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September Newsletter

The turmoil continues in the world and it seems like the onslaught of new problems is coming faster and faster. We are confident these difficult times will pass, but in the short term the news is unsettling. For stocks we are in bear market, meaning the trend line for stock prices is heading down. The down trend has been in place for eleven months. Since the highs of last October, the blue chips, as measured by the S&P 500 are down approximately 18 percent as of August month end.

The obvious question is why own stocks at a time like this. If we knew the future we would have gotten our clients out of the market last October at the high. Of course we could not predict the future in October, and we don't know when the bear market will end (assuming it hasn't already). We only know whether we are in a bull or bear market by looking backwards, usually for an extended period, and of course it is then too late. We know losses are not pleasant so we emphasize diversification to design portfolios so that when times like this occur the portfolio losses are kept within the limits stated in the Investment Policy Statements. This has generally worked, but there are of course no guarantees that this will happen. Occasionally a client tells us they now prefer less risk than we discussed when times were good and we amend the Investment Policy Statement and change the portfolio accordingly. Our insistence that we understand how investment products are designed and each one's inherent risks has kept our clients away from the many exotic investment products that have imploded over the last year.

We hope you agree that these are times that our services are most valuable. Many investors have not had the benefit of services similar to those we provide. We welcome the opportunity to talk with people who have not received this service, so please let your friends know we are available to talk about their situations.

The economies around the world have weakened, but because we measure things after they have happened, we don't yet know whether we are in a recession. What is interesting is the tremendous cross currents. While housing and banking are very weak, rising US exports are strong, acting as a counter weight. Also energy, commodity, and natural resource sectors have been doing very well, at least until recently.

Many of you are probably tired of my "Super Trends" theory, but I think it sets the foundation for what is going on now. Super Trends looks at the economic side of David Friedman's "The World is Flat". Computers and the winning of the Cold War which permitted free markets to spread around the world sparked the huge global economic growth. As I recall the World Bank reported that 500 million people in China alone have been lifted out of poverty. The huge economic growth has driven the great wealth creation as reflected in the stock market gains over the last decade or two. That wealth has now set the stage for the major problems that have been unfolding over the last year.

The credit crisis I blame on old fashion greed. Good things go too far and everybody throws caution to the wind when they think they can make easy money. Then it ends with much pain. Consumers bought houses they couldn't afford and took money out of their houses that they shouldn't have. Professional money managers ignored risks in investments they bought or encouraged others to purchase. The Congress and the Executive branch also bare blame. They encouraged people to own homes they could not afford, they structured Fannie Mae and Freddie Mac with conflicting objectives (making a profit and promoting housing) so they could not succeed, they required many institutions to only buy certain credit rated bonds which encouraged the institutions to look at the bond rating rather than the underlying quality of the bond they purchased, and on and on.. And then of course there was fraud and deception.

The US consumer standard of living had been subsidized by cheap products from emerging markets like China. The huge amount of money used to purchase these goods then recycled back into the US to purchase treasury bonds, thus keeping interest rates low and spurring the housing boom. This is all changing with major ramifications to consumers' life style and to the economy as a whole. Looking forward perhaps consumers will take control of their lives and save for retirement. This is one of the several major changes that could be occurring.

The booming world economy lifted millions of people out of poverty, wanting a better life style and the "stuff" that accompanies it. Manufacturing "stuff" (and growing food, constructing roads, and fueling new cars, etc) requires raw materials, sparking a run up in commodity and energy prices. I think it was only a matter of time before the price spike occurred. Supply could not increase to meet the increased demand so the impact was price increases and shortages. Increased production of many commodities is restricted around the world by governmental action, or inaction, making the spike in prices steeper. For instance, much of the world's oil supply is controlled by governments which are slow to increase production. US consumers have responded to the higher oil prices and are taking both short and long term actions to reduce demand. Governments in some of Asian markets have stopped subsidizing oil consumption, so their citizens feel the impact of higher prices and cut back use. This is likely to slow growth rather than reduce use. Agricultural products have run into similar shortages and price spikes. World wide farmers are responding to the higher prices by increasing production. It will be interesting to see how quickly the markets return to "normal."

Geopolitical risks are concerning. Iran holds the potential for serious problems. While the war in Iraq cools, Afghanistan (and Pakistan) unrest heats up. China's rise continues, and we find ourselves competing with them economically for the same resources and goals more and more. I find the Russian aggression into Georgia particularly troubling. Democracies respond slowly to such threats so the magnitude of the threat and tension may continue to build before we adequately respond to stop their aggression. Super

Trends has come full cycle. The end of the Cold War with the fall of the Berlin Wall was one of the factors sparking the world wide growth. Increased living standards drove up the demand for oil which in turn provided the revenue to Russia to rebuild military power. Pieces are in place for a return to a Cold War, with a newly imperial Russia replacing the old Soviet Union. Increased resources spent for the military around the world can only reduce resources spent to improve people's lives. We have lived through many years of a Cold War and I am sure we can do it again, but I really like it the other way. This is likely another parameter we need to factor into our investment strategies.