WINTER 2010

in Context

WEALTH STRATEGY FROM A DIFFERENT PERSPECTIVE

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The Year That Was 2009

The severe bear market of 2008 that continued into the first quarter of 2009 tested even the most disciplined investors. What happened in 2009 to cause investors to be described by the financial media as "skittish" for almost an entire year?

The Year in Review
The recession that began in December 2007 continued into 2009 with the gross domestic product falling during each of the first two quarters. After the S&P 500 Index lost 37 percent in 2008 (its largest calendar year loss since 1931), the S&P 500 lost almost 25 percent by March 9. The unemployment rate was more than 8 percent by March and headed for a peak of 10.1 percent in October.

Headlines covered skyrocketing budget deficits, the continued fall in home prices, inflation concerns, and the fall of the dollar and its status as the world's reserve currency. Consumers saw another dramatic rise in the price of oil. After ending 2008 at around $40 a barrel, oil reached more than $80 in October. Gold screamed past $1,200 an ounce. Globally, problems persisted in Iraq, and the situation worsened in Afghanistan and Iran.

Despite all these woes, on March 10, the market began its greatest rally since the 1930s.

The Rally They Never Saw Coming
It is not easy to live through difficult times without feeling some trepidation about what the future holds. Investors have faced difficult markets before. Many chose to hang on for the rallies that occurred after banner down years, such as when the S&P 500 rallied significantly in 1935–37, late 1953–55, 1958–59 and 1975–76. The S&P 500's rally of 67.8 percent from March 10 to the end of 2009 while not unprecedented was certainly not expected.

Bear markets are usually accompanied by countercyclical policy actions. Central banks around the world took dramatic steps to improve the situation, and governments enacted stimulative fiscal policies. Anticipating the ultimate effects, markets typically rally well before economies recover.

As 2009 ended, inflation remained low, and home prices were beginning to stabilize in many areas of the country. The index of leading indicators rose in November for the eighth straight month.

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Shelf Life

"The great investor Benjamin Graham once defined happiness as 'living well within one's means.' Did he mean '*living well* within one's means' or 'living *well within* one's means'? I think his ambiguity was intentional: He meant both."

—Jason Zweig, *The Little Book of Safe Money*

Defining Indicators

When the latest economic indicators are announced, those numbers are apt to make the evening news. Some look at industrial production while others report retail sales figures. While it is clear that these numbers provide a snapshot of recent economic activity, some assume that the numbers carry additional meaning of a predictive nature.

The most important message that investors can take from regular announcements of economic indicators is they mean very little for one's investments. Investors should not attach particular value to monitoring those indexes in relationship to their portfolios.

Take for instance, the Chicago PMI (ISM-Chicago). The Institute for Supply Management compiles a survey/index of business conditions in the Chicago area, commonly referred to as the Chicago PMI. Many think that overall economic activity in the Chicago area is representative of the overall economy. Still, the Chicago PMI number encompasses the data for that specific dataset only.

Same for a number like jobless claims, which quantify new unemployment claims that are compiled weekly to show the number of individuals who filed for unemployment insurance for the first time. What these and other indicators do not carry: any predictive value for investing.

Some may choose to analyze the data from economic indicators and attach additional meaning to it. But the data from any indicator is by its nature looking back at a period already passed. The financial markets are leading indicators, meaning that the collective wisdom of the financial markets has already "priced in" much of the economic data before it is even announced. It is good to know what these indicators are, as long as investors don't think they mean something for their investments.

Fed Policy Statements and the U.S. Economy

By Dr. Laurence H. Meyer

The Federal Open Market Committee (FOMC) has continued to be very cautious about growth, judging from the updated forecast released after the November meeting, the discussion in the minutes for that meeting and Chairman Ben Bernanke's most recent speech.

There are, nevertheless, some grounds for optimism, at least about fourth-quarter growth, though much of the growth this quarter reflects a temporary boost from a cyclical rebound in inventory investment and from fiscal stimulus. The real test of a sustainable recovery will come in mid-2010 when these special factors diminish or reverse. By that time, consumer spending, business fixed investment and residential investment will have to strengthen, as we expect, to support continued above-trend growth.

The unemployment rate rose consistently in 2009. We expect the unemployment rate to rise further, above the 10 percent rate today, and then, although declining, we expect the unemployment rate to remain very elevated for a long time. In addition, given the persistent slack, we expect inflation to moderate further, and to remain very low.

There were few substantive changes in financial markets since the December FOMC meeting as market conditions have generally continued to show signs of stabilization following the impressive improvement seen earlier this year. The Committee is likely pleased by recent trends. Conditions in corporate debt, conforming mortgages and equity markets also remain supportive of a recovery. Despite these positive signs, Committee members will continue to have lingering concerns about financial and credit markets, including the availability of bank credit, especially to small businesses, and the possibility of renewed difficulties in the mortgage market as government support is removed.

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The Institute for Supply Management Index rose in December for the fifth straight month.

Even if the recession is over, it may be some time before it becomes official. Of the last nine peaks and troughs dating back to 1980, a period of six months to close to two years passed before the National Bureau of Economic Research made its official announcement.

In for the Long Haul
As investors look back on a memorable year and prepare to embark on a new decade, they might consider taking along the following insights. First, bear markets are inevitable (and that is a good thing or there would be no risk investing in stocks and, therefore, no equity risk premium).

Second, the world is never really as dark as it appears to be during a bear market (nor as bright during a bull market). The problem with bear markets is their arrival and departure dates are unknowable — no matter how much investors wish that someone could accurately tell them where the market is going next.

Finally, although the future is unknown, investors can still take steps to create a well-designed plan. When the weight of this difficult economic period lifts, investors will have a chance to catch their breath and consider how this bear market was a necessary pit stop on the road to achieving their financial goals.

Making Plans

Four Questions on the Home Mortgage Front

How has the industry changed since late 2008?
Credit standards have tightened. Standard debt-to-income ratios are 38 percent for conforming loans and 45 percent for nonconforming (known as jumbo) loans. In the past, those guidelines were highly flexible. Today, while still flexible, they are less likely to be broken. Loan-to-values (LTVs) have also tightened. Gone are 100 percent LTV loans.

Credit scores now play a much more important role. In today's market, the best quoted rates are based on a client having a credit score of 720 (conforming loans) or 780 (jumbo loans). As one's score falls, the loan rate increases — as it should.

Should a second mortgage be structured as a HELOC or HEL?
This depends on the anticipated repayment schedule for the loan and the client's overall financial picture. If the client has the means to pay off the loan anytime the rate becomes unattractive and it will be repaid in a short time, say 1–3 years, a home equity line of credit, or HELOC, will usually be fine. If the loan will be repaid over a longer period and the client does not have the means to pay off at any time, it is more prudent to use an amortizing home equity loan, or HEL.

What are soft lender costs?
Anything other than the appraisal fee, credit report fee, tax service fee, flood report fee and title company fees could be considered soft costs. Examples of soft costs are origination fees, application fees and table funding fees.

Is the adjustable-rate mortgage (ARM) still a prudent option?
It depends. If an individual expects to be in a home less than five years, then a 5/1 ARM makes sense as the rate is currently less than a 30-year fixed. A 5/1 ARM has a fixed rate for five years, then changes to an adjustable rate for the rest of the loan. For those unsure how long they will stay, the 30-year fixed rate is so low (4.875 percent) it would be financially prudent to consider this route. (As of 12/09.)

Source: Wells Fargo Home Mortgage, St. Louis

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