

All Eyes on the Reserve

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Investing was easy a year ago. We asked our clients to put as much money into the plummeting U.S. stock market as they could reasonably do. We pulled money from cash and bonds and anywhere else that made sense. We targeted large U.S. companies, especially the most beaten-down sectors; financials and oil.

At the time, oil had plummeted from nearly \$150 per barrel to about \$40 per barrel, and financial stocks carried valuations reflecting many fears. Since then, of course, the stock market has roared back from its lows, with energy and financials leading the way. We are pleased to see the results.

What now?

I agree with the pundits who say the easy money in the stock market has been made. Standard valuation numbers say that stocks are relatively attractive, but not deeply discounted. Of course, there is also an enormous amount of cash that is looking for investment, whether it is held by individuals, institutions, corporations or sovereign wealth funds. The broad U.S. stock market could easily rise by double-digits again in 2010. Of course, we could also see declines, although this seems to be less likely given the many factors pushing in the upwards direction.

The chart below contains Federal Reserve data which provides an excellent summary of many different forces at work in today's economy.

F.1 Total Net Borrowing and Lending in Credit Markets
Billions of dollars; quarterly figures are seasonally adjusted annual rates

Description	2004	2005	2006	2007	2008	2009	2009
					Q1	Q2	
1 Total net borrowing	3132.1	3560.3	4022.9	4501.7	2651.1	-224	-241.1
2 Domestic nonfinancial sectors	1997	2328.9	2399.7	2539.1	1888.2	1371.2	1646.3
3 Household sector	1055	1170.7	1176.1	855	35.6	-155.9	-233.2
4 Nonfinancial corporate business	202.8	330.2	465.8	842.8	368.7	153.6	72.3
5 Nonfarm noncorporate business	246.1	332.1	409.1	403.7	177.1	-176.7	-274.5
6 Farm business	15.8	17.3	14.2	14.6	26	1.2	-0.6
7 State and local governments	115.4	171.7	151.2	185.9	41.7	109.4	187
8 Federal government	361.9	306.9	183.4	237.1	1239.2	1439.6	1895.3

We can only imagine Ben Bernanke's thought process as he watched line 3 shrink in 2009. Those numbers reflect money that households borrowed, through home equity and credit cards, etc. Most of this money was quickly spent at Home Depot, Best Buy and other retailers. Since our economy

is comprised of roughly 70% consumer spending, Ben was watching the air get knocked out of the lungs of our economy. I am sure that he was worried about impending calamity. If you look now at line 8, it is clear what the federal government has been doing. They have been trying to prevent our lungs from collapsing as the air leaves quickly in line 3.

If we look at line 3, it looks like the economy might stop breathing. However, because line 8, we can look at line 1 and see that overall we just got the wind knocked out of us, but we should be able to recover and continue onwards.

So we are cautiously optimistic about recovery. But the recovery might look different than what we expect, because federal borrowing of \$1 trillion is different than consumer borrowing of \$1 trillion. Much of the government borrowing has not been spent, but rather placed onto balance sheets at the banks, with the imperative that they must lend. The banks, of course, cannot lend because many homeowners are underwater on their mortgages, and unemployment and bankruptcies are high. So the quantity of money is growing, but the velocity of money is decreasing because individuals and businesses are spending less. Individuals cannot borrow even if we wanted to.

Other government money has been earmarked for infrastructure projects such as electronic medical records, new roads and bridges, and railway development. But these projects can take years to plan and carry out, so line 8 money simply does not go into the economy as quickly as line 3 money.

The following investment guidance does not and should not replace the creation and maintenance of a sound financial plan. A good investment for one person might be a horrible investment for another, depending on the situation.

- **Bonds.** Common sense says inflation is coming. However, the numbers show that velocity of money is actually decreasing, no one has money to spend, and inflation might not come for quite some time. We would target 10-30% of a portfolio in mainly high quality corporate and individual bonds, with a small exposure to high yield and international bonds. We recommend neither an ultra-short nor ultra-long duration, as we are neutral yet cautious on the inflation outlook.
- **Gold.** We view this as a speculative investment. Gold might double or triple in price if other people keep buying, or it might lose half of its value. We do not recommend buying gold at this time, although we understand some of our clients feel comfortable holding some gold in their portfolio.
- **Oil.** We are neutral. \$80 per barrel could move up or down depending on what happens with the U.S. dollar, and depending on how quickly or slowly the economy rebounds.
- **Financials.** The U.S. has the second-most banks per capita of any country in the world (Germany is first). We still like financials, but we prefer to overweight smaller- and mid-size banks which are ripe for industry consolidation.

- **International equities.** Our official prognosis for the dollar is that it could strengthen, or weaken, or stay the same. There are numerous academic, economic and political arguments in any direction. Because of the currency volatility that exaggerates foreign stock performance for an American, we are careful here. We target a 10-20% weighting, depending on risk tolerance. We prefer Asia, excluding China, over Europe.
- **Small companies.** This is our favorite area. As large companies struggle to grow, but large amounts of cash are looking for a home, acquisition activity should pick up. Small companies can also grow more nimbly in a struggling economy than a behemoth such as Wal-Mart or General Electric. Valuations are generally more attractive than they are in the large company sector. We recommend 25 – 40% of your allocation in small- and medium-sized companies.
- **Large companies.** We are neutral here. We target a 25-35% allocation.

FIAT Wealth Management is located in Long Lake, Minnesota. It is a boutique financial planning company owned by Brad Gotto, Matt Stahl and Greg Naylor. We especially enjoy working with people who live within their means so that they can give back to their families and communities. We specialize in retirement income planning and asset management, and are currently taking on new clients.

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