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## LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

*Registered Investment Advisor, Wealth Management & Financial Planning*

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# ***Outlook & Trends***

Economic and financial market conditions have shown modest improvement over the last quarter. The major drags of unemployment and the moribund housing market remain in force, as do government support programs in the form of spending legislation and Federal Reserve programs. But concern is growing over the government's ability to sustain its support due to the rapidly increasing national debt. What will be the solution? Listening to the news can get confusing as politicians make their arguments and counter-arguments intended to promote their agendas. This issue of *Outlook & Trends* reviews the competing economic theories and some of the possible outcomes.

**The Economy & Markets**

The economy and the equity markets have picked up during the last quarter after hitting a soft patch in the middle of the year. Leading indicators are pointing upwards. Retail sales and corporate profits have regained the ground they lost since 2007. Real GDP grew at a 2.6% annual rate during the third quarter. The Federal Reserve reported that the economy continues to improve. Even employment is a bit higher, although unemployment hit a new high of 9.8% in November. Lack of vitality in real estate continues to be a major impediment as mortgage defaults continue to be worked off through the foreclosure process. The Mortgage Bankers Association reported that 9.39% of residential mortgages are delinquent and 4.39% are in foreclosure.

The financial markets responded to the improved outlook by reacting differently. The stock market climbed, expecting better economic growth, which perhaps coincidently began to occur before the election when a change in Congress was becoming likely. The bond market fell off from its overvalued perch as interest rates rose after the Fed began its second "Quantitative Easing" program. When completed in June, the QE program will have injected $600 billion more into the economy with the purpose of giving a boost to asset prices, so that people will feel wealthier, more inclined to spend, and stimulate economic activity. Will it work? That is a topic that has been debated heatedly by the pundits.

**The Keynsians, Supply-Siders and You**

In the last issue of Outlook & Trends, we likened the economy to a gasoline lawn mower engine; saying that in order to get the engine started, it was necessary to have both fuel and a spark. The government had provided much money (economic fuel), but there had been no spark. The study of economics teaches that the supply and demand of goods and services tend to find a balance. The question is how can we move the balance point away from the current low-growth, under-employed state in which we find ourselves. Secondly, assuming that we are successful, what will the economy look like at that point?

During the Great Depression of the 1930's, John Maynard Keynes, advanced the idea that the way to increase employment during slow economic periods was to increase what he called "aggregate demand", that is, to increase overall consumption and investment. In other words, he advocated making sure that the economic lawnmower engine had fuel. He suggested that it was the proper role of the government to provide that fuel through deficit spending if necessary. European governments and the US adopted this theory and provided ongoing stimulus spending and deficit financing, creating economies that continued to grow through the years as the fuel was continually added.  Expanded social programs, defense spending, mortgage subsidies all increased "aggregate demand". However, instead of simply being used temporarily to get the engine re-started in recessions, the programs became permanent and continuous. It is easy for a government to spend, but very hard to cancel a program once it has started. Keynesian policies resulted in the 1970's "stagflation", a period of high inflation, low growth and unemployment. (The measurement of stagflation at the time was the "misery index", which gained notoriety during Jimmy Carter's tenure).

These economic troubles in the 1970's bred advocates of the other side of the equation. The "supply-siders" argued that encouraging growth in investment and the production of goods, which is the engine's spark, would provide economic growth. Rather than artificially supporting demand, the supply-siders' prescription is reduction of taxes and improvement in the business and investment environment. We are sure you recognize both of the arguments.

The onset of the current predicament resulted in the recent shift back to Keynesian stimulus programs, real estate purchase incentives, cash-for-clunkers etc, all funded through deficit spending. The Keynesian prescription appears to have effectively stopped the financial meltdown, but the spark needed to get the economy growing has been missing. Possibly the change in Congress and the supply-side extension of the Bush tax cuts will provide the spark and get the engine turning again. But we will also have to deal with the after-effects of the economic medication.

Whether Keynes or supply-side, the longer-term problem is the federal debt. It is an issue that has been recognized for years, but remains un-addressed by politicians worried mostly about the next election, for as Keynes famously said, "In the long-run we are all dead." The problem is that with the demographic push from the retiring baby-boom generation, the long run is approaching ever more rapidly. If a family has been taking on excessive debt to live an unsustainable life style, at some point they must reduce their living standard voluntarily, or their access to credit will be cut off, forcing them back to financial reality.

The Federal Reserve has stated that their concern is deflation, and has been actively trying to re-inflate the US economy. Sooner or later the economic pace will pick up again. The Fed believes that this can happen without excess inflation. Let's hope they are right. Otherwise, the next best scenario suggests an outcome of inflationary price increases and rising interest rates, possibly accompanied by a cyclical rise (and fall) in stock prices.

Over the longer-term, the country must deal with its debt. This could mean tax increases, spending reductions or both. The longer the current trends remain in place, the more abrupt the eventual change will be. Given that most of the spending growth is in the "entitlement" programs of Social Security, Medicare and Medicaid, it is likely that these benefits and their associated taxes will be prime targets. It is also reasonable to think that tax policy will be adjusted to reflect a mixture of Keynesian and supply-side thinking intending to increase overall revenue. Debt reduction by means of intentional inflation will be a distinct possibility, in order to repay the debt in cheaper dollars.

Putting this together suggests that people should be preparing for a time with higher taxes and less reliance on the government. This suggests the importance of making sure that family budgets are in balance and additional money is saved to be able to make up for future reductions in government services and payments. If the government cuts back, everyone will be affected, but those with savings will be affected the least.

As always, if you need to build, rebuild, adjust or review your financial plan and strategy to make sure you are prepared for what ever economic outcome that occurs, we suggest you seek a Certified Financial Planner™*,* who acts as a fiduciary. Choose a fee-*only* advisor like *LFM&P* that does not receive commissions or rebates from selling you financial products like load funds and annuities. A good plan, executed well, that can survive a tough economic climate, is likely to be an investment worth far more than the cost. To learn more about our client goal-centered financial planning and management services, please call or e-mail. Once again, we invite you to look at our newly expanded website, www.linnardfinancial.com.

Dave

Barby

David C. Linnard, MBA, CFP®
President

Barbara V. Linnard
Vice President

LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.
46 CHESTER ROAD
BOXBOROUGH, MA 01719

LFMP@LINNARDFINANCIAL.COM
WWW. LINNARDFINANCIAL.COM
978-263-0025