LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

October 1, 2012

Outlook & Trends

We seem to be in a state of suspended animation. All the complexities we discussed in the July edition of *Outlook & Trends*: the fiscal cliff, unemployment, the European quagmire, the US deficit, and the exponential growth of the national debt all remain in the forefront of economic issues. The primary change has been the Federal Reserve deciding to double-down on their old policy, now resolving to provide open-ended monetary stimulus in a resolute effort to support economic activity. It is as if we are passengers riding behind a steam locomotive whose only option is to go where the tracks lead, with a train crew who believes that their only job is to keep shoveling the coal.

The Economy

The argument about whether or not we are in a recession continues unabated among a number of business cycle watchers. The latest GDP reading for the second quarter suggests the annual growth rate is a measly 1.3%. The unemployment rate declined to 8.1%, but this was not because employment improved much. It was because many people gave up looking for work. The good news is that housing is holding its recent gains, with unsold inventory less than last year, and prices rising in all areas, except the northeast. The stock market recently rallied to four-year highs, interest rates fell to all-time lows, and consumers have recently become more optimistic about the future.

Spain has joined Greece in the European conundrum. The financial markets raised the interest rates that Spain needs to pay to borrow, which threatens to upset what remains of their financial equilibrium. Cutting government spending and benefits has led to civil unrest in both countries. In addition to concerns for Greek and Spanish civil stability, European financiers also worry about the possible effects on their banking system. The largest holders of the government debt are European banks. If a government defaults, it is possible that banks could fail, leading to a financial collapse similar to our Lehman Brothers trauma in 2008. To forestall that outcome, the European Central Bank agreed to purchase government-issued bonds in the secondary market. This intervention is designed to reduce the Spanish and Greek borrowing costs and save them from a market-induced collapse.

QE and The Federal Reserve

At the beginning of our recovery, the Federal Reserve began a policy of monetary stimulus, as it has often done in the past. It reduced interest rates, which, in a normal business cycle, makes companies profitable and provides an incentive to invest in new facilities. The pick-up in business activity and new investment causes new hiring, which in turn, gives consumers more money to spend. In the past, as they became more optimistic, consumers borrowed against the future to improve their standard of living in the present. This created even more business, more investment, and more credit. It is a wonderful mechanism, when it works.

This time, consumers, businesses, state and local governments, and financial institutions found that they had taken on debts that they could not repay. Houses were under water and foreclosed, credit cards were maxed-out while salaries disappeared. Banks became gun-shy from lending to those who could not repay. Local governments reduced workers to trim excessive payroll obligations. To counteract the marked reduction in normal economic activity, the federal government stepped in to fund stimulus programs, hire more workers, bail out companies, buy mortgages and “clunkers”, etc., trying to act as the economic engine. By borrowing heavily to fund these initiatives, the government wound up effectively transferring wealth to the banks, and the debt of the private economy to itself.

But the government does not produce. Not only that, it has the desire and ability to “regulate” economic activity, which impedes the very production that is regulated. It only consumes what others produce, transfers money from

one person to another, or from the future to the present by borrowing. The government can provide temporary support, but economic effect does not multiply the way it does in the private sector. Given the gridlock between the executive and congressional branches of government, that support is coming from continuing budget deficits and Federal Reserve policies. Rather than just providing a jumpstart, the Fed has continued to pump money into the economy through its quantitative easing programs. The Fed has intentionally tried to manipulate the markets to reward holders of risk assets, like the stock market, to create a "wealth effect", to make people feel better by seeing their investments gain value. It has also reduced interest rates to ease borrowers' (including the government's) debt burden, and help the housing problem through cheaper mortgages.

The most recent incarnation of Quantitative Easing, after QE1 and QE2, is being called QE3 or QEternal or QE Infinity, due to its open-ended nature. The Fed has said it will buy $40 billion worth of mortgage and treasury securities per month indefinitely until unemployment comes down to an "acceptable" level. That is in addition to the other support programs that are already under way. The Fed says the purpose is to improve employment. The Fed chairman has claimed that Fed actions have increased employment by 2 million jobs and increased economic output by 3%. But employment is fairly stable and observers outside the Fed dispute Bernanke's claim that QE is an effective remedy for unemployment. Why such a big program now? Is the Fed expecting something worse?

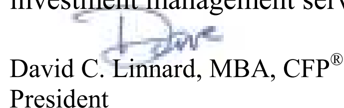
All told, economists expect the outlays of the program to total between $250 billion to $2 trillion with a median estimate of about $750 billion injected into the economy, a size similar to the "big bazooka" TARP and "stimulus" programs of 2008-2009. Is it coincidental that the "fiscal cliff" is expected to reduce government spending by a similar amount -- $600 billion? Probably not.

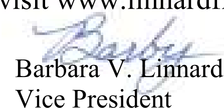
Where does that $750 billion or more, plus the $2.3 trillion that has already been spent come from? Have you ever noticed the words "Federal Reserve Note" on your dollar bill? US currency and other US money is a claim against the Federal Reserve. By buying bonds, the Fed is "expanding its balance sheet", which means it is adding more assets (the bonds) and more liabilities. Liabilities just like your dollar bill. In essence, the Fed is printing money.

This discussion would be academic, if printing money and a burgeoning government debt did not suggest potentially significant dangers in the future. What will happen to the artificially high levels of risk assets like the stock market, when the Fed ends its supportive policies? Although inflation is not a problem today when economic activity is low, if the Fed has not reduced the excess money in circulation, the inflationary teakettle will start whistling as the economy heats up again. When activity picks up, interest rates will also climb, particularly if inflation increases as well. The government's borrowing costs will rise along with the rates. How will federal spending be maintained? If government spending is cut, and the Fed has to pull its printed money back, the effect will likely slow the economy back down. Working people will be affected the least. People living on fixed pensions and annuities, and those receiving government payments may be affected the most. Investors should maintain and grow principal carefully to maintain their self-sufficiency. This scenario sounds a lot like Spain.

There is the possibility that, with skill, perhaps some luck, and policies that promote growth, the government can stop shoveling the coal and take control of the train, hopefully sooner rather than later. But, it is prudent for us as individuals, to consider the possibilities, know and execute a good 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.





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
978-266-2958

A Registered Investment Advisor and NAPFA-Registered Financial Advisor