

Market Update - March 2009

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So does the volatile stock market leave you scratching your head? Over the past couple of weeks we had seven trading days that drove the market (S&P500) up over 14% and then again on Monday, March 23rd, it was up over 7%. Remember that statistic we last passed along that indicated there is over \$8 trillion sitting in Money Markets and CD's just waiting for a glimmer of hope to start moving back into the market? So is the bear heading for the door or is this just a bear market rally? It is hard to say. (As we finalize this letter on Monday, March 30th the market is selling off....) There are certainly many issues at play. The government keeps surprising us. Last week the Fed announced plans to buy back \$300 billion of US Treasury bonds as well \$750 billion of agency mortgage backed securities (such as FNMA bonds). This initially drove the yield on 10- year Treasuries down by almost .5% and also pushed down the mortgage interest rates. That said here is an interesting quote from JP Morgan Asset Management (March 19, 2009).

Why would private investors, be they from Beijing or Buffalo, be willing to accept a 2.5% yield on those bonds (10-year Treasuries) today? Some might, for as long as the recession is deepening, but any hint of an economic turnaround ought to lead to a whole-scale dumping of Treasuries. And, with normal mortgage spreads, this could boost 30-year fixed rate mortgage rates to somewhere between 6% and 7%. This wouldn't be an economic disaster. Nobody today is hesitating to buy a house because mortgage rates are just too high, and even mortgage rates between 6% and 7% would still be extraordinarily low by historical standards. But as Alan Greenspan used to say, the law of supply and demand has not been repealed, and regardless of its intentions, the Federal Reserve should not be able to sustain today's low Treasury or mortgage rates, once the economy shows any solid signs of stabilizing.

The big concern that we now hear in the media is the coming inflation. JP Morgan also had a good explanation and a reminder of Economics 101.

Inflation hawks are concerned about the huge expansion in the money supply implied by the Fed's actions as well as the equally mammoth federal budget deficit. However, neither of these forces should lead to inflation in the short run. Again, supply and demand come into play. The U.S. economy is suffering from massive oversupply.

- Twelve and a half million workers are looking for a job – nearly twice as many as two years ago.
- We are using just 71% of our industrial capacity – the lowest level in 26 years.
- Inventories of houses and cars still seem plentiful relative to current sales.

If Washington is successful in generating extra demand, competitive forces should translate this demand into higher output rather than higher prices. Inflation only becomes an issue when extra demand meets a lack of supply and sellers finally have the bargaining power to raise prices.

This is where time is on the Fed's side. We often sprint into recession, but meander into expansion. Even the blockbuster expansion of the 1980s took six years to cut the unemployment rate from 10.8% down to 5%.

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The Federal Reserve has a printing press, and right now, they are cranking it up. But they also have an incinerator to destroy excess money when it is no longer needed. During the next long expansion, they will have plenty of time to sell Treasuries and other securities back to the public, mopping up excess money supply. With this in mind, and provided they are as disciplined in removing monetary stimulus as they have been bold in adding it, the upcoming expansion should be as benign in terms of inflation as each of the last three.

The bottom line for investors is, despite the drama in the Fed's announcement, it probably justifies neither the best hopes of the bond market nor the worst fears of the currency markets. For once, the stock market, in a modest advance, may have gotten it right, reflecting a small short-term positive for the economy with only limited inflation downside.

So now may be the time to once again review your portfolio. You may consider looking at it as three buckets. The first bucket is for Preservation of Capital. This is the money you don't want to fluctuate. Perhaps it is funds that you will use in the next year or two. The second bucket is for Income. If you are in need of current income these funds would be set aside to create a regular check coming in. The third bucket would be for Growth. These are funds you need to grow for the future and help keep up with inflation.

This system may help you carefully consider what piece each of your investments should be playing in your portfolio and help take the emotions out of the decision making.

One of the boons of this market craziness is a drop in mortgage rates. We have recently found 30 year and 15 year fixed rates as low as 4.625%! So it may be time to refinance if you have at least 20% equity in your home. Here's a hypothetical example of Sue Homeowner with a \$300,000 mortgage (she has had for 5 years), a current rate of 5.625% and she pays \$1857 per month. She found a 30 year fixed rate mortgage at 4.625% with costs of \$2200 plus one point (\$3000) for total costs of \$5200. Assuming that she pays these fees out of pocket and refinances the \$300,000 her payment would drop to \$1542. But the real savings comes into play if she keeps making her same payment of \$1857 per month. This would save her over \$85,000 over the life of the loan.

How are you feeling emotionally these days? The ups and downs of the market can certainly make us lose sight of the big picture. A few years ago it felt like real estate would never go down. In the late 90's it seemed the tech boom would never end. Up until a few weeks ago some thought that the market would never go up again and then we had a turn for the better. So all these emotions often push investors to buy or sell at exactly the wrong time. Please take a look at the Emotional Investing flier we have attached. The picture tells the story of how our investment decision making looks like a clock. We tend to invest from nine to twelve o'clock when everyone else is investing and prices are may be at their highest. We tend to sell at four to six o'clock when stock values may be most attractive. What time do you think it is?

As always, feel free to call us with any questions.

Barbara Williams and Gloria Foote

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About the time we can make ends meet, somebody moves the ends. - Herbert Hoover

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