MICHAEL COLEMAN, PH.D.
Registered Investment Advisor
RETIREMENT INCOME SPECIALIST

2124 Main St., Suite 170
Huntington Beach, CA 92648
Tel 714.960.2316
800.660.8727
Fax 714.960.0589
mdcoleman@unitedplanners.com
www.michaelcolemanphd.com

Great Stock Market?
Poor Economy?
What Gives?

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It has now been a little over a year since the stock market bottomed out and began a new phase of "growth." I put "growth" in quotes because the question still remains: is this merely a cyclical recovery in what will turn out to be a more extended Bear market, or is it the beginning of a multi-year Bull market? This letter will discuss both sides of this issue. I will also review our investment strategies to point out that we do not need to know the answer to this question in order to be successful investors. The new Risk Management system I put in place in 2009 will give us the flexibility to deal with either of these possible futures.

Great Stock Market/Poor Economy: What gives?

How can the stock market being doing so well, when the economy is still in such bad shape? Ben Graham, the father of Value Investing, has observed, "In the short run, the market is a voting machine; in the long run, it's a weighing machine." What Graham meant is that the stock market is often moved by mass psychology and group behavior based on a belief about the immediate future. Robert Shiller's studies[1] have analyzed the many complex factors that can go into sustaining such a belief, one of the most important being the psychological momentum and mass behavior created by rising prices themselves: if prices are going up, many people believe they will continue to go up so they start buying into the markets, and their new buying helps to drive up prices further. However, at some point, the prices of stocks will become aligned with the economy. If businesses have sustained profitability, stocks will maintain their advances. Or, if investors come to recognize that the profits aren't there or are no longer there, prices will collapse. We have just witnessed two dramatically unsustainable cycles over the last 10 years.

Here are a few reasons why I feel we may be in the beginning of a sustainable Bull market:

1. This most recent near collapse of the banking system has been averted by the quick and decisive action of Central Banks around the world. In other words, the crisis that precipitated the problem is already behind us. Much of the stimulus provided by both the Central Banks and the National governments has yet to be fully felt in the economy. With the banks now stabilized and government spending allotted but not yet fully applied, we may have a good base to begin a new growth phase.
2. Companies are reporting significantly higher profits than they had a year ago. They have been ruthless in cutting costs and eliminating waste, employment costs are lower, and production has been downsized to match current sales. In addition, the Fed has

announced that interest rates will remain "very low" or "extremely low" for an "extended period."[2]

3. Even with 17% of our population unemployed or underemployed, we still have 83% employed and consuming. In other words, we still have enough people employed to sustain business profitability at a reduced level. If unemployment improves over time, so might sales and business profits.

Here are a few reasons why this current market rally may be unsustainable and another painful downturn could be in our near future:

1. With short-term interest rates virtually zero, we appear to have reached the end of a very long 28-year cycle of falling interest rates. (Rates can't go below zero.) Falling interest rates make bonds profitable, credit easy, and provide a "tail wind" for business expansion. Legendary bond investor Bill Gross's portfolio has reduced its holdings of U.S. Government bonds by 40% over the past 9 months to the lowest level in the fund's 23 year history.[3] (Bonds go down in value when interest rates go up.) The Mortgage Bankers Association expects the 30-year mortgage rate to be as high as 6% by the end of this year.[4] (An increase of 1% adds about 19% to the cost of the mortgage payment.)
2. The real estate markets may have further to go on the downside. At the end of 2009, nearly eight million households, or 15% of those with mortgages, were behind on mortgage payments or in the foreclosure process.[5] In my last quarterly letter I pointed out the massive number of Alt-A and Option Adjustable Rate loans that come due in 2010 and 2011.[6] Most of these loans have negative equity and cannot be refinanced, so we could have another large wave of foreclosures.
3. We could have a double-dip recession. Federal Reserve Chairman Bernanke said the risk of a double-dip recession was "not negligible" but believed that it has receded in recent months.[7] The National Bureau of Economic Research has been unwilling to declare "officially" that the recession has ended because of this possibility. One member even stated, "There is a significant risk the economy could run out of steam sometime in 2010."[8]

Strategies for Uncertainty

As I am writing this letter we remain fully invested in all of our accounts according to the suitability of the client and the options available in the specific contract. Our equity indexed annuities are beginning to lock in gains with annual resets.* Our fixed annuity accounts are enjoying multi-year interest rates that we locked in several years ago. Our exclusive money manager, Ocean Park Asset Management, had a profitable first quarter and is also fully invested at this time. In summary, we had a good first quarter in every account, and are currently invested as if this Bull market is sustainable.

However, as you all know, I developed a Risk Management System over the past several years and formalized it last spring. This System allows me to take your allocations defensive, depending on short-term market actions, at any time. My staff and I monitor the markets daily. If rising interest rates, problems in the real estate markets, or a double-dip recession show up and the markets start to falter, we will institute defensive allocations quickly.

In February, we had a nice test of our system when fears about sovereign debt roiled the markets. We went briefly to a defensive posture in every account until the markets started to recover. In this instance, the markets immediately recovered, and so we immediately reentered. Just consider this a "fire drill" practice. In summary, we intend to protect you quickly if this Bull market turns out to be merely cyclical, and another down market ensues.

Also in February I gave my annual Market Update seminar for some of my Northern California clients and I was surprised to find out that most of my clients in the room didn't even know I had a website. (I've had one since 1999. Check it out at www.MichaelColemanPhd.com). For the most part this website is merely a "brochure" for the world at large, but there is one section that many of you might like to use, under the tab: "View Your Accounts". You can use the links in this section to log into any of your accounts with us and see what your values are 24/7. If you have any questions, just call Bonnie (800-660-8727) and she can help set you up.

Call me if I can help you with any financial issue. Also, please send us pictures of your vacations or new homes; we like to see what you are up to, and I would like to set up a web page with client pictures of retirement successes (as you define "success"). This could include anything from trips, to vacation homes, to grandchildren.

Michael Coleman, Ph.D.
Registered Investment Advisor

[1] Robert Shiller, ***Irrational Exuberance, Second Edition***, 2005.
[2] ***Reuters***, "Bernanke says rates to stay low for "extended period," April 14, 2010.
[3] ***New York Times***, "Interest Rates Have Nowhere to Go but Up," April 11, 2010.
[4] ***Ibid.***
[5] ***The Wall Street Journal***, "Foreclosures Hit Rich and Famous," April 9, 2010.
[6] ***The Coleman Report***, "The Good News & The Challenges," February 2010.
[7] ***Reuters, op.cit.***
[8] Martin Feldstein quoted in the ***New York Times***, "Recessions Arbiters, Wary of Certifying an Upturn," April 11, 2010.