



## November 2009 Hot Topics

# Is the Worst Over?

*The stock and bond markets are indicating that we may have seen the bottom of this economic cycle. The markets are reacting to indication that the stimulus efforts may be working. Bad economic news comes less often and in many cases the numbers are improving. But is the worst over?*

With the sharp rallies off the March 9<sup>th</sup> lows, the summer and fall seem to be giving way to a more somber view of a potential recovery.

Consumers continue to cope with near double digit unemployment and the ongoing recession while trying to salvage what they can of retirement and investment accounts. The U.S. auto industry operates as a former shell of itself, but manufacturing overall is showing some signs of stabilization. Banks and financial institutions still face pressures but posted substantial earnings recovery.

Economic data remains mixed and often contradictory. One must have faith in the ability of the U.S. economy to return to sustainable growth.

The tough part is the not knowing which way the economy and consequentially the stock market will move and over what length of time. No one has a crystal ball, but now being warier and wiser, we can look toward what's on the horizon.

### How It All Started

It's hard to pinpoint the beginning of the financial crisis. The first signs appeared in late 2006 and 2007 when sub-prime mortgage lenders started going under. The government recognizes the problem and in 2007 began a series of moves to shortstop the growing number of mortgage defaults.

Through the fall of 2007 and into 2008, the government was actively injecting money into the banking system while simultaneously lowering the interest rate.

The Bank of America's Jan 2008 purchase of Countrywide Financial, the country's largest sub-prime lender, made BoA the nation's largest mortgage lender.

While mortgage defaults were in the news, this event put the issue on the front page and highlight for most Americans the seriousness of the mortgage defaults.

Then beginning in Jan 2008, banks began to fail. One in January, another one in March followed by two in May. JPMorgan Chase & Co. acquired The Bear Sterns Corporation in March 2008 at a fire sale price. And then the failure of Indymac Bank, on July 12<sup>th</sup>, 2008.

Many believe it was the failure of Indymac Bank that started the banking dominos to start falling. The failure of Indymac is widely blamed on Senator Chuck Schumer (D) New York who purposely leaked an internal memo on June 26<sup>th</sup>, 2008 calling into question Indymac Bank's viability. The discloser resulted in an eleven day run on Indymac resulting in the withdraw of more than \$1.3 billion dollars.

John Reich, the director of The Office of Thrift Supervision at that time directly placed the blame for the bank's failure on the comments made in Senator Schumer's letter. Indymac Bank was not a poster child of how to run a bank and may well have failed at a later date. And maybe not. We will never know. But at the time Indymac was the most expensive bank failure ever.

Blood was in the water and the Wall Street sharks began to circle Fannie Mae and Freddie Mac. Short sellers, who profit when the price of a stock falls, attacked these financial giants along with other large banks driving their stock price into the ground. One name that stands out is George Soro, the billionaire who broke the bank of England in late 1992 with his shorting the sterling. Soro takes major short positions in US and European stocks, the dollar and 10-year Treasuries. The book he published in April 2008 along with his many appearances on financial shows and written commentary help his positions become big winners.

And then came September 2008, the most harrowing month of all. Fannie Mae and Freddie Mac are placed under government control. Bank of America takes over Merrill Lynch and Lehman Brothers files for Chapter 11 bankruptcy. The consumer starts noticing things were

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not right and stopped spending which sent demand into a free fall. Washington Mutual Bank failed in September and twelve more would fail before the end of the year.

The U.S. stock market bottoms on March 9<sup>th</sup>, 2009 down 56.78% from the October 2007 high.

## Getting Our Bearing

So where do we go from here? No one knows for sure except we do know that the business cycle and the economy move in a constant pattern of up and down cycles. If the pattern holds true then we should be looking at a gradual if uneven recovery. This will ultimately lead to yet another sump. Like waves on the ocean, you cannot prevent naturally occurring events.

But the one thing we did learn is that the world economies are much interwoven. The U.S. sells raw material and finished products to other countries who in turn sell us raw materials and their finished products. The U.S. is not likely to experience sustained consistent growth without the same occurring in other countries.

What we want to do is avoid overreacting to the latest sentiment. Many investors now want a more actively managed portfolio which implies that somehow one can foresee which way the market will move. The best evidence that market timing is a bad idea is the market's recent behavior. Very few people predicted the crisis. Of those who did, most have been predicting it for years. Peter Lynch famously said, "Far more money has been lost by investors preparing for corrections or anticipating corrections than has been lost in the corrections themselves.

## The Road Ahead

There are investment strategies to consider going forward. The first step is to look at your overall investment portfolio within the context of a financial plan. We shouldn't be focusing on individual investments or the hot sectors.

We do want to hedge the potential inflation risk by considering precious metals and high yield bonds. Diversification is a technique to help reduce risk, but there is no guarantee that diversification will protect against a loss. When the boat is sinking it doesn't matter which seat you are in. You will still get wet.

We shouldn't depend solely on the U.S. economy to drive our portfolio. Having a position in specialty sectors like emerging markets, consumer staples, science and

technology in addition to the U.S. overall market will help to ensure your portfolio has a chance of growth.

In this era of American economy, investors chart their courses. Consumers set aside more savings. Workers value their jobs more than ever. The greatest cause for optimism may be that we're grinding through this recession. This is a good thing.

This material was written by David Snellen.  
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## Moving Forward from the Credit Crisis

*On Monday, September 15, 2008, the country awoke to news that three of the nation's largest financial institutions were unable to survive without help. Merrill Lynch found a buyout partner in Bank of America. AIG was able to secure funding from federal sources. Lehman Brothers, however, was unable to secure a lifeline and the firm filed for bankruptcy, the largest in history and a major spark that set off the global financial crisis.*

In a matter of days, the nation's financial structure had changed.

By now, this story is painfully familiar to most investors, who watched portfolios and retirement account balances shrink in the ensuing months. Now, more than a year after that fateful September day, the economy shows signs of stability. Yet many investors still wonder what has been done to correct the mistakes uncovered during the credit crisis and, more importantly, whether this situation could happen again.

Several proposals have come from the new administration, and the financial institutions have worked to "clean up" their balance sheets. However, it is still unclear exactly what form, if any, reform will take.

## Reform Still to Come?

In March, Treasury Secretary Tim Geithner sought legislation that would empower the government to take over failing institutions like Lehman Brothers in order to prevent domino-like collateral damage from taking down other firms. This "resolution authority" would let the government step in, as it did with Fannie Mae and Freddie Mac just prior to Lehman's collapse, to help firms avoid bankruptcy, which can freeze credit markets and lock up assets. Proponents say that the resolution authority, if executed properly, could be more efficient

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than ad hoc bailouts and could help avoid “too big to fail” dilemmas. However, the measure seems to be in legislative limbo and may not move forward.

## A Presidential Proposal

In June, President Obama released an 88-page plan that detailed his proposal to overhaul the financial regulation system. In general, his plan would give the government greater power over Wall Street. It aims to increase government oversight and close regulatory gaps. The president’s proposal also seeks to create a new agency that would oversee consumer products, including mortgages and credit cards. The administration maintains that regulatory reform is a top priority, although no official legislation has yet been proposed.

Some observers question whether the proposed regulations will amount to safer and more efficient markets or lead to less efficiency and expensive bureaucratic overreach. Either way, the plan will likely see revision before anything is enacted.

In a bid to win support for his planned overhaul of the financial system, President Obama gave a speech to bankers on Wall Street on September 14, 2009, warning against the reckless behavior that led to the financial crisis. The president urged the big banks to put senior executive bonuses up for shareholder votes and to create pay structures that reward employees for long-term performance instead of short-term gains.

President Obama has also stressed the importance of bringing change to Fannie Mae and Freddie Mac. The administration’s proposal, however, is not expected until early 2010.

For their part, banks have been working to improve their balance sheets. The stress test that the 19 largest banks went through earlier in 2009 helped to diagnose the health of the institutions, revealing that while many of the firms needed to raise additional capital, the amount needed was lower than many people had predicted. Moreover, the largest banks have all made great strides to improve their capital ratios, considerably reducing leverage.

With the economy out of intensive care, the focus shifts from setting the break to preventing further injury. Although some steps have already been taken, additional government and private-sector action may be needed to reduce the risk of future problems.

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## Social Security Outlook

*Despite years of arguing about how to address the demographic problems facing Social Security, there has been no measurable progress. The nation’s old-age insurance program is still facing insolvency.*

The most commonly suggested reforms include raising Social Security taxes and lowering benefits. If your retirement is a long way off, you might consider the possibility that Social Security may not provide a significant source of your retirement income. Here’s why.

- In 1945, there were 42 workers per beneficiary. In 2007, the ratio fell to 3.3 workers per beneficiary. The ratio is expected to be only 2.1 workers per beneficiary by 2034.
- If no changes are made to the system by the time today’s 36-year-olds reach age 69 (in 2041), benefits for all retirees would need to be cut by 22% from currently scheduled levels, with further cuts needed in succeeding years.
- In 2008, the average monthly retirement benefit was \$1,079. Consider the effect of a 22% benefit reduction: It would bring this amount down to \$842.
- Although the average Social Security benefit will have a higher dollar amount in 2041, it’s likely that, in real terms, the spending power of the average benefit will be about the same as \$842 in today’s dollars.

Benefits by the Numbers <sup>4</sup>	
9	Number out of every 10 people aged 65 and older who receive Social Security benefits
12½	Years of life expectancy for a 65-year-old in 1935
18	Years of life expectancy for a 65-year-old in 2008
20	Percentage of married Social Security beneficiaries who rely on Social Security for 90% or more of their incomes
41	Percentage of unmarried beneficiaries who rely on Social Security for 90% or more of their incomes
50	Number of Americans (in millions) who will collect Social Security benefits in 2008
96	Percentage of U.S. workforce covered by Social Security
614	Amount (in \$ billions) that Americans will receive in Social Security benefits in 2008

Of course, anything could happen by the time you become eligible for Social Security retirement benefits. But until the system is fixed, it might be a good idea to scale back your Social Security expectations and seek ways to make up the potential shortfall through increased saving and investment.

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- **Social Security Outlook** – Despite years of arguing about how to address the demographic problems facing Social Security, there has been no measurable progress. The nation’s old-age insurance program is still facing insolvency.

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