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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

Long-time readers of Outlook & Trends know that our objective is to provide a different perspective of financial and economic thinking and events. This time the economic malaise has become so obvious that we guess this issue will provide more of a confirmation of your thinking than a new way of looking at the world.

Human nature tends to celebrate the good times and ignore the bad as much as possible. We can coast through the good times and revel in our successes. It is during the tough times though when the greatest focus is required and extra effort is rewarded. Maintaining awareness in the harder times preserves financial health and prepares us to take advantage of the eventual opportunities that always follow. We suggest that you see these times as an opportunity. Take the time, and make the effort, to understand the issues and prepare appropriately for the future.

The Economy

The economy performed better in the second quarter than the first, with a real growth rate of 1.3%. That beats the 4/10% reading in the first quarter, but is still basically flat. However, prices increased by 3.3%. During the late 1970's, during Jimmy Carter's era, the term "stagflation" described a period of stagnant growth and high inflation. We seem to be repeating the "stag" part, but the "flation" is still pretty normal, historically speaking.

Taking the position "This time is different" is often dangerous. History often repeats, since it is driven by forces that are propelled by human nature. On the other hand, blindly following the prescriptions of the past, rather than thinking through the current problem, also courts disaster. The Federal Reserve has artificially created most recent recessions in order to cool down expansionary periods. They have done this by reducing the supply of money and by raising interest rates, making new investment less profitable. After a sufficient time-out, the Fed then simply lowered rates and increased the availability of money. The economic engine accelerated again. This process worked, because the pre-requisites for continued growth remained in place during the cool-down period.

But this time the Fed reduced rates, committing to keeping them low for two years hoping to persuade businesses to re-invest. They tried to increase the money supply with the "QE1" and "QE2" programs to propel the economy to "escape velocity" where it would be strong enough to grow on its own. Alas, "QE2" turned out to be a like a hot air balloon. While the burner was on, corporate profits grew and the economy lifted slowly, but as soon as the fire went out, the economic balloon drifted slowly back to earth, settling essentially where it began. The government's fiscal "stimulus" programs have had the same effect.

Why? Because this time does appear to be different. The economy built up too much debt and must reduce it, a process known as "deleveraging". People used higher real-estate values and relaxed lending standards to acquire too much debt. It created a euphoric feeling of wealth that was artificial. That wealth disappeared with lower home values, yet the debt remains. Much of it has been transferred to the government. Naturally, people are being more cautious and spending less. With less spending (plus an unsettled regulatory environment), businesses have little desire to expand and hire. The resulting stubborn unemployment and federal debt acquisition has reduced government tax revenues and increased expenses. This unhealthy situation makes people even more cautious.

Meanwhile, problems in Europe continue to progress on a parallel track. Many pundits expect Greece and possibly others to default on the burdensome government debt that it acquired by overspending in pursuit of their welfare state. They say default is not a question on of "if", but "when". It is suggested that such an occurrence could be the European equivalent of our Lehman Brothers collapse in 2008. The effect could be to cause bank failures and be the shock that drives the European (and our) economy back into recession. Other observers of leading economic indicators suggest that our economy is entering a new recession now, even without Europe's help.

The statistics we watch do have one possible brightening spot this quarter. The National Association of Realtors reports that recent existing home sales are up 21% vs. August 2010. There is 13% less of an inventory of unsold homes overhanging the market, but prices are still 4% lower. It may be a start though.

<u>The Markets</u>

The stock market dropped 13% over the quarter, reflecting the US and European economic concerns. We see virtually all sectors deteriorating, with the exception of most bonds and utility stocks. This configuration is often associated with an early to mid-staged bear market. Although price patterns do not predict the future, it is interesting to note that the stock market has been tracing out a path very similar to early 2008, after the Bear Sterns hedge fund collapse, as the stock market rolled over from its high. At that time, a rally followed for several months before Lehman Brothers bit the dust and took the stock market down with it.

<u>Implications</u>

In our role as financial advisor, investment manager, and financial planner, we continually consider what does this mean and what should we do? To answer, we try to put today's events in a historical context. We suspect that the de-leveraging process will take time. The more the government does to mute the effects, the more palatable life will be, but the longer the process will take. Lower growth can be expected while the economy is healing and recharging its batteries for the next growth spurt. For investors, this is consistent with a secular bear market. This type of market has cyclical expansions and recessions superimposed upon an unimpressive longer-term trend.

Despite the problems, by some measures stock prices are not yet cheap. On average, these measures suggest stocks will only see a 1% real (above inflation) return over the next 10-15 years. Bonds are even worse. Ten-year Treasury bonds yield 1.9%, while inflation has been 3.8%. This means than bond savers are losing real buying power. Until the Fed policy changes, cash will provide virtually no return, so cash accounts may actually be the worst, losing 3.8% this year in real buying power. Savers and retirees need to reduce their investment return expectations.

With potential stock and bonds returns so low, and cash earning almost nothing, what can a person do? This environment suggests two things that may contradict the conventional wisdom:

1) Planning your future based on the historical investment returns, including those provided by automated retirement plan calculators may provide overly optimistic results.
2) The buy-and-forget strategy that is favored in secular bull-markets, may be replaced by the "buy-low sell high" strategy, which gains acceptance in volatile secular bear markets.

LFM&P addresses these issues first from a planning perspective by "stress-testing" our financial plans to see how client's earnings, investment and spending plans would have held up if historically difficult periods are repeated in the future. After planning, execution is just as important. LFM&P's MarketAware℠ approach is an adaptive strategy, which recognizes and adjusts portfolio asset allocations based on market conditions as they develop. 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.

Dave

Barby

David C. Linnard, MBA, CFP®
President
LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.
46 CHESTER ROAD
BOXBOROUGH, MA 01719

Barbara V. Linnard
Vice President
LFMP@LINNARDFINANCIAL.COM
WWW. LINNARDFINANCIAL.COM
978-263-2958