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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

One crisis has been averted, and we seem to have some breathing room for now. Overall, the outlook remains mixed as the world economy and policy makers continue to wrestle with solving the twin problems of low economic growth and debt accumulation.

The Economy

The US economic picture looks a bit brighter. Employment continues to increase. There are 1.5% more jobs now than there were last year at this time. This is approaching the peak annual rate of increase logged during the 2003-2007 expansion, which was 2.1%, but there are still 5 million less jobs now than there were in 2008. At the current rate of increase, it will take about 2 ½ more years to recover the jobs that vanished. The improving trend is not lost on consumers though. While still glum by historical standards, consumer confidence is back to last summer's level, and consumers are once again adding to their debt by buying with credit. Their ability to repay the added debt is as strong as any time in the last 30 years, suggesting that the stability of household finances has improved significantly since debt use peaked in 2007.

Additionally, the real estate market has stabilized. February home sales were higher this year than last, and the inventory of unsold homes is smaller now, indicating rising demand and reduced supply. This is a welcome sign. Unfortunately though for sellers, prices have fallen back to last year's level after rising through last summer. Mortgage rates ticked up a bit recently, but still remain near the lows not seen in more than 50 years.

The perceived improvement over the last few months is largely due to the European community's success in neutralizing the financial effect of the Greek default. They provided $1 trillion in low-interest, three-year loans to prop up their banking system to avoid (or postpone) a systemic financial failure. But, the saga is not necessarily over. Portugal and Spain are expected to be the next problems. Meanwhile, all of that money, plus the Fed's "easy money", and the US government's excess spending is sloshing around in the world economy. This extraordinary, coordinated, world government economic support has temporarily lifted our economy, our stock market, our companies' profitability, our gasoline prices, and our politicians' re-election probabilities. The main question is whether the structural problems in Europe and the US will be effectively addressed, and can be solved gradually, before the rescue resources available for bail-outs run out, forcing the life-support plug to be pulled.

Despite looking better, the outlook has a few thorns among the roses. Fed chairman Bernanke recently said, "conditions remain far from normal… Moreover, we cannot yet be sure that the recent pace of improvement in the labor market will be sustained." In fact, some commentators have been saying that seasonal adjustments in economic statistics have caused the data to look better than they actually are. Time will tell if this is true, but the Federal Reserve is forecasting a reduced growth rate, averaging a sluggish 2.5% for 2012, due in part to slower economic activity outside the US.

The Markets

During the first quarter, equity values moved up, and bond values fell as the Greek crisis was resolved. The strength in the equity market is consistent with a presidential election year and is likely a direct result of the injection of the European bailout funds into the world economy. But, since a low economic growth environment is expected, even with continuing government intervention, market gains could reverse if support is removed, repeating the pattern we saw last summer.

The effect of the Federal Reserve's economic support policy has been to artificially penalize low-risk savings like bank accounts and bonds and reward higher risk investments like stocks. Bank account and Treasury yields have posted record low rates, actually providing a negative return for savers when the effects of inflation and taxes are considered. On the other hand, values of riskier assets increased, propelled by high corporate profits and supported by easy money. While it benefits the government to finance its ever-growing indebtedness at low interest rates, the government's windfall interest reduction is essentially a tax paid by risk-averse investors, who have historically depended on interest income. It has been necessary to take more risk to try to earn a return. Unfortunately, a strategy of chasing yield by increasing risk may accomplish just the opposite, for it increases the chance of loss.

At some point, economic activity will grow more strongly, and the Fed will let interest rates rise again to their normal levels. Since bond prices fall as rates move higher, bond investors not only have a current low rate of return, they also face risk from reduced asset prices. On the other hand, both international and domestic economic trends could conceivably result in another significant decline in equity prices at some point. While we can expect investment values to grow over the very long-term, today we find both geo-politics and economic markets to be more unsettled and unpredictable than usual.

How Should We Dress Today?

Rational decisions require some knowledge of the environment. Each day, we select the clothing we will wear after considering our activities and expected weather conditions. The success of this and other decisions depends on our knowledge of the current conditions, the potential for variation, and our knowledge of the alternative solutions.

On a 90-degree day, we have all the information needed to decide to dress lightly, but without further information, we would likely expect this weather to persist indefinitely. Knowing that the average annual temperature is 50 degrees is not particularly helpful for any given day's decision, but does change our future expectations. Without the additional knowledge, we would not recognize that our current frame of reference could be completely incorrect when applied to the longer-term. We would get very cold, if we only have short-sleeved shirts when winter arrives.

In 2000, most thought that the economic summer was normal, rather than an aberration. In 2007, government financing policies promoted an artificial real estate expansion that seemed unremarkable to many at the time. It has gotten colder since then. Investing strategies that worked well leading up to those points have been less effective afterwards, but will become appropriate once again when sustainable growth returns. Flexibility is important.

It is hard to get a fix on the economy right now, because it is being so heavily supported by government policies, which give the illusion of warmth. Like the summer weather, it is a question of distinguishing between the short- and long-term forces at work. Easy money is lifting corporate profits and stock prices in the short-term, leading many to point to price/earnings ratios that suggest that the stock market is under-valued. Like the summer, this condition could remain for some time, but is the high level of earnings sustainable? Is our current frame of reference reliable? History shows that profits can be expected to vary with the business cycle. History also shows that the business cycle often coincides with the presidential election cycle (i.e. peaks in 2000 and 2008). Over the long-term, the average stock price "temperature" is about 30% below today. Winter stock prices are below that.

In these unpredictable times, the key is to adapt, plan and manage risk. A good, well-executed plan is likely to be an investment worth far more than the cost. To learn more about our client goal-centered financial planning and investment management services, please call or e-mail. We invite you to visit www.linnardfinancial.com.

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