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The “New Normal” May Be Quite Rough

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As we look back over the first half of 2010 we can see a number of trends that may come to define the “New Normal” for some time to come. There are four that particularly concern me: increased stock market volatility, world-wide debt restructuring, continuing real estate foreclosures, and unemployment.

Stock market volatility

The first quarter ended with the stock market slightly up, but the second quarter erased those gains and ended with most major stock indexes down. On June 30, the U.S. stock market as measured by the S&P 500 index was down year to date -7.57% and the foreign markets as measured by the EAFE were down -13.23%.¹ Viewed from a longer perspective, it appears as if the stock market may be in a trading range -- going up a bit, then down a bit – without being clearly in either a growth phase or a sustained decline.

We must remember that stock market investing is not like earning money in a bank. In a bank we earn interest every month, whereas in the stock market there can be months, years, and even decades when there can be high volatility but no net sustained gains. The most recent example is still with us. If you invested \$100,000 in the S&P 500 on January 1, 2000, after 10.5 years (and much excitement both up and down) your account would only be worth \$70,150 on June 30, 2010!² Another sustained period of high volatility and no gains lasted from February 1966 to October 1982, when the Dow Jones Industrial average had a total gain of less than 1% over a period of almost 17 years.³

The main lesson I take from this history is that “buy and hold” is not a dependable investment strategy. There are times to be invested in stocks as well as times to be in other asset classes. For these reasons, over the years I have attempted to adopt our investment strategies to suit the current investment environment as well as your individual goals and life situation. Currently we are reserving the option of being very nimble, of going defensive quickly, and of using investments other than stocks, such as alternative asset classes like high yield bonds. Our past performance is, of course, no guarantee of future results.

Debt Difficulties Worldwide

In order to stave off a worldwide collapse of the banking system, central banks in all of the major developed countries intervened heavily in the financial markets in 2008 and 2009, flooding the markets with liquidity, buying up toxic assets, extending guarantees, etc. I agree with the judgment of most economists that these interventions were probably necessary to save us from a world-wide depression. However, we are not out of the woods yet. In effect, the net result of these actions is that the developed world transferred much of what was private debt to sovereign debt (i.e. government bonds).

Just as banks hid their debt problems until events forced their exposure, sovereign debt is now being revealed as problematic. Greece was the most recent example. For a few months the markets were roiled by the fear of a default by Greece on some of their bonds that were coming due in June and July. The European Central Bank (ECB) pacified this fear (at least for now) by essentially guaranteeing a line of credit of nearly \$1 Trillion to cover not only Greece, but Portugal, Italy and Spain as well.

Europe's problems gave us a temporary reprieve because our debt looked good by comparison. However, we are also going deeper into debt with as yet no political will to make the hard decisions to fix the long-term, structural problems. Below is the best chart I could find to show our total cumulative debt situation, and this chart is more than a year out of date.⁴ Our debt is much worse now.

Total Credit market Debt as a % of US GDP

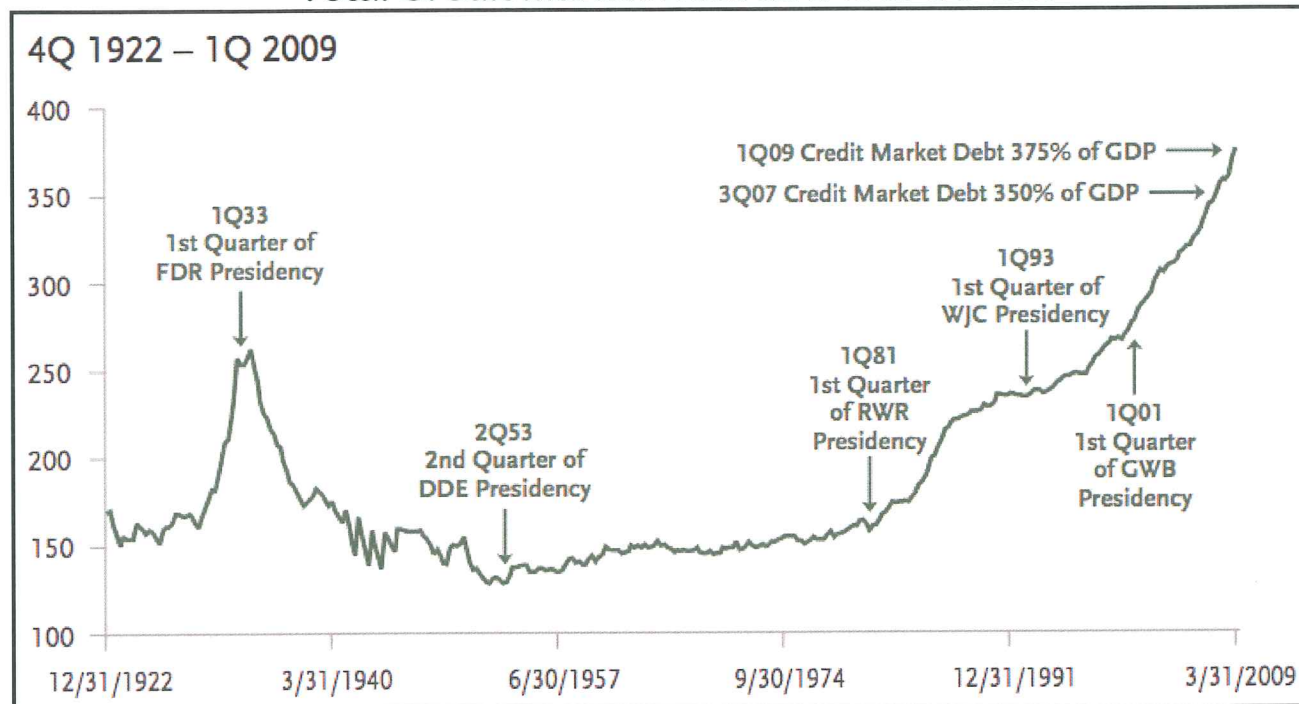


Chart Courtesy of TWC

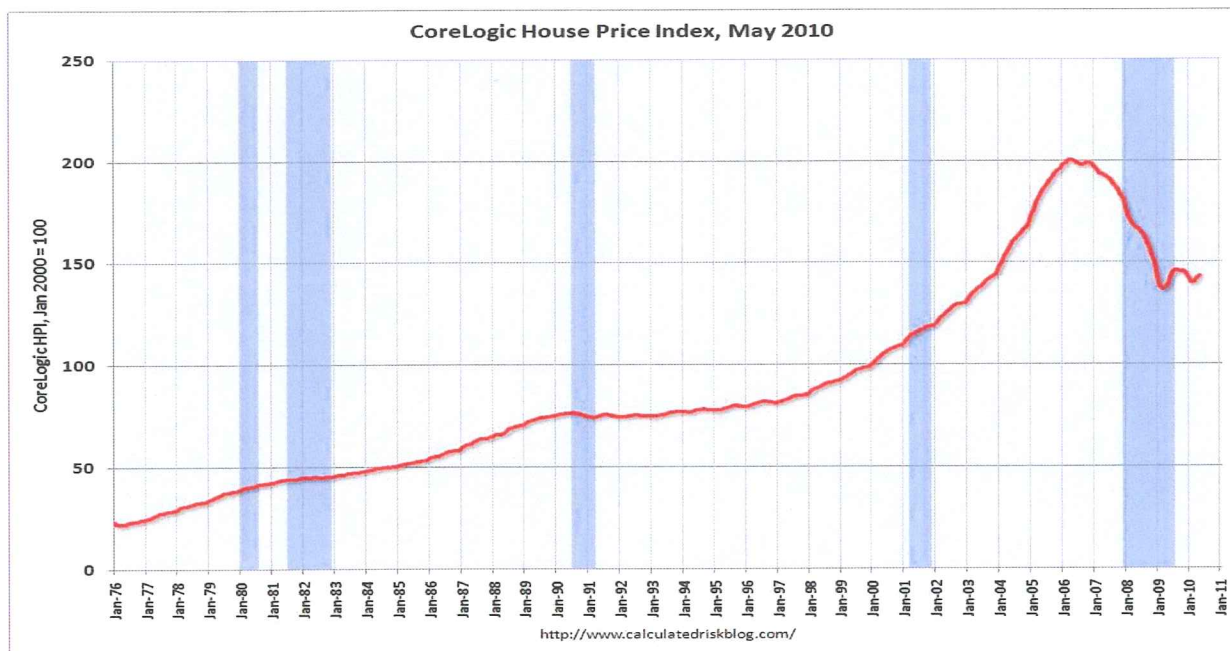
There are three choices that governments can make to manage their debt: cut spending, raise taxes and/or default. Every one of these choices brings pain to some important constituency, so none is easy. A fourth way out is not under any government's control: have the economy grow

so much that tax revenues increase on their own. Since robust world-wide economic growth is unlikely over the next several years, I remain hopeful that governments can find the right mixture of spending cuts and revenue increases to not derail our current anemic growth and to avoid any major defaults.

This has implications for our investing. I no longer trust the credit quality of states, so we no longer recommend municipal bonds. When we do invest in bonds, it will never be in individual issues but only in diversified pools. In addition, as I noted above, we will remain nimble and attempt to change our allocations in light of market conditions.

Real Estate: Another Leg Down?

Elizabeth Warren, Chair of the Congressional Oversight Committee monitoring the TARP funds, is very worried about continuing problems in both commercial and residential Real Estate. Regarding commercial loans she said that we have “3,000 of the 8,000 banks in the United States” that are “dangerously exposed on commercial mortgages” and that the problem will be “getting bigger in the years ahead.” It is her opinion that the value of the property that collateralizes most commercial mortgages will have shrunk by 50% by the end of this year! In addition, she projects that we will have 1,000,000 residential foreclosures a year for the next four years. These are problems in our future, not just our past.⁵



Above is a chart of residential real estate prices going back to 1976. You can see that prices have retreated to their 2004 levels (so far) and it is at least possible for them to retreat further. On the other hand, interest rates are the lowest they have been for 50 years!⁶ For any of you who have positive equity in your homes, now is an excellent time to consider refinancing and locking in a lower rate. If you are unsure whether refinancing makes sense for your situation, or if you need a referral to a mortgage broker you can trust, please give me a call.

Chronic Unemployment?

Currently our official unemployment rate has retreated from 9.7% in January to 9.5% at the end of June 2010.⁷ However, this figure does not include those who want full-time work but only work part-time. Nor does it include “discouraged workers”, who haven’t looked for work in the past 4 weeks because no job seems available. When these are entered into the figures, real unemployment and underemployment is more like 16.5% of those who are able to work.⁸

Due to reduced spending by governments, anemic growth in the economy, and a contracting or bottoming real estate market, I do not see the drivers for much additional hiring in the near future. At the same time, I am well aware that we Americans are extremely adaptable and that the industries that create new growth could be in the process of invention as I write this. (Remember computers, cell phones, the Internet, etc.!) Although we hope for the best, it is probably prudent to assume that we will have high unemployment for at least several years more.

Summary

Even though we may be coming out of the greatest recession since the 1930s, we do not expect the recovery to be either smooth or painless. We expect unemployment to remain high, and real estate prices to remain soft or to go even lower. We expect taxes to be higher and government benefits to be reduced. We expect the stock and bond markets to remain volatile until the economy is clearly on a sustainable growth path.

On the positive side, we’ve been living on borrowed money and borrowed time for too long, and a serious restructuring is long overdue. It’s now fashionable to reduce debt, to be more energy efficient, and to live our lives more sustainably. Our investment strategies are designed to be nimble and adaptable to market conditions and they remain in place. I am available if you have any questions about your individual situation or have any financial issues that I can help you with.

The views expressed are those of the author as of the date noted, and are subject to change based on market & other various conditions. They may not reflect the views of United Planners Financial Services of America.

Certain risks exist with any type of investment & should be considered carefully before making any investment decisions. Keep in mind that current & historical facts may not necessarily be indicative of future results.

¹ Morningstar Principia, July 2010.

² *Ibid.*

³ 0.83% over 202 months to be exact. “Dow Jones Historical Trends,” Rydex/S&P publication DJCSI-0110x1210 #503

⁴ www.ritholtz.com/blog/2009/07/the-jalopy-economy/

⁵ PBS News Hour, June 22, 2010

⁶ CBS News, June 24, 2010 “Mortgage Rates Sink to the Lowest Level on Record”

⁷ www.bls.org

⁸ *Ibid.*