MICHAEL COLEMAN, PH.D.
Retirement Income Specialist

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

Economic Update 2013

March 2013

There are a number of issues that continue to concern me in my endeavors to grow and protect your retirement assets. Among these are: Will the economic recovery continue? Do we remain in a Secular Bear Market? How long will interest rates stay low? Who wins and who loses when interest rates stay too low?

The Economic Recovery Continues, but...

In 2012 the U.S. stock market, as measured by the S&P 500 had a very volatile year falling over 10% in June before finishing on a strong note, up 16% for the year with dividends. All of our accounts, whether managed by me or by Ocean Park, were much less volatile than the S&P, and finished strongly positive for the year.

Our economic recovery from the near depression of 2008 seems to remain on track even if it is tepid by post World War II standards. Real estate appears to have formed a base and prices have not only stabilized but are increasing for homes that qualify for standard financing, i.e. for homes in the $200,000 to $600,000 range. In the last month or two we have even started to see bidding wars on houses at the lower end. The son of one of my clients recently made an offer on a $374,000 home in Los Angeles. To be sure he got it, he offered $375,000 slightly ABOVE the asking price. However, there were 80 (!) other simultaneous offers, twenty were for all cash, and the house ended up selling for well above $400,000. On the one hand this is "good news" in that it signals a bottoming of the market. However, this type of bidding hasn't been seen since we were last in a raging real estate bubble, so it is not indicative of a healthy stable real estate marketplace.

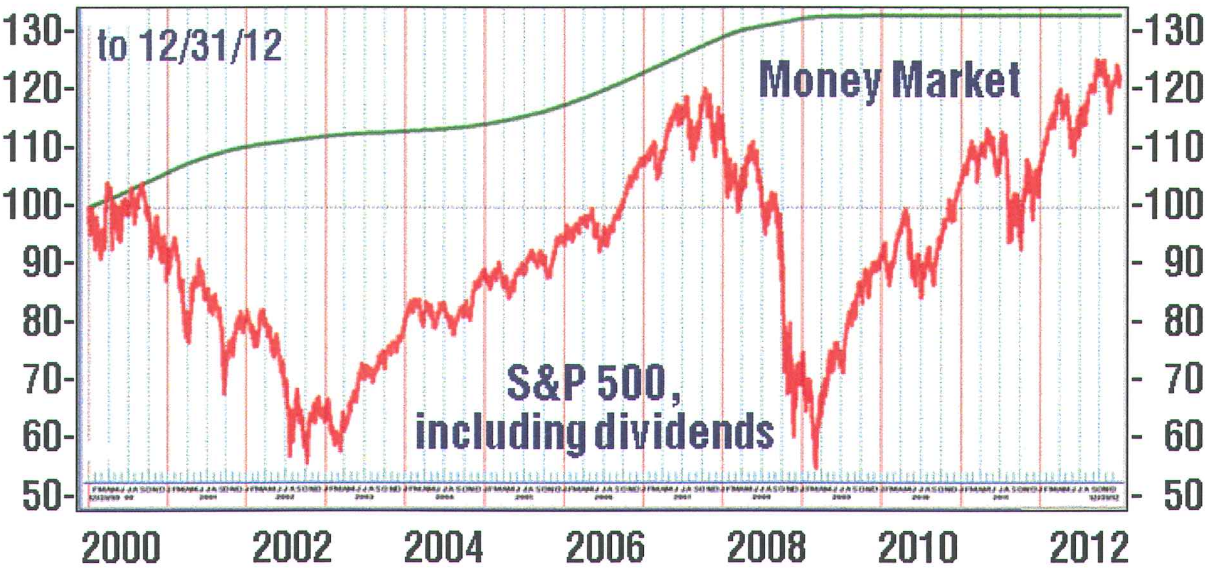
Stocks are currently selling at reasonable price/earnings ratios, and businesses in general are nominally profitable because they have downsized to the current level of opportunity. In addition, they are sitting on a lot of excess cash which is a lot better than being deeply in debt. However, this cash is also a troubling sign, because it may indicate that businesses still fear an imminent downturn, or they do not see productive opportunities, or both.

A major troubling aspect to the improvements in both stocks and real estate is that they are largely based on, and supported by, government manipulated low interest rates. We currently have no accurate way to estimate what market interest rates might be or what effect market interest rates would have on these major sectors of our economy. As Ludwig von Mises noted many years ago,

> No very deep knowledge of economics is usually needed for grasping the immediate effects of a measure; but the task of economics is to foretell the remoter effects, and so to allow us to avoid such acts as an attempt to remedy a present ill by sowing the seeds of a much greater ill for the future.

Is the Secular Bear Market still continuing?

In early March 2013 a number of financial commentators have excitedly reported that the stock markets as measured by either the S&P 500 or the Dow Jones Industrials, have "hit a new high!" Putting it this way sounds exciting, but another way describe the same phenomena is that the stock markets have finally "got back to even" to where they were 5 years ago! Or, have finally "slightly exceeded where they were 13 years ago!" See the chart below which shows that over the past 13 years ending on December 31, 2012, the S&P 500 has not done as well as a money market account!



The hypothetical illustration above does not reflect any real investment results.
The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. Investors cannot directly invest in an index.

This is what is meant by the term "Secular Bear Market": namely, a market that goes up and down, but which has no net gains for a very long time. Past U.S. Secular Bear Markets have lasted from 17 years to 25 years according to research done by Guggenheim Investments.[1] Although I am happy to have a currently growing stock market, I am investing as if this current bull market is only cyclical and may also end badly, like the prior two shown in this chart, and I want to maintain trailing "stop-loss triggers" on all accounts which I manage.

When Interest Rates are Zero, who wins?

In 1948 Henry Hazlitt wrote a brilliant book entitled ***Economics in One Lesson***[2] which, among other things, argued that any change in economic policy always creates both winners and losers. This means that no economist can be trusted to be truly "objective." Every commentator will be either on the winning or the losing side of any given policy.

I think that virtually all economists agree that prompt action by the Federal Reserve Bank (the Fed) in lowering interests quickly, and in keeping them low, helped to prevent the Great Recession from collapsing into a 2nd Great Depression. However, like all changes in economic policy, there are both winners and losers.

Clear winners are the major banks which would have all gone bankrupt due to their foolish, leveraged, unregulated financial bets. They're not only alive but extremely profitable as well. Other winners are the Real Estate marketplace, the stock market, high yield bond holders and issuers, and debtors of all stripes.

When Interest Rates are Zero, who loses?

A significant class of losers is the middle-aged and elderly, particularly pre-retirees and retirees. There is no safe place to put retirement money where it can currently earn a reasonable rate of return. State, County and City Governments are also losers. Most offer defined benefit pension plans which now may not earn enough to meet their contractual obligations. They will have to make up the short-falls with reduced services, greater employee contributions and/or higher taxes. Finally, life insurance companies are already under great strain because they must rely on an interest rate spread to cover their long-term obligations.

Probably the largest potential class of losers is the "Prudent Investor." Government manipulated low interest rates force down returns on all safe investments. A "hunger" for yields can lead to foolish investment decisions. Temptation arises to take risks that one would normally avoid. Bubbles can be created: Remember Real Estate from 2002 to 2008? Currently the "hot" topic in the investment world is "alternatives". When I press people for a definition of this word, I find that it may mean almost anything other than stocks or bonds. Stocks have been a wretched investment for 13 years, and bond interest rates are too low. Now we are being encouraged to invest in commodities, emerging markets, gold, silver, farmland, hedge funds, managed futures, long-short, among other choices. Above all I view this as a time to be very patient and careful, and to remember at all times Mark Twain's dictum (which he learned through painful experience): "I am more concerned about the return **of** my money than the return **on** my money."

Update: Our High Yield Bond Strategy

As all of our long-term investors know, we have been using a tactical allocation strategy that has over-allocated to high yield bonds since 2007. From 2008 to the end of 2012, High Yield bonds as measured by the ML US High Yield Master II Index have had an annualized yield of 10.01% which compares very favorably with the S&P 500 Index which had an annualized yield for the same period of time of only 1.66%.[3] We believe this strategy may continue to be successful for several more years.

The Fed has stated their intention to keep interest rates at or near zero at least until mid-2015.[4] In an environment of low interest rates, we believe more and more investors will be attracted to the higher dividends of the high yield bond asset class. Paradoxically, defaults in the high yield space are at historic lows, precisely because these companies are able to refinance at lower rates whenever their bonds come due.[5] History has shown that high yield bonds can have capital gains similar to stocks but with much lower volatility. Finally, we do not believe in "buy and hold" and we maintain a sell discipline on all our high yield bond investments designed to conserve the majority of our gains when this marketplace turns down. Past performance is no indication of future results.

Michael Coleman, Ph.D.
Registered Investment Advisor

[1] Document: DJCSI-15-0112x1212 #4388
[2] Hazlitt, Henry, ***Economics in One Lesson***, Arlington House Publishers, New York, 1948, 1962, 1979.
[3] Morningstar Principia 12-31-2012
[4] http://www.nydailynews.com/news/politics/fed-hold-interest-rates-joblessness-dips-article-1.1218600
[5] http://www.forbes.com/sites/marcprosser/2013/01/26/4-reasons-the-junk-bond-rally-will-continue-in-2013/