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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

Almost 100 years ago, Robert Frost wrote:

"Two roads diverged in a yellow wood,
And sorry I could not travel both
And be one traveler, long I stood
And looked down one as far as I could
To where it bent in the undergrowth…"

The country is divided between two very different political economic theories. As this newsletter is written, our leaders are attempting to pull the country down two very different paths, a tug-of-war guided by maps of strongly believed economic ideologies. The most recent geological obstacle has been a cliff. It remains to be seen whether we can navigate that with only a few scrapes and bruises. The roads may lead to other challenges, including aging companions, a Tsunami of debt, an inflationary explosion, and financial hurricane, but at the moment those possibilities are not immediately in front of us. They are only envisioned, so many people are not concerned – yet.

The Economy

The November election changed very little in the economic trends. As evidenced by the Fiscal Cliff negotiations, our government remains in a state of gridlock. The Federal Reserve re-confirmed its plan to print money until unemployment drops or inflation returns. There continue to be concerns about how the government will reduce the country's voracious appetite for borrowed money and whether the Federal Reserve will be able to safely unwind the excess money (a.k.a. debt) it has created.

The indicators suggest that the economy is improving. Unemployment continues to drop slowly. GDP growth increased in the third quarter, and the housing market continues to improve. These numbers may not be all that they seem however. The rate of employment growth has peaked at consistently lower levels during each expansion period since 1978. After four years, this period appears to be peaking at the lowest level since before 1940. GDP was up, but much of the increase was due to the production of unsold goods and increased government spending. Neither of these factors suggests continuing strength. Personal consumption also increased along with consumer confidence, but recent confidence measures have ticked down again in the last two months.

According to the National Association of Realtors, existing sales are up, unsold inventory is down, and prices are up (except in the Northeast). No doubt a relationship exists between this improvement and continually decreasing mortgage rates, which are being held down by Fed policy. Freddie Mac reports an average 30-year fixed rate mortgage rate is 3.35%, which is a drop of .6% since early 2012.

The Markets

Fed policy continues to subsidize consumers and borrowers at the expense of savers. Investors have had to take on more risk and reach for yield in bond and stock markets that have been distorted by Fed manipulation. Treasury debt interest rates are among the lowest in history. Awash in easy money, corporate profits remain reasonably healthy, growing at a 7.5% annual rate. The combination of money looking for a home and record profits have supported the stock market and created a potential bubble in high-yield (also known as "junk") bonds. This equilibrium may continue to last as long as the Fed is supportive and the Fiscal cliff / increased taxes / spending restraints do not bite too hard. Otherwise, a return to normal long-term stock market valuations, some 30 - 40%

below present prices, would not be unusual. Interestingly, the stock market remains below the point in September when the Fed announced its last "QEternal" policy, suggesting that its ability to support the markets may be waning.

There are other potential negatives on the horizon. Beyond the new tax increases and a potential debt limit fight early in the new year, the calendar also suggests that the first year and a half of a presidential term are the weakest, since presidents like to get their recessions over with early. Additionally, while the stock market usually rises during the last five days of the year and the first two of the new year, the "Santa Claus rally", so far the market is flat. The Stock Traders Almanac warns, "If Santa Claus should fail to call, bears may come to Broad and Wall".

The Larger Picture

There has been much said about the "fiscal cliff" since we first mentioned it in *Outlook and Trends* six months ago. The fiscal cliff is a completely artificial creation by politicians, who either wanted to avoid handing a political victory to the other side, or responsibility for taking unpopular actions. Unfortunately, much of the commentary of late has been reduced to what income level constitutes "wealthy", which totally misses the point. Tax increases and reductions in planned government spending will have a further negative impact on an already squishy economy and could be expected to create a short-term shock as the economy adjusts. On the other hand, reining in government debt is necessary for the economy to regain its vitality over the long-term. While deficit spending may be a short-term economic stimulant, recent studies suggest that excess debt creates a counter-productive long-term drag.

Over several decades, or more, politicians have ingratiated themselves with their constituents by using the government to subsidize favored interests by borrowing money, which is politically easy, rather than raising taxes, which is politically hard. Recently the practice has grown exponentially. Recall TARP, Clunkers, Auto companies, and Shovel-Ready. Sluggish world growth and Fed policy have allowed the increase, because the government has been able to borrow at historically low rates to finance itself. Investors have been willing to lose money by loaning it to the government at rates that are below inflation. This has included China, which has loaned our own dollars, earned from trade, back to us, in order to support their own economy. At some point the balance will change, just as it has changed for the southern Europe welfare states. Borrowing creates a short-term illusion of wealth. Real national wealth, like personal wealth, comes from production of useful goods or services.

We make these points, not to engage in political discourse, but to suggest that in preparing for your long-term financial well-being, it is necessary to think beyond the economic paradigm you have known for most or all of your life. If the US economy is going to regain its vitality, government spending will likely fall. Additionally, taxes will rise for everyone, but likely more so on the wealthy, investors, and savers. (Recall bank robber Willy Sutton's explanation, "That's where the money is").

From a planning perspective, saving to create a greater measure of self-sufficiency will be important to replace government benefits and subsidies. Developing a strategy to shift taxable income to tax-free income is also a long-term solution. Consider Roth IRAs for retirement, 529 plans for education saving, Health Savings accounts for medical savings. The staple savings plans of today, 401(k) plans and traditional IRAs, are merely ways to postpone taxes, which is good for the short-term , but potentially exposes the saver to higher taxes in the future.

In these unpredictable times, the key is to remain aware, consider alternatives, 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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