

3rd Quarter Economic and Market Commentary

How can I describe the past few months? We're all glad to see some stability return to the economy and the markets in general. The Great Recession, second only to The Great Depression in length, appears to be finally waning. Even the most negative doomsayers have capitulated and agreed that, yes, the worst may in fact be behind us. Many leading economic indicators show consistent increases in manufacturing output, home sales, and other key measures of growth. The markets have rewarded those of us who exercised patience, while those that chose to guess (or second guess) the future direction of things have been left wondering how they could have missed such a splendid recovery in asset values. (In fact, the stock market just turned in its best third quarter since 1939.) To those unfortunate folks, I can offer only four words. "I told you so."

Now, before you misinterpret my response, understand that I am simply referring to what history has shown us time and again, and not to any clairvoyance on my part. In my commentaries from late last year and earlier this year, I consistently highlighted what usually happens when busts end. Things get better. Markets improve. We do not know exactly when it will start, how long it will last, or how rapid the recovery will be, but things have always gotten better after a recession. There is little motive to bet against history in this regard.

But, this is all in the past now. What does the future hold? Good question.

Not all elements of the economy recover simultaneously. It doesn't work that neatly and conveniently. In every past recovery, there are varying degrees of fits and starts. This one will be no different, and in fact the fits and starts may last longer than past recessions. The elements giving us the most "fits" currently are:

1. **A jobless recovery.** It's difficult to imagine a sustainable growth pattern with unemployment stuck at 9.8%. It's predicted that it may be the end of 2010 before we begin to see the jobless rate fall. This will most certainly be a drag on recovery.
2. **Saving, but not spending.** The consumer, who represents two thirds of our GDP, is still not spending at rates even close to historical averages. But, they are saving. Estimates are that the national savings rate is currently around 6%. (You may recall that it had been zero for some time leading up to the recession.) In the

long run, this savings pattern is a good thing. In the short term, however, it will dampen the growth rate of the economy.

3. **The deficit.** Now approaching \$12 trillion, this is perhaps the most worrisome element from my view. Regardless of your political leanings, the current administration is spending money at an unsustainable rate. While noble in its intent, you simply cannot fix all this nation's ills simultaneously. The deficit will in fact be reduced by the continuing repayment of bailout funds and by normal resumption of economic growth, but it won't be nearly enough to bring it back to a manageable level. Reducing the deficit needs to become a major priority in Washington.
4. **A weak dollar.** A byproduct of the deficit, the dollar's ills would be much more concerning if the rest of the world were not in the same boat. The fact is all the developed economies have increased their respective deficits to thwart the global recession. Misery loves company. Still, the Fed must carefully manage fiscal and monetary policy in the near term to avoid further weakness. We have all heard the whispers about the impending collapse of the dollar as the globe's financial yardstick. As soon as someone shows me a viable alternative given the rest of the world's problems, I'll be sure to relay it to you.

Each of these are legitimate concerns and, taken together, present the economy with some difficult headwinds. But, you must weigh these "fits" against the "starts", such as:

1. **Improving corporate earnings.** The engine of economic growth, companies continue to surprise on the upside. This is a powerful counterweight and will ultimately lead to job growth and a stronger dollar.
2. **Responsible lending and borrowing.** You say you can no longer buy a house with no money down and no proof of income? Good. Sanity is finally returning to the credit markets. While painful, this will be a strong underpinning of sustainable growth.
3. **Lots of dry powder.** The St Louis Federal Reserve estimates there is more than \$8 trillion currently residing in savings, checking, and CD accounts. How long will people be willing to accept zero/ low returns on this pile of cash before putting back to work in stocks, bonds, and real estate? Not forever, I'd guess.
4. **Capitalism lives on.** Despite rumors of its untimely demise at the hand of socialism, the private sector will in fact be the solution to many of problems created by Wall Street's excesses. The tug of war between government intervention and free markets will be won by the latter as soon as Congress realizes it is out of bullets...and blank checks. Let's hope it's soon.

These economic fits and starts will be reflected in the stock, bond, and real estate markets in the short term. There are those who suggest that the dramatic rise in

values have gotten ahead of economic reality. Others suggest that the market recovery is just beginning. Still others portend things will get worse again before they get better. All three camps back up their assertions with mountains of charts, graphs, astrological signs, and chicken bones. Fact is -the future short term direction of things is no clearer today than it was a month, a year, or a decade ago. It's my advice you stay focused on your longer term objectives - whether that's five years or thirty five years. By focusing on your longer term goals, you can eliminate some of the short term noise and distraction. As the last nine months have proven, fits and starts are to be expected. Diversification, patience, and quality can smooth out these short term bumps, and create longer term wealth for us all.

See you next quarter.

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