JVL Associates, LLC NEWSLETTER

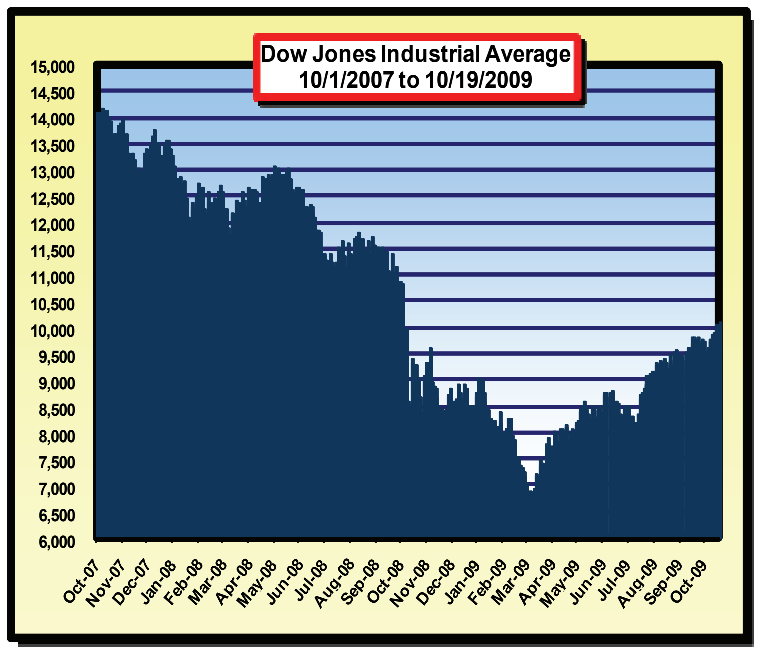
Reflections / Recovery

SEPTEMBER 2009

Reflections:

I recently returned from the Financial Planners Association's Annual Conference in Anaheim, CA. It was almost exactly one year ago that we were meeting in Boston, MA during the first week of October, 2008 when the Dow Jones Industrial Average's (DJIA) dropped below 10,000, falling almost 2,500 points in one week. That week ushered in the official start of the bear market as the week's decline brought the market's drop to over 20% from its November, 2007 high. The markets continued to slide hitting its low on March 9, 2009. But since then the market has rocketed higher, up over 50% and again topping the 10,000 level.

One of the themes at this year's conference related to the role of the financial planner / investment advisor. The events of the last two years reinforce my belief in the answer to the question "what do I manage during market crises?" As a financial planner / registered investment advisor I believe strongly that I manage three separate and distinct things.



First and foremost, I manage people. Clients are people and people have emotions. Emotions that create excitement when markets go up, create anxiety when markets are flat and create fear when markets go down. Emotions that remember the latest market decline more clearly than they remember previous market advances. Emotions that are swayed by the so-called "experts" featured on TV or in news magazines. My role is to be the clear, calm voice during all this emotion and give intelligent, prudent, concise advice. By listening to the emotion, combining it with proven investment theory and historical market events, I strive to bring a steady voice to the thought process. There is nothing wrong with changing course as your tolerance for risk changes during volatile times, but knowing and understanding emotions are key to the investment process.

Second, I manage portfolios. Portfolios are constructed with asset classes, not specific securities. Reading about and studying the economy, researching the correlations between asset classes and understanding long term historical returns and trends are critical to constructing a portfolio that can withstand the market's volatility. Focusing on where the economy is heading, not just where it has been, is vital to the portfolio's makeup. Differing times in the economic cycle can create unique opportunities for portfolio allocations. My role is to adjust asset allocations to meet current economic conditions.

And third, I manage money. Each asset class in a portfolio needs to be implemented with a specific investment. It could be an indexed exchange traded fund (ETF), an actively managed mutual fund or a specific corporate or government security. My role is to make sure that we fill the asset allocation with the security that meets your investment objective both in terms of risk and return.

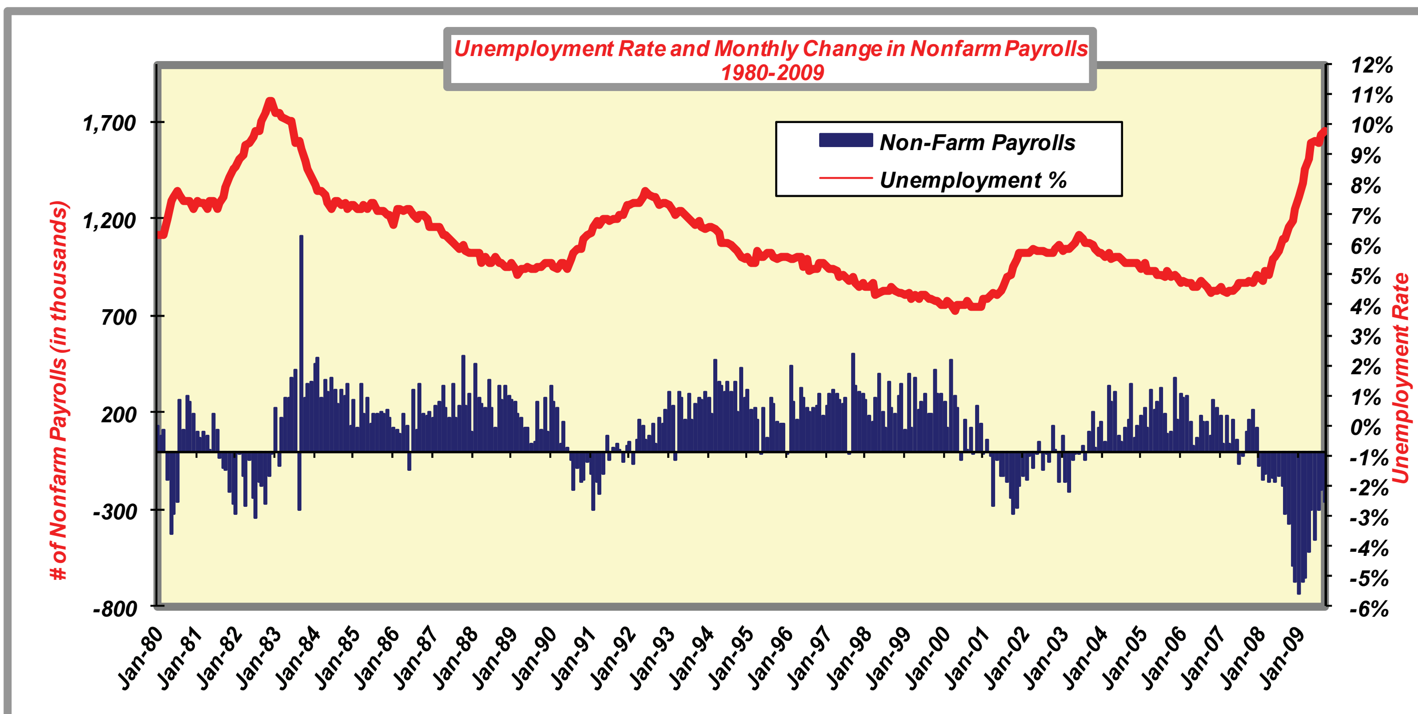
It has always been my goal to be available to you, both in good markets and in bad. Your questions and concerns over the past year have challenged me to dig even deeper into how we can accomplish your goals and objectives. Please keep talking and let your emotions out! I will continue to be the clear, calm voice you can trust.

Recovery??

The third quarter, 2009, will most likely become the official end of the current recession. Many people believe that third quarter GDP (Gross Domestic Product) will be positive when it is announced and that the fourth quarter will remain slightly positive as well. It will take some time for the economists to label an "end" to the recession but even with the recession "over" we face many headwinds to a recovery.

Employment:

The employment picture will continue to be a drag on a recovery. An analysis of the Bureau of Labor Statistics information **(1)** points out some of the larger issues relating to the employment numbers. The United States has lost 7.6 million jobs since the current recession began in December, 2007. The "official" unemployment rate is 9.8%, the highest rate since June, 1983. This represents 15.1 million workers.



But, we must dig a little deeper. The "official" unemployment rate does not count the 2.2 million workers **(1)** who have not looked for a job during the last four weeks because they have become discouraged and don't believe there are any jobs available in their area for them. If you include those workers the unemployment rate jumps to 11%. In addition, the "official" unemployment rate does not include the 9.2 million workers **(1)** who are employed part-time but wish for full-time work if it were available to them (involuntary part-time workers). Adding in those workers causes the "true" unemployment rate to be 16.8%. The Bureau of Labor Statistics keeps these records and calls this the U-6 unemployment rate. But, that is history – aren't we about to go into a recovery?

A recent study **(2)** focuses on the amount of jobs needed over the next five years (2010 – 2014) to get the unemployment rate back down to a more acceptable 5%. First, the U.S. economy needs to create 1.5 million jobs per year just to keep up with current demographics. Next, it needs to create enough jobs to get the "official" unemployed down to 8 million workers. Combined, this requires that the U.S. economy create over 14 million new jobs over the next five years which amounts to an average of 233,000 new jobs per month for sixty consecutive months. That is a formidable challenge!

It appears high unemployment may be with us for some time.

Loan Defaults:

Another potential headwind facing a recovery is the question of losses on outstanding loans. Financial institutions are battered with loans that are either delinquent or in default. The International Monetary Fund (IMF) recently projected that the global banking sector will incur losses from bad loans totaling $2.8 trillion. Of that amount, banks have only recorded $1.3 trillion on their financial statements and could face another $1.5 trillion in write downs. **(3)**

During the most recent quarter, Bank of America wrote off $10 billion in bad loans and increased its reserve for further losses by $11.7 billion. **(4)** Wells Fargo increased its allowance for loan losses by $6.1 billion. **(5)** Capital One, the large credit card company, reported that its annual bad debt charge-offs amounted to 9.77% of outstanding balances. **(6)**

Home foreclosures in the U.S. rose to over 930,000 in the third quarter, 2009. The foreclosures were almost evenly split between the top, middle and bottom tier of the housing mortgage market. In addition, 46% of Option Adjustable Rate Mortgages are currently 30 days past due. **(7)** The problem is not just for subprime loans anymore.

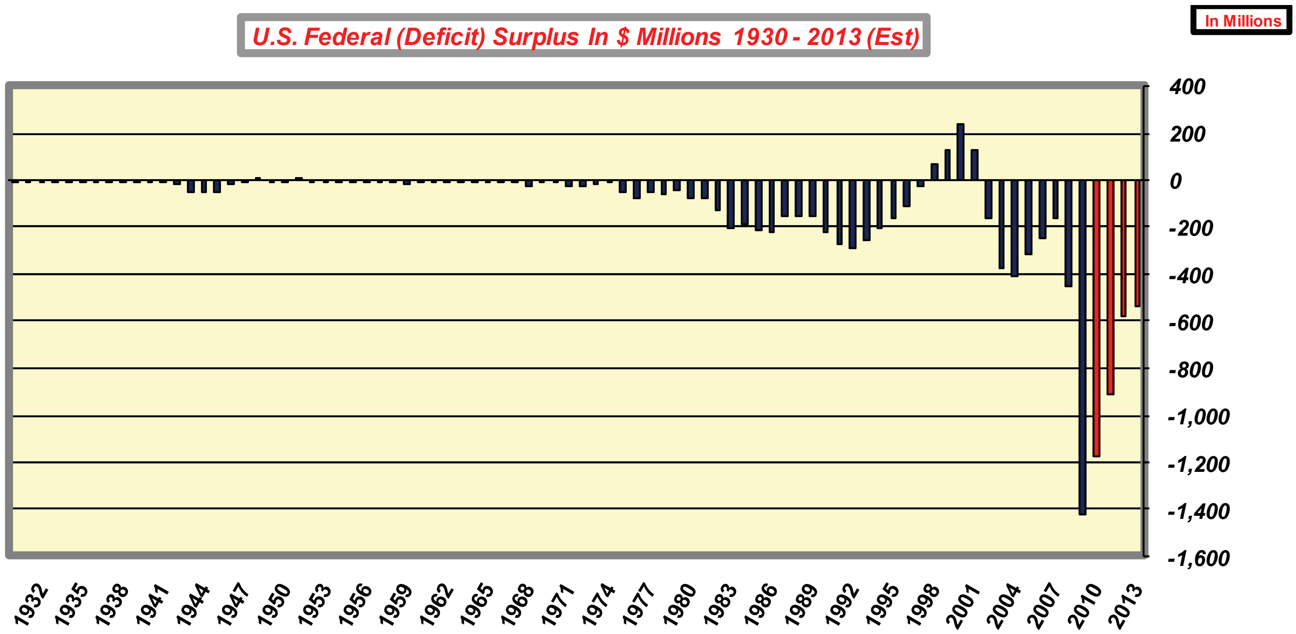
Compounding the residential mortgage market problems is the real possibility that house prices will continue to fall. A recent study by Fiserv, a financial information and analysis firm, predicts that house values will fall another 11% by mid 2010. **(8)** The study believes that the foreclosure market will continue to dampen house prices well into the future.

In addition to residential mortgages and credit card defaults, financial institutions are facing increasing pressure from commercial real estate loans. According to Moody's REAL commercial property price index, prices on commercial real estate are down over 30% from last year and down over 38% from their October, 2007 highs. **(9)** The Federal Reserve recently stated that "the weakest link in the recovery was commercial real estate. Conditions were described as either weak or deteriorating across all 12 regions surveyed." **(10)**

The potential effect of loan defaults has a wide impact on the recovery. According to a recent Institutional Risk Analytics report **(11)** over 2,200 banks received an F rating on their Bank Stress Index grading system. That represents 25% of every active bank in the U.S. as of June, 2009. Financial Institutions are under pressure, both from government regulatory agencies as well as shareholders, to "clean up" their balance sheets. This pressure causes tighter lending practices and less new lending thus dampening the recovery.

Government Finances:

The Federal government recently closed its books for the fiscal year ended September 30, 2009. The one year deficit totaled $1.42 trillion. **(12)** This is three times the largest previous deficit in history. The projected Federal budget deficit for the current fiscal year is another $1.26 trillion. **(13)** Future deficits are currently projected to total $9.1 trillion in the coming decade. **(12)** The federal debt currently stands at almost $12 trillion and is increasing by almost $4 billion a day. **(14)**



The federal government takes in just under $1 trillion a year in personal income taxes. **(15)** Raising taxes to close the deficit would require a 100% increase in personal income taxes! And that does nothing to reduce the overall national debt!

The potential implications of the increasing federal deficits are numerous. First, increased deficits mean increased borrowing. The U.S. is relying on foreign governments to purchase their debt. China, the largest foreign holder of U.S. debt, recently lectured the U.S. on the need to assert fiscal responsibility. **(16)** If the largest foreign holder of our debt is telling us to keep our deficits in order, how much more debt are they willing to buy?

Second, the increasing debt raises the real possibility of higher long term interest rates and inflation. The temptation to print money to service the debt becomes more tempting as the national debt grows beyond our ability to pay. The dollar's value, as measured against a basket of foreign currencies, is dependent on the markets view of its relative strength over the long term.

Third, the U.S. dollar is currently the global reserve currency. Oil and other commodities are traded in U.S. dollars. As the U.S. debt increases the future stability of the dollar as the global reserve currency is threatened. Already, leaders of China, Russia and Brazil have called for a new global reserve currency. **(16)** France and Malaysia have both gone on record stating the dollar's role as the world's reserve currency present inherent economic instabilities, with dangerous consequences. **(17)**

The federal government faces the challenge of reducing spending and the annual deficits at the same time they are trying to "reform" health care. The stability of a recovery is dependent on the long term strength of the U.S. dollar.

So where does that put us – are we in a recovery? I believe we are in the early stages of one. However, I also believe that the recovery will not be as robust as many hope. The headwinds are not going to go away easily.

Remember, the economy is not the "market". It is conceivable that the "market" has more room to run as the economy struggles through the recovery phase. Our strategy is to develop portfolios that meet your risk and return objectives throughout any economic scenario. Feel free to call and share your thoughts and your emotions. I would love to hear from you.

By: Jerry VanderLugt CPA CFP®

References:

1) www.bls.gov News Release, USDL-09-1180, October 2, 2009
2) www.2000wave.com John Mauldin, Thoughts From The Frontline, Welcome to the New Normal September 25, 2009
3) Wall Street Journal - Expect Plenty More Bank Losses, Says IMF By Bob Davis, September 30, 2009
4) Yahoo News - Bank of America Loses $2.24B as Loan Losses Rise By Ieva M. Augstmus, AP Business Writer, October 16, 2009
5) Yahoo Finance - Wells Fargo 3Q Profit rises, But So Do Loan Losses, October 21, 2009
6) Yahoo Finance - Capital One Shares Tumble As Default Rates Worsen, October 15, 2009
7) Agora Financial - 5 Minute Forecast, October 15, 2009
8) Yahoo Finance - Homes: About To Get Much Cheaper, October 20, 2009
9) www.financial-planning.com Commercial Real Estate Prices Fell Further in July By Aleksandrs Rozens, September 22, 2009
10) Yahoo Finance - Fed Survey: Housing, Manufacturing Drive Recovery, By James Aversa, AP Economics Writer, October 21, 2009
11) www.institutionalrisk.blogspot.com Dennis Santiago, CEO After Six Months, Déjà vu, August 31, 2009
12) www.content.usatoday.com Obama Team Makes It Official: Budget Deficit Hits Record. By a Lot, October 16, 2009
13) Budget of the United States Government – Executive Office of the President of the United States – Historical Tables
14) www.brillig.com U.S. National Debt Clock, October 22, 2009
15) www.usgovernmentrevenue.com Government Taxes and Revenue in United States in 2009
16) Fidelity Investments Market Analysis, Research & Education, Will China Stop Buying U.S. Debt?, September, 2009
17) Wall Street Journal - Inevitable End To Dollar's Reserve Role?, September 1, 2009

1535 44th Street SW, Suite 400 Wyoming, Michigan 49509 616-261-2800