Morgan Funds, you can't implement austerity measures when you are in a recession. "You need to stabilize the patient before curing him." Spain and Italy have unemployment rates of 25% and the age group under 25 has an unemployment rate of 50%! The southern European countries need growth.

International Monetary Fund (IMF)

October 9 the IMF published its updated Outlook Report. It reduced the estimate of global growth for 2013. Financial controls, fiscal stimulus, and political turmoil were some of the factors identified. The market response was that the Dow Jones Industrial Average lost over 100 points (10/9/12).

The IMF did marginally upgrade its expectation for U.S. growth for 2012.

Continued inside...

One of the benefits of having signed up for your electronic safety deposit box (portal) occurs if you upload a copy of your passport. In case of emergency, you have access to the information.

Clients of Financial Connections

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Leaving home

The phrase "boomerang generation" has come to sound familiar. It describes children who leave home but come back. Nearly a third of Americans between the ages of 18-35 were living with their parents in 2010, resulting in a slowdown of what the Census Bureau calls "household formation." However, a recent study shows nearly half of those living with their parents plan to move within the next two years; an additional 26% plan to move out in about three years.

Home buying triggers a wide range of economic and job growth.

Second-hand car shortage

A sidebar to the Great Recession is a shortage in used cars. With the recession, people are keeping their cars instead of buying new ones. In fact, the average age of light vehicles reached an all-time high of almost 11 years.

The purchase of new cars this year is expected to reach 14 million from a low in 2009 of 10.4 million. General Motors reports car sales at their highest level since August 2009. We would anticipate the inventory of used cars to rise again.

Your portfolio

Included with our newsletter are your reports. We strive to build portfolios to minimize the downturns and participate in the upturns. Since we don't believe anyone can time the market, we try to design portfolios to weather all ebbs and flows of market returns.

One of the downsides to this approach is that you do not fully participate in rapid growth environments. If you would like to discuss changing your risk profile to participate more in the upsides, recognizing the potential for more downside, we are happy to have this discussion.

Please give us a call.

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FINANCIAL PLANNING FOR LATER YEARS

Our money needs to stretch further as we live longer. Creating a plan for later years can offer comfort as we go forward or raise a flag early enough to make adjustments. To determine how long your money might need to stretch, we begin by designing a plan.

<u>The Process</u>

First the client gathers information. Today, with computers, obtaining the latest values for retirement plans, bank accounts, investments, and Social Security may just take a few clicks. Using software to track your expenses may be another click instead of preparing an expense review manually (think Mint.com, Quicken, etc.).

One of the most difficult tasks is for people to figure out what they expect to spend in retirement. The starting point is to take a look at your current expenses and extrapolate what a future lifestyle might look like—and whether your income will allow it.

This may be complicated by questions like whether you plan to work during the traditional retirement years, what hobbies you plan to pursue, whether you'll keep your current home or downsize, and how long you'll live.

<u>Your Behavior Patterns—a key to success</u>

Being able to enjoy a successful financial life, and meet your goals, depends far more on your behavior than your financial planner. Even if your planner gets an extraordinary rate of return on your investments and you can tolerate the volatility in these investments, how much you save and invest from the monthly budget will be a more important factor in funding your desired lifestyle. And the amount of your future expenses will be a critical determinant in reaching your goals.

It is important to know whether the amount you're saving and investing today is likely to be enough to meet your future needs. If not, it's better to make a course correction now, before it is too late.

In addition, it's always better to have an understanding of your future expectations so you can start making concrete plans for that part of your life when work becomes optional. For some people who enter their retirement years and look back, advance planning and preparation turn out to be the most valuable part of a financial planning relationship.

If you would like to start or update your plan, please give us a call.

A person can use the designation CFP® only after passing a two-day exam and working for three years in the profession. Please join us congratulating Chris for completing her work requirement to officially become a Certified Financial Planner™ Professional.

WHAT IS QE3 AND HOW WILL IT IMPACT YOU AND THE ECONOMY?

On September 13, Federal Reserve Chairman Ben Bernanke announced that the Fed would undertake a new program to stimulate the U.S. economy--and the move was immediately dubbed "QE3" by pundits and columnists. But what exactly is QE3, and how is it likely to affect you and the rest of us?

Previous QEs

"QE," as you may know, stands for "quantitative easing," which is a surprisingly simple tool that any government's central bank can use to put new money into its economy. In most cases, the central bank buys government bonds and puts them on its balance sheet. A more complicated example is the Federal Reserve Board's response to the 2008 global economic meltdown, which is now called QE1. Before Congress had finished squabbling over the political ramifications of putting out the fire, the Fed purchased $600 billion of toxic mortgage-backed securities (pools of home loans) whose values had gone into free-fall on the balance sheets of large lending institutions. When that didn't completely stabilize the banking system, the Fed bought roughly $500 billion more bank debt off troubled banks' balance sheets and became an active purchaser of short-term Treasury obligations.

The stimulus accomplished three tasks. First, it took toxic securities off the books of large banks and prevented them from collapsing—averting what most economists at the time thought of as a prelude to disaster. Second, as the Fed became an aggressive new bidder in the Treasury auctions, it created more demand for short-term Treasuries, lowering the interest rate the government had to pay on its burgeoning debt while the government decided how else to shock the economy back to health.

Third, the transaction amounted to printing money, since the Fed could simply buy the securities based on the full faith and credit of the U.S. government. In all, $2 trillion of new money entered the U.S. economy, and the hope was that this would result in more lending, more buying, and a quick exit from the recession.

QE2 started in November 2010, when the Fed purchased another $600 billion of Treasury securities. Once again, new money entered the economy and the U.S. government's borrowing costs dropped to near zero levels. Perhaps more important, this initiative also caused the value of the dollar to drop, making U.S. exports cheaper, stimulating export activity, and counteracting efforts by Japan and other countries to make their own exports more attractive on the global market.

Then, from late 2011 through the end of this year, the Fed extended QE2 with something that has been described as "Operation Twist," an effort to reduce longer-term interest rates. Under Operation Twist, the Fed has been selling $700 billion worth of its short-term Treasuries and is using that money to bid on longer-term government bonds. Once again, the central bank has increased demand for bonds, driving down longer-term rates, and reducing the government's longer-term borrowing costs.

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WHAT IS QE3 AND HOW WILL IT IMPACT YOU AND THE ECONOMY?

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QE3

So on to QE3. Why is everybody so excited about it? In its third round of stimulus, the Fed has pledged to buy $40 billion worth of mortgage-backed securities a month—that is, to inject $40 billion a month into the pool of money that banks can lend to homeowners, so they can either buy new homes or refinance the homes they own.

This is not a trivial sum; it amounts to fully 10% of the value of new mortgage activity in the U.S. economy. And it very precisely targets one area of the American economy that has shown little sign of recovery since the 2008 downturn. Total new mortgage activity in the U.S. has fallen from $600 billion a month in 2007 (a relative boom era) to $370 billion currently. That translates into a lot of homes not being purchased.

If QE3 works as expected, the additional money will drive down mortgage rates, which would make homes more affordable. That should attract new buyers of homes and stimulate the moribund construction industry. Greater demand for newly constructed homes could move the job market needle by creating work for all the professions that rely on home construction and housing, including realtors, contractors, architects, attorneys, appraisers, plumbers, roofers, carpenters, producers of lumber, sheetrock, and concrete.

At the same time, QE3 will put a little extra money in the pockets of people who refinance their current mortgages at lower rates. If they spend some of that money, then that, too, will help spur additional economic activity.

How is it working so far? Interestingly, mortgage rates have hardly budged since the first QE3 money began filtering into the marketplace. Economists believe that 30-year rate fixed-rate mortgages will eventually come down from 3.55% to somewhere around 3.25%, and 15-year fixed-rate mortgages could drop from 2.85% to 2.75%. But that hasn't happened yet, in part because banks haven't relaxed their tight lending standards, in part because many banks currently have so many refinancing applications on their desks that they can't process any more.

As a result, the pernicious initial effect has been to give cheaper money to banks without lowering mortgage rates. Instead of lending more money at lower rates, banks are simply taking a larger spread on the loans they do make. That's why you sometimes hear that QE3 has been a government welfare program to large, solvent lending institutions.

The last and perhaps most effective stimulative effect is psychological. Unlike the QEs of the past, QE3 has no time or dollar limits. The formal announcement of the program promised that it would continue until the Fed has decided that there is "substantial improvement" in economic growth and the unemployment rate. These are not precise terms, and of course commentators have been trying to parse out what "substantial improvement" means. In real terms, however, it appears that the Fed has lost patience with corporations hoarding cash rather than investing in their own (and the economy's) growth, and banks that have been sitting on all the cheap QE money that is available to borrow and re-lend at a profit to homeowners and corporate borrowers. If these companies stay on the sidelines and refuse to participate in the economic growth that

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the Fed is determined to engineer, then they'll be left behind and forced to answer to their shareholders.

Of course no one mentions the lack of fiscal stimulus offered by the executive and legislative branches.

If the housing market and construction industry can be lifted off the ground, we have to assume that GDP numbers will go up. Estimates vary, but the U.S. economy needs to reach 3% annual GDP growth before hiring levels absorb new job market applicants and start to reabsorb the people who lost their jobs in the downturn. The Fed seems to have decided that reviving the construction industry is the most focused possible way to bring about the growth that economists would expect America to achieve by 2014 without the benefit of a stimulus.

One more thing: how much does QE3 add to the national debt? Zero. For the money it created, the Fed owns interest-bearing mortgage-backed securities and pools of mortgage debt, which can be sold at any time, and it earns a return on the money it magically created in the meantime.

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Bob Veres—journalist

BLESSING OR CURSE?

Imagine a time when the U.S. doesn't depend on oil from the OPEC nations; a time when the policies of the U.S. aren't tied to importing oil.

<u>This would be a blessing</u>

The magic word is SHALE. Its potential yield of natural gas in the United States equals the oil available in **two** Saudi Arabias! The potential yield from shale is not news, but improved geological studies and new technology have made extracting natural gas from shale economically feasible. Natural gas is the cleanest of the fossil fuels.

In 2005 we imported 60% of our oil but have brought the amount down to 42%. If or when U.S. companies decide to spend serious resources to harvest gas, we could export it to other countries while decreasing our dependence on oil.

Ed Morse, an energy expert at Citigroup said, "In the geopolitics of energy, there are always winners and losers. The U.S. is going to win big, and someone else is going to lose big."

The October 5 *Wall Street Journal*, "Natural Gas Glut Pushes Exports" highlights a consortium of energy companies planning to build a pipeline for natural gas. It reports on how the United States is in the process of turning from an importer of oil to a potential exporter of natural gas. Natural gas production was up 28% in 2011 from 2005.

<u>And/or a curse</u>

The method used to extract gas is called fracking. The process receives mixed reviews. There have been numerous leaks, shoddy work (i.e., cracked cement leaking the chemicals), etc. In an interview on *60 Minutes* (Shaleionaires), the Sierra Club spokesperson said the problem was a lack of *regulation and accountability*.

<u>Investing</u>

Brian and Jill have been contacted by companies sponsoring new mutual funds that invest in shale conversion. It is considered a "gold rush." While we are watching these investments because of their low correlation to the stock market, we don't feel it is an appropriate investment at this time, especially given the environmental concerns.

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