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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

July 1, 2008

Outlook & Trends

This is a time of economic crosscurrents; some real, some imagined, and some promoted by politicians and others to further their own interests. To stay on the course to your financial goals, it is helpful to maintain an accurate perspective of where we are in the continuous flow of economic events, as well as having a sound investment strategy and a financial plan as a guide. In this issue, we hope to help you make sense out of the oil controversy.

The Economy

Recession? Most everyone who has been listening to the pundits on the news "knows" that we are in recession. Thus far, however, the data has failed to confirm the hype. The official definition of recession is two quarters of negative GDP growth. The economy grew in the last two quarters, albeit slowly. This is not to say that we do not have some significant economic challenges, or that a real recession will not come eventually. We do and it might.

Clearly, falling housing values and rising energy and food prices are pressuring consumers. Retail sales have increased by 2% over the last year, but this is primarily due to the extra dollars spent on food (+6.2%) and fuel (+18%). How are consumers coping? Perhaps the 6% increase in consumer credit provides the answer. The consumer squeeze shows up as the lowest confidence readings since 1980. The data also show that most people continue to be more concerned about the future than their current situation.

The great real estate money machine that generated phantom wealth earlier in the decade is running in reverse. Median national home values are down 6.5% from the last year and the inventory of unsold homes has yet to recede as foreclosures bite. Additionally, 30-year mortgage rates have increased by about 6/10% over the last quarter. Working out the credit problems brought on by aggressive lending and borrowing will still take more time. It is not at all clear that the big investment banks that hold sway on Wall Street, which dodged the credit bullet with the help of the Fed, will continue to avoid problems. A failure in this sector, while not directly related to consumers, could affect many people's 401(k) values, if the stock market continues to sell off as a result.

The Financial Markets

The stock and bond markets are seeing their respective glasses as half-empty. Stock prices are flirting with their January and March lows as the market attempts to sort out how tough the situation really is. As one might expect, energy stocks have provided some strength to the market, while the financials have led the decline. Long-term Treasury bond prices have fallen 5% since mid-March, reflecting the emergence of inflationary signs based on the run-up in oil. Stock prices usually lead the economy by six to nine months. If stocks can hold their current levels, that will be a good omen. Conversely, if prices fall significantly from here, it may signal that the economy is entering a real recession and will take a while longer to regain substantial growth. Caution is warranted.

Oil

The politicians and pundits are having a lively debate about what, and who, should be blamed for the sharp run-up in the price of oil and gasoline, as well as what we should do about it. It is clearly a complex problem with a number of facets. Many of those who debate the issue seem to concentrate on the elements that support their private agenda. It is important for the investor to view the issue objectively and resist unproductive "noise". Here is how we see it.

The price of oil, like other assets and commodities, responds to the laws of supply and demand. In markets for stocks, bonds, real estate, and oil, the price is set by the last willing buyer agreeing with the last willing seller. If the two did not agree, there would be no transaction, and the true price would not be known. Supply and demand can operate on the level of the commodity itself, where, in this case, the last willing buyer is the person filling their car's fuel tank at the pump. If everyone refused to pay $4.00 per gallon, the price would be less than $4.00 per gallon. If people are willing to pay more, the price will rise to that level.

Supply and demand operates over both the long- and short-term. Over the long-term, in a free market, rising prices should encourage suppliers to bring more oil to market, reducing the price through competition. But oil is not a free market. The supply of oil is constrained internationally by agreements among the major producing countries, as well as by our own government for political reasons. Since oil is an international commodity, the price is increasingly influenced by emerging market countries that are acquiring energy for their rapidly growing economies. As time goes on, the U.S. will continue to have less and less ability to exert an influence on the demand side of the equation. The last willing buyer will be more and more likely to be Chinese. Additionally, as our government's spending and low interest rate policies devalue the dollar, the price that Americans pay in dollars goes up faster than the price paid by others using their own currency. Over the long-term, the solution is clearly to increase the supply of oil and competitive energy sources, as well as to support the dollar by gaining control over government spending.

Oil and gasoline futures, which are contracts between a buyer and seller to purchase oil or gas at a future time, have appeared to have a significant impact on the fast price increase. Called "greedy speculators" by some, the participants in the futures markets have been increasingly dominated by investors such as hedge funds and pension funds, rather than producers and users of oil. As with any traded commodity, lopsided short-term demand from enthusiastic buyers can drive the price up, particularly if the participants need only put up a fraction of the purchase price ("margin"), as they do in the futures market. Oil companies are using the futures price to define the price they pay and charge, so the increased futures activity has contributed to the fast price increase at the pump. This phenomenon is not much different than the market bubbles that occurred recently in stocks and real estate. Oil is different than stocks, however, and more like real estate, because it is tied to a tangible commodity. The short-term must eventually respond to the long-term supply and demand, and may even respond to visible plans to increase supply. If more supply comes on the market, or the gas buyers refuse to buy, the holders of futures contracts to buy oil will lose money, enthusiasm will wane, and prices will fall.

Is a short-term solution to outlaw the futures market, or restrict participation, as some suggest? No. Without the liquidity provided by futures, the entire oil market will be subject to major disruptions, like those we see today in real estate and credit availability. However, speculative activity, while beneficial in moderation can become a mania when it is overdone. The stock market crash of 1929 was exacerbated by the same low margin requirements. Since then, the requirement that stock traders put up at least 50% of their equity has kept a 1929-like scenario from reoccurring. Regulators could consider this type of approach, although it could be difficult to implement beyond their jurisdiction in an increasingly global economy.

Investors, particularly those with positions in energy stocks, should take note. Market bubbles always burst eventually, and when they do, prices can fall dramatically. In the interim, however, the effect of rising oil prices may extend well beyond energy. Market dislocations like we are currently seeing produce both opportunities and risks. To learn more about our risk-managed investment approach and client goal-centered financial planning services, we encourage you to contact us or look at our website, www.linnardfinancial.com.

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