



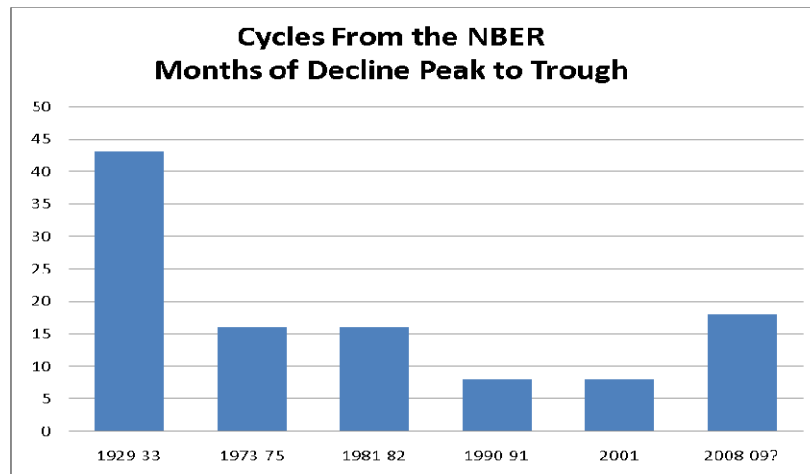
## THIRD QUARTER PERSPECTIVE July 7, 2009

### Market Review

As a life-long swimmer, I've often felt it oddly comforting to know just how deep the water in the pool was. Somehow knowing where the bottom was lessened my anxiety, and helped me keep focused on my workout. These feelings were even more magnified when I left the swimming pool and started open water swimming in lakes and oceans.

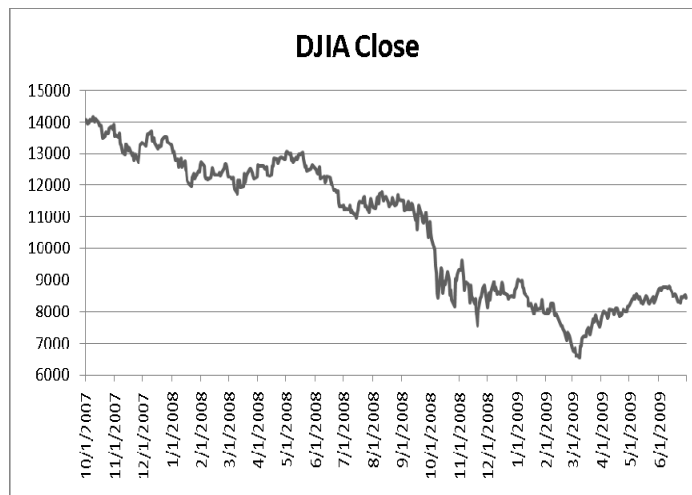
As I reflect back on these feelings, I can't help but notice the similar emotions that are drawn to the surface in such a volatile market like the one we've been experiencing the past year and a half. At a recent FPA meeting, I attended a presentation by John Mitchell, a well known local economist. In his speech, John noted that the current recession is already one of the longest recessions in recent US history -- shorter only than the Great Depression, as can be seen in the chart below.

For many of our clients who became adults in the 1970s - 1990s, the length of this recession is probably being viewed with great anxiety. If we look at the period between November of 1982 and December of 2007, the US was in recession only about 5.3% of the time, or 1 month out of every 20. Contrast that with the current decade, and it is not difficult to understand how the current recession is pushing them into uncharted waters.



Source: data from the National Bureau of Economic Research (NBER)

Looking at the current recession from a stock market perspective, we can see the Dow Jones Industrial Average (DJIA) dropped 54% between October 9, 2007 and March 9, 2009 (see graph below). Other major indexes and many international indexes fared even worse. For some people, the month after month declines had them wondering if we were ever going to find a bottom and anxiety was at an all time high.



Source: data from [www.finance.yahoo.com](http://www.finance.yahoo.com)

Between March 9th and June 30th of this year we've had a nice bounce, with the DJIA gaining 1,900 points, or 29%. This bounce has resulted in positive year-to-date returns, and more importantly, has helped ease some of the anxiety many investors have been feeling.

No one can say that the market has bottomed out, or determine now whether the recovery will be a classic "V" shaped or "W" shaped recovery. However, we are at least seeing a slowing in the rate of deterioration of major economic indicators, and many economists believe that we are in the early stages of a recovery. From our perspective, whether we have a "V" shaped recovery or a "W" shaped recovery, time is our ally, and better times are ahead as we work our way through this difficult recession. -- Joe

## Inflation

The economic green shoots that appeared this quarter have reduced some uncertainties that we went into the quarter with. Our financial system seems to be moving towards stabilization - banks who failed the Fed's stress test had no trouble raising the required capital in the stock market, and the flow of credit continued to improve. At the very least, each day that passed didn't bring a new initiative from the Fed or the Treasury aimed at keeping the banking system functioning, which was a nice change of pace.

Now that that threat of financial system collapse and deflation (falling prices) seems to have subsided, we're boomeranging back into concerns about future inflation. Inflation is a phenomenon familiar to any of us who lived through the 1970s, when annual inflation averaged 7%/year for the decade. Inflation is particularly problematic for people in retirement, which will be more and more of us as the baby boomers age, because most retirees don't have wages that adjust upwards with inflation -- only costs that do.

**Why worry now?** Inflation is unlikely in the near term -- with unemployment way up and consumer spending way down, it's hard for prices to rise. But there are other forces that are causing inflation concerns, as explained by Washington Post columnist Robert Samuelson in a column from June 8<sup>th</sup>:

*"Are the Federal Reserve's easy-money policies laying the groundwork for higher inflation?... The questions arise from the Fed's strenuous efforts to contain the economic crisis. It has cut the overnight Fed funds rate almost to zero. It has made loans when private lenders wouldn't -- in the commercial paper market, for instance. To lower long-term interest rates, it has pledged to buy \$1.25 trillion of mortgage securities backed by Fannie Mae and Freddie Mac and \$300 billion of long-term Treasury bonds. All these measures are without modern precedent.*

*Precisely, say the inflation worriers. Once the economy recovers, the easy money and credit will spawn inflation. Cheap loans will bid up prices; wages may follow. Low interest rates will encourage spending and deter saving. The Fed will be "under pressure from Congress, the administration, and business...to prevent interest rates from increasing," warns economist Allan Meltzer of Carnegie Mellon University. With huge budget deficits, the White House and Congress will want to hold down borrowing costs. Inflation psychology will emerge."*

**The impact of inflation.** It's easy to understand the impact of inflation on your spending. If inflation runs at 5%, what cost you \$100 this year will cost you \$105 next year. Compound that for a few years, and you can see how difficult inflation becomes for people whose incomes aren't also rising at the same 5% compounded rate. But inflation also has an impact on your investment portfolio, with some assets responding well, and others losing value.

Assets that are good hedges against inflation are those that tend to rise in price when inflation goes up, like cash (inflation usually means higher interest rates on cash), real estate (prices for homes tend to respond quickly to inflation), gold (demand for gold goes way up when people fear that paper money is suspect) and commodities (prices of inputs like oil, timber, etc. rise very quickly with inflation). Holding a fixed-rate mortgage looks good in an inflationary environment; your mortgage payment doesn't change, but for people still working, wages should be inflating.

Inflation causes other asset prices to drop, including stocks. Stocks are a good hedge against inflation in the long term, but in the short term, stock prices don't like inflation spikes at all, as companies can't pass on their increased costs fast enough to the consumer, so earnings and stock prices drop. The values of bonds also fall with inflation; investors demand more return for their dollars in an inflationary environment, and in order for the yield on any given bond to go up, the price has to drop.

**Positioning your portfolio.** We've added investments to most of our clients' portfolios in the last several years that should respond positively in the event of higher inflation: a commodity fund, a Treasury Inflation Protected Securities (TIPS) fund, a Real Estate Investment Trust (REIT) fund, and a targeted cash position. We've also shortened the maturities in our bond/CD ladders -- rather than going out five years, we're buying shorter term debt in the expectation that as the economy recovers, the Fed will raise rates to avert inflation, or inflation fears will spark higher market interest rates.

**Federal deficit spending and inflation.** The other driver of current inflation worries is concern about projected federal budget deficits. We entered this recession with federal debt standing at about \$10 trillion. According to The New York Times, deficits 2009 - 2012 are expected to run at \$1.2 trillion/year, quickly ballooning our federal debt. That could become a serious problem, as too much supply of US debt could drive up interest rates, slowing economic growth, and sparking inflation (for a quick explanation of how we got from annual budget surpluses at the start of the decade to these huge deficits, type in Leonhardt Red Ink in the Times' search field).

The biggest driver of projected deficit spending in the longer term isn't the stimulus package, or the Bush tax cuts, so whatever your political affiliation, there's no sense arguing over those, as they're small potatoes. By far our biggest spending issues going forward are Medicare/Medicaid costs (see the Congressional Budget Office's June 2009 "Long Term Budget Outlook" for a sobering assessment of future increases in that spending if current costs and/or benefits don't change).

**Current outlook.** Right now, the bond market isn't pricing in significantly higher inflation, which you can see when you compare the yields on plain-vanilla US Treasuries to inflation-protected US Treasuries. The difference is 2-2.5%, which certainly doesn't reflect anticipation of a return to 70s-style inflation. Nonetheless, adding inflation hedges to your portfolio for the long term is a prudent measure. A lot of things from the 70s seem to be coming back -- small cars, long hair on young men, maxidresses, and ABBA. Here's to hoping inflation won't return as well. -- Therese

## Shorts

- **Higher limits of FDIC insurance extended.** Congress has voted to extend the higher insurance limits on FDIC-covered bank accounts. The limits were temporarily increased last fall from \$100,000 to \$250,000 per account owner per institution; that higher limit will now apply through 2013.
- **Cash for clunkers.** This program, which provides cash payments to buyers who trade in a qualifying less fuel-efficient car or truck to purchase a new, more fuel-efficient car or truck, is now law, and could be of benefit if you have a car with low trade-in or resale value and were planning on replacing it. Details are lengthy, and can be found at the website the federal government has set up to answer questions: [www.cars.gov](http://www.cars.gov).
- **Summer jobs and Roth IRAs.** We're big fans of gifting funds to children or grandchildren to fund a Roth IRA while they have earnings from a summer job. A Roth can be funded for up to \$5,000 this year, but the contribution can't exceed the child's earned income. Roth IRAs are ideal for the long term: funds accumulate tax-deferred, and in retirement, are taken out tax-free.
- **Staff News.** We've been out and about in the community this quarter: Karen spoke to a group of volunteers who provide general financial advice to church members at University Presbyterian Church, and Joe spoke to a class of post-grad accounting students at the UW about the financial planning and investment industry. Joe was also quoted in the Seattle Times on June 1 talking about Washington's Guaranteed Education Tuition (GET) program. The big news: Karen is a grandmother! Her daughter Brooke gave birth to a beautiful, healthy baby boy on June 29<sup>th</sup>.
- **Assigning blame for the financial crisis.** From an article by Nick Paumgarten in the 05/18/09 New Yorker:

*"The crisis is the culmination of events and trends, reaching back, depending on your perspective, four, seven, seventeen, twenty-two, twenty-seven, thirty-eight, sixty-five, or a hundred and two years. The subprime-mortgage meltdown, the subsequent collapse of the wider real estate market and then of securities based on real estate, and of the firms and funds holding those securities, and of the companies selling insurance against the failure of those firms, and potentially, of the insurers' counterparties, and so on: you could say that all this is merely the finale to a multi-decade saga set on Wall Street and Main Street, in Washington, Riyadh, and Tokyo. The causes are technological, mathematical, cultural, demographic, financial, economic, behavioral, legal, and political. Among the dozens of contributors and culprits, real or perceived, are the personal computer, the abandonment of the gold standard, the abandonment of Glass-Steagall, the end of fixed commissions, the ratings agencies, mortgage-backed securities, securitization in general, credit derivatives, credit-default swaps, Wall Street partnerships going public, the League of Nations, Bretton Woods, Basel II, CNBC, the SEC, disintermediation, overcompensation, Barney Frank and Chris Dodd, Phil Gramm and Jim Leach, Alan Greenspan, black swans, red tape, deregulation, outdated regulation, lax enforcement, government pressure to lower lending standards, predatory lending, mark-to-market accounting, hedge funds, private-equity firms, modern finance theory, risk models, quants, corporate boards, the baby boomers, flat-screen televisions, and an indulgent, undereducated populace."*

Despite the fact that this list makes your head spin, and seems designed to confound rather than clarify, the sheer poetry of the crescendo makes for entertaining reading!