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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

In our last letter we discussed how the forces of interest rates, the falling dollar and the credit markets were slowing the growth of the US economy. These forces continue to remain in place today, although the trends are more mature and the results are becoming increasingly visible. To stay on the course to your financial goals, it is helpful to maintain an accurate perspective of where we are in the continuous flow of economic events, as well as having a sound investment strategy and a financial plan as a guide. Hopefully this letter will help you with the perspective. Hopefully you have an advisor helping you with your strategy and financial plan.

The Economy

The problems that have ailed the economy until now have been largely a result of artificial causes brought on by participants in the financial markets. The low interest rates and financial engineering early in the decade made mortgages, and therefore residential real estate, more affordable than ever before, causing prices to increase dramatically. People took on dangerous short-term debt with variable rates and increased their indebtedness even further by tapping their home equity. Banks and mortgage companies were more than happy to profit from satisfying the demand by originating risky loans, and then unloading the risk by repackaging and selling the loans to unsuspecting investors. Today the whole process is operating in reverse. House prices have been falling. Risky loans are being foreclosed at a loss to both the homeowners and the investors. Several hedge funds that bought the mortgages are now defunct, and a large investment bank teetered on the brink of collapse.

These financial machinations have had little to do with most real economic activity, which is the production of goods and services, but the economy is beginning to look like the wagging tail at the end of the financial dog. The first sector to be affected was real estate, as housing construction and suppliers went into their own private recession. Now the financial services industry is following. Lending standards have tightened in response to the credit problems, restricting borrowing and resulting in slower overall consumption and business activity. Heavier debt, plus the bad news continually reported by the media, has caused consumer confidence to plummet, resulting in less spending and slower retail sales. The slower activity is now beginning to show up as increasing unemployment.

Whether or not this "de-leveraging" process has caused a recession is debatable for now, but if the trends continue unchecked, a recession will clearly be the result. Two regiments of the economic cavalry are riding to the rescue, however. Most taxpayers and wage earners should receive an economic stimulus check in May. These checks are expected to boost retail sales and therefore employment. Secondly, the Federal Reserve Bank has been implementing new ways to keep the mortgage failure chain reaction from further hurting the economy.

Looking ahead, we may find that the seeds of the next economic problem are contained within the fruit of today's solution. Governments that print money, overspend, and keep interest rates too low for too long cause inflation. All of these factors contribute to a falling dollar, which in turn increases the cost of imported items and commodities like oil. Fortunately these effects are currently being softened by the anti-inflationary effects of inexpensive imports of goods and services from expansion-minded developing economies like China and India.

The Financial Markets

There are few investment areas that are currently performing well. Real estate values have continued to drop in all sections of the country, except the Northeast. The flat stock market trend mentioned in the last issue was, in retrospect, rolling over into a downtrend at the time, which was very unusual for the last months of the year. Stocks played the role of the canary in the credit crunch coal mine with the S&P 500 losing 14% from November through January – a period that historically gains 4.9% on average. Short-term interest rates like the 13-week Treasury bill rate are at the lowest level (1.35%) since 1958. Other forms of "safe" investments like Certificates of Deposit and Money Market funds that earn less than that 5% or so are actually losing money when inflation and taxes are considered. Treasury bonds, which earlier benefited from rate reductions and "a flight to safety", have stalled recently. They provide relatively low yields and remain very overvalued in comparison to stocks.

What is an investor to do at times like this when very little is working, with the possible exception of gold and other commodities? Consider protecting your capital and looking ahead, for times always change. Housing prices will recover when lower mortgage rates work through the system. Stocks have the potential to rise significantly, just by returning to a more normal valuation. The S&P dividend yield, another measure of stock value, is currently higher than it has been at any time since 1996, including the stock market bottom in 2003.

<u>The Parable of Mr. Market</u>

Warren Buffet recalls Benjamin Graham, widely considered the father of modern value investing, telling a parable about a fellow called Mr. Market. Imagine that Mr. Market is your business partner. Every day, Mr. Market comes to you and names a price at which he will sell his interest in the business to you or to buy your interest. Although Mr. Market is very accommodating and makes this offer to you reliably every day, Mr. Market has incurable emotional problems. Some days he is euphoric and sees only the good factors affecting the business. Those days his offered price is very high, because he is greedily anticipating great gains. Other days Mr. Market can only see problems ahead. On those days he offers you a very low price, because he is fearful of major losses occurring. Fortunately, Mr. Market does not mind being ignored. He will just show up again the next day with a new price.

We might add to this story that Mr. Market has a half-brother called Mr. Media, who follows Mr. Market everywhere and breathlessly reports all the details of Mr. Market's mood two days after the fact. Unfortunately Mr. Media has inherited similar genes and his moods are even more extreme than Mr. Market's. He also has the unfortunate habit of fabricating a good-sounding story when he does not really understand Mr. Market's mood. There are three ways to deal with Mr. Market and Mr. Media. You can ignore them and concentrate on soundly running your business. You can take advantage of the pair by accepting Mr. Market's offer when it is either exceptionally high or low. Alternatively, you can allow yourself to be influenced by them and become as disoriented and confused as they are.

Today Mr. Market is depressed. Will he become even more depressed in the future? Very possibly. Will he once again become euphoric and overly optimistic? Absolutely. We suggest that you develop a strategy for dealing with Mr. Market that is consistent with your financial plan. Try to filter out media reports about Mr. Market's health and mood swings and consistently execute your own approach.

For help dealing with Mr. Market, and to learn more about our client goal-centered financial planning services and our risk-managed investment approach, we encourage you to contact us or look at our website, <u>www.linnardfinancial.com</u>.

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