KOVALCIK & GERAGHTY
WEALTH PARTNERS LLP
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Newsletter

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"Fifty Cents"

By Matthew G. Kovalcik, CDFA, CFP®

I have never been accused of being "hip." I guess I should not feel too bad. After all, a 42 year-old, balding, slightly overweight, white guy from Powell Ohio would not be the first thing you would think of when you hear the term "hip."

Since most of the people I spend my time with are just like me, I do not know too many people who fit the definition either. I guess famous people like athletes, movie stars and musicians are hip. Some people in the music world must think they are because they call themselves hip-hop artists. What is hip-hop? Hip-hop is a form of music most people think of When they hear the term "rap." Just a guess, but I bet most rappers think of themselves as pretty "hip."

A few months back I saw a rapper who goes by the moniker "50 Cent" on the financial channel. He was on to promote a new book of his titled the The 50th Law. While I never read the book, I understand it to be a philosophy of approaching life without fear - a good philosophy in some respects, I suppose. I was surprised at how sharp the fellow - 50 Cent - seemed to be. I'll admit that I had my presuppositions of this guy if for no other reason than he chose to go by 50 Cent rather than the grammatically correct, 50 Cents.

Approaching life without fear should lead to a more exciting life. Things like jumping out of an airplane, walking a tightrope or taming lions sound exciting. Or you could trade all that for the heart-pounding capital markets. Or you could be a policy maker in Europe. Now that is exciting!

Last week the Eurozone thought the problems in Greece would be put behind them with a Greek bond write-down of 50 cents on the dollar. The markets cheered! Yes, I will say that again, they cheered at the thought of losing half of their investments in Greek bonds. We knew that would be short-lived. George Papandreou, the "then" Prime Minister pulled a one-eighty and announced he would hold a referendum to seek support from the people before a final agreement was made. This began to worry the Eurozone because other countries, mainly Italy and Spain, two countries with significant problems of their own, hold significant amounts of Greek debt. Now, all of a sudden, they are less capitalized than they'd like to be. As I type this, the interest rate on Italian bonds is over 7.2%. That is up from the mid-six's just two days ago. Panic is sweeping through Italy because they are expected to have bond pay-outs and redemptions of 200 Billion in 2012, and bill redemption of 108 billion Euros, according to Bloomberg on November 9, 2011.[3] They simply cannot sustain this level if interest rates (and their cost of capital) continue to rise.

Higher taxes and government spending cuts (read: Austerity) have weakened Greece's economy, making things worse instead of better. The problem (or exciting part of a policy makers job) is that European and US deficits are on an unsustainable trajectory. And too much belt tightening at the exact wrong time risks slowing the recovery. A better policy is to try to boost growth.

We believe above all else that if you could pinpoint overall economic growth to one key thing it would be job growth. We know that consumers making more income will spend more and save more and that will be a catalyst for the economy. Until that happens, it seems very unlikely to us that the economy can get back on a sustainable trajectory. The average company looks pretty good right now. Since early July 2011, about 80% of all companies reporting earnings have beaten their estimates.[1] We fear, as we have written to you in previous months, earnings look good because companies are not investing enough nor are they hiring. U6, a measurement of both the unemployed and underemployed, still rests in the 16% range. Too high for comfort.

According to an article I read in The Economist, the Organization for Economic Cooperation and Development - OECD - has recently updated its projections for weak global growth. They have slashed US and Eurozone growth expectations for the year 2012. In addition, the International Labor Organization, part of the United Nations, said it will take five years for us to return to pre-crisis job levels. It's the opinion of the International Labor Organization that 80 Million jobs are needed worldwide - 27M jobs in the developed world, and 53M jobs in the emerging countries.

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This makes investing in the capital markets exciting. Not hip-hop exciting, but gut-wrenching exciting. At a high level, I feel there are four opportunities in which you can invest - cash, bonds, stocks and alternatives. Cash, while low risk, literally pays you nothing today. After inflation, there is a loss of purchasing power that many investors often forget to factor into their risk calculations. The federal reserve, along with other foreign governments have been on a bond-buying binge and have driven up prices while yields have fallen. Committing money to some parts of the bond market are downright dangerous right now. Since bonds are very much like a teeter totter, buyers today will most likely earn a nominal return while they wait for the bond to drop in value.

Stocks, while potentially offering some nice dividends, are not without risk. If, looking for that dividend income, you were heavy in stocks in September 2011, you likely paid a dear price. October, then most likely, rewarded you for hanging in there. Bottom line... nobody knows for sure what will happen in the near future but a volatile ride ahead seems likely. The Alternative Investment space - things like real estate and commodities - are equally volatile as stocks but in most instances offer less of a dividend.

The current yield offered by an investment is often a pretty accurate predictor of the future returns. If yields are low (always because prices are high), future returns tend to be low as well. Just the opposite is true - higher yields (and low prices) tend to lead to periods of growth. Today yields are low in cash, bonds and stocks. What is ahead? Not sure... but a "risk-off" posture seems to make sense to us, at least for the time being.

You remember the saying that "a calculation does not have to be complicated to be good." As of yesterday the Dow Jones only had to grow by 14% to return to the all time highs last seen in the September 2007. Some market mavens predict this gap will close. Maybe it will, maybe it won't. We don't believe that is the question. A better question is, if the gap closed, could it hold. We think not, but let's explore that scenario for a moment. If the markets closed the gap in 2012, we would be forced to compare the economy from 2007 to 2012. Things like unemployment at nearly double the 2007 rate, a housing market dramatically different - swinging from a boom in 2007 to a position where, according to Bloomberg, nearly 11 million, or 23% of mortgages, are underwater,[2] etc. - argue that a sharp rise would not be sustainable.

For our part, we like a little excitement in our lives from time to time. We approach investing with a recognition (and fear) that the capital markets could easily turn against us if enough bad news grabbed traction. Accordingly, we'll stay conservatively invested.

Best wishes to you for a wonderful Thanksgiving surrounded by those who matter most to you!

Sources:

[1] Gammeltoft, Nikolaj. "U.S. Stocks Decline Amid Debt Concerns, Profit Forecast From 3M." businessweek.com. n.p. July 26, 2011.

[2] Gopal, Prashant. "U.S. 'Underwater' Homeowners Rises to 28.6%." Bloomberg.com. n.p. November 8, 2011.

[3] Vasarri, Chiara. "Italy Seen Struggling to Attract Buyers for Treasury Bill, Bond Auctions." Bloomberg.com. n.p. November 9, 2011.

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Have a safe and joyful Thanksgiving!

"As we express our gratitude, we must never forget that the highest appreciation is not to utter words, but to live by them."
-John F. Kennedy