LFM&P

LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

Since events often do not turn out as might be reasonably expected, we try not to make predictions, but rather think about the possible outcomes and be prepared. As the world governments continue to rely on short-term fixes to long-term problems, Europe is in recession, and the US economy is being kept afloat by government fiscal and monetary support. This support could end rapidly once the November elections are over and we get ever nearer to the edge of what Fed Chairman, Ben Bernanke, called the “Fiscal Cliff”.

The Economy

The US economy continues to muddle. First quarter GDP grew by a fairly anemic 1.9%, but the Federal Reserve survey reported that economic activity expanded at a “moderate” pace in May. Consumers weren’t so sure, however, as unemployment ticked up again and confidence dropped in May and June. After being a long-term drag, housing is continuing to brighten, with existing home sales up 13.6% from last year and 6.4 % higher prices.

Economic activity is dropping off across Europe as well as China, creating an overall global slow-down. Just as a rising tide is said to lift all boats, the opposite is also true, and the global tribulations can add to the headwinds faced by the US. Greek voters caused a scare for the Euro leaders by almost electing a minor political party that promised to renege on the prior bailout agreements and their austerity provisions. Now Spain has entered the mix, asking the rest of Europe for money to shore up its banks. All of the summit meetings have only succeeded in buying time and forestalling a collapse but have not solved the main issue. The weaker nations splurged and ran up a bigger credit card balance than they can handle. How will the bill be paid, and who will pay the bill? Those are the unanswered questions. They are remarkably similar to the questions the US government must answer to repay years of deficit spending in order to move beyond our economic malaise.

The Markets

The stock market continues to act like a yo-yo with Europe holding the string. The S&P 500 was down 3.3% during the quarter. A larger drop was rescued at the last moment by a Euro meeting, which caused a 2.5%, one-day month-end rally. Ten-year treasury bonds yielded an all-time low interest rate (Robert Schiller data from 1871) of 1.59 % during the quarter as Fed monetary policy and the bonds’ global safe-haven status raised the price and, in turn, lowered the yield. Corporate profits are growing at an annual rate of 6.5%, which, if the economy stays afloat, could support stock prices for now, but long-term valuations are about 40% above their neutral value. It is possible that stock prices could fall to this lower value or beyond if government support ceases and /or the economy turns down.

The Fiscal Cliff

Our January issue compared the government's fiscal predicament to that of a financially dysfunctional family. (If you would like to read it go to www.linnardfinancial.com.) To carry that analogy further, let's assume that this family has been living beyond its means for some time. Both husband and wife held well-paying jobs, but their quest for having the finer things in life was stronger than their budget discipline, so they borrowed what they needed from their home equity and credit cards. They thought they would pay it all back in the future when they got their next raise. That led to expenses greater than their income and a mounting debt balance.

Then their neighbors started losing their jobs and could not find new ones. Our family started to become concerned about their debt and started arguing. One shouted “Cut your expenses!” The other retorted, “Tell your boss to give you a raise!" As they continued their argument, they were financially paralyzed, and the debt continued to grow. Just when it looked like it couldn't get worse, the couples' employer, told them that their main customer was not only cutting back their widget orders but would also be demanding a rebate on every widget produced. As a result, the couple would have to take a pay cut. They had a dilemma. If they stopped their borrowing, they would have to endure a lower standard of living. If they kept borrowing, it would be only a matter of time before their credit lenders cut them off. What are they to do?

On a national level, taking the economic theories of John Maynard Keynes to an extreme, our elected officials found that spending borrowed money helps the economy. A good economy makes people feel good about their standard of living. People, who feel good, re-elect their officials, who then borrow more money, and the cycle continues -- until it has to stop. It has to stop at some point, because the debt burden becomes too great and either interest payments become too large, or lenders begin to worry about repayment and cut off lending. Europe, and more specifically Greece and Spain are grappling with that question right now. What are they to do?

If feeling good is an important re-election pre-requisite, politicians will do what is necessary to keep the money flowing, or at least postpone any uncomfortable actions until after elections and their careers are safe for another term. The day when our national widgets are scheduled to be cut back is January 1, 2013, the so-called "Fiscal Cliff", which represents a possible sharp cutback of up to $607 B (billion) in economic support for the economy. Unless the government can stop its internal arguments long enough to take action, the $221B "Bush" tax cuts will expire, $65B automatic spending cutbacks will occur, the $18B "Obamacare" surtax will begin, and the 2% payroll tax holiday will expire ($95B). Additionally, the $11B Medicare "Doc Fix", extended unemployment benefits ($26B), and the AMT patch will end, plus $171B of other changes will occur at the beginning of the year.

Economists estimate that these actions would reduce US GDP by 3.5%, at a time that there will already be pressure from the European recession, creating an economic contraction at a rate that the Congressional Budget Office estimates would be -1.3%. This American version of "austerity" would be good for the budget deficit, but a bit of a shock to the country's feeling of well-being. It is instructive to note that, while these changes would have a significant effect, the reduction is only one-half of the current $1.2 Trillion budget deficit. What are they to do?

The government's response is presently unknowable. It may depend on the results of the November elections. We can assume that, if all the tax cuts and spending are re-instated, the budget deficit and national debt will continue to grow -- until it must stop. The economy and investment markets may continue to muddle along, or even get a burst of energy, if the Fed re-establishes its direct quantitative easing support program. On the other hand, if the government gets on the "austerity" bandwagon, the longer term problems will be addressed, or at least postponed, but the cost will be a more severe, perhaps temporary, slow down. This could trigger a renewed bear market and set the stage for a bottoming out process, albeit at lower and more difficult levels than today. There is another possibility. Perhaps the officials can become more flexible and agree on a middle course that will reduce debt by promoting economic growth. When that occurs, the investment climate should show a distinct improvement.

As we suggested at the outset, predicting an outcome is likely to meet with questionable results. It is better to think about the possibilities, know and execute our well-considered personal financial plan, stay aware, and map out a strategy to handle whatever occurs. That's what we will do.

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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