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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

What is going on in Washington and Europe? The political spinners have made the most important financial issues of our day almost incomprehensible. Here's our take.

The Economy & Markets

The economy grew at a fairly anemic annual rate of 1.8% in the 3rd quarter. Unemployment is down a bit, to a still too high 8.6%. Consumer confidence has improved, but is still in the dumps. Europeans continue to be challenged to prevent their version of our recent financial collapse, which could be exported to the U.S. and elsewhere in the world as a recession. Housing sales are up, but prices are still falling.

The economy remains awash in liquidity, provided by the Federal Reserve, which has translated into record corporate profits. Reduced fear of a European financial meltdown allowed the S&P 500 to regain much of what was lost during August, and to close the year almost flat. Lackluster stock performance, despite heavy Fed support, suggests either continuing structural weakness, or lack of confidence in Washington, or both.

Debt, Financial Stability, and Europe

When employed responsibly in good times, debt can promote growth and expansion that would not be possible without it. When times are bad, debt magnifies risk by adding expense and requiring repayments that can break stretched budgets. The use of debt has financial value, if it results in the creation of more income than it costs, but is dangerous when it is used to accelerate consumption or postpone facing financial responsibility. U.S. consumers have recently re-learned these lessons. They found that buying a house can be good, but buying too big a house can be dangerous if times turn sour. Using credit cards to purchase otherwise unaffordable items is a major cause of financial trouble.

CNBC's Rick Santelli provides an interesting illustration. What would you think of this family's financial situation?

Annual Family Income	$23,000
Annual Family Expenses	$36,000
New Credit card Debt to finance the expenses	$13,000
Total Outstanding Debt	$151,000

It looks like this family is in a heap of trouble. If the $151,000 is a long-term mortgage, maybe there is hope. Over the long run, inflation will reduce the relative value of the mortgage debt, but clearly the family must either increase their income or reduce their expenses soon. If they don't get new jobs or work longer hours and cut back expenses, their profligacy won't work much longer. They won't be able to continue to roll over their existing debt and keep adding the new amounts they need to finance their new expenses. The creditors they depend on will either cut them off or jack up their interest rates and make a bad situation even worse. The only solution will be bankruptcy.

It may or may not surprise you that this financially dysfunctional "family" is really the U.S. Government. Just add eight zeroes to each number, i.e., tax revenue is $2,300,000,000,000 or $2.3 trillion, budget deficit $1.3 trillion, total debt $15.1 trillion, and you can see Washington's problem in a nutshell. (Numbers from www.usdebtclock.org.)

Europe's problems are similar to ours, but even more complicated. There, the "family" is made up of wealthy parents (primarily Germany), who maintain a conservative financial philosophy, and free-spending children with credit cards (the "PIIGS" - Portugal, Italy, Ireland, Greece and Spain). The kids have borrowed too much for years based on their parents' credit rating. The parents do not want to bail out the kids, because they do not feel responsible for the kids' spending. They suspect that, unless the kids take responsibility for their predicament and cease their free-spending ways, the parents will continue to get stuck with the bill. Unfortunately their tough love may cause the family to dissolve, or force one of the kids out of the house.

In the real, non-hypothetical world, the PIIGS are already seeing the creditors pull back and demand higher rates. The current interest rate on the Greek 10 year bond is 34.9%! and Italy's is 7%. There is no way Greece can pay 35%. Without a bailout from other countries, they have little choice but to disavow the debt. A recent settlement forced their bank creditors to "voluntarily" accept 50 % loss. They are trying to convince creditors that they are turning over a new leaf by reducing their budget expenses and raising taxes, but this has thrown the country into recession and social unrest, both of which are counterproductive.

There is an even more acute side to the problem. Banks have been a primary source of credit for the PIIGS. Because government debt was previously considered riskless, the banks did not have to keep any loss reserves for these loans. Without reserves for substantial questionable loans, the solvency of the creditor banks has been called into question. Who wants to deposit money or loan to a bank that might fail? The lack of lending to, and among, the banks could cause the financial system to freeze up due to the fear of lending to banks that could become insolvent. This over-leverage and lack of a safety buffer is reminiscent of the inadequate loan underwriting standards that gave rise to the U.S. "Troubled Asset Relief Program (TARP) program on the brink of just such an occurrence in 2008.

However, the world has learned a little from that experience. The European governments (and the Fed) have been working hard to protect the banks by providing them with the money they need to operate, so they don't have to depend on other lenders. The Fed is indirectly providing them with access to dollars to replace the usual U.S. loan sources, like U.S. money market funds, that have dried up.

These financial maneuvers are buying time and shoring up the European banking system, but they have not solved the underlying problems of the PIIGS. Some predict a full or partial breakup of the Eurozone, so the weaker countries can be free to go back to their own currency, reduce its value through inflation, and then repay debts with cheaper money. Others say the breakup of the Eurozone would be an unthinkable calamity. Fortunately U.S. banks and corporations are in a much stronger financial position now to resist imported problems, due to the Fed's easy money policies. In time, all these issues will be resolved in one way or another. We expect that governments will need to reduce their heavy reliance upon debt as economic fuel.

We enjoyed an unprecedented expansion during the 1990's as (and because) our debt and risk culture grew. It will take time for this mindset to reverse, a process that is exacerbating the political and ideological disputes that are growing today. It would not be unrealistic to expect that an extended economic "boom" environment will not return again until a new foundation is laid and the "family" has stabilized their finances. Continuing and periodic stresses are likely to continue. We must recognize that the 1990's have past, and we have entered a new, changing, and uncharted environment. We must adjust to it and manage our personal finances through it. While this may take more effort than during the easy years, the good news is that the financial future is more likely to resemble much of our financial history, in which people not only survived, but many also capitalized on it and prospered.

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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