



Life After 2008 — What Happened?

-J. Kevin Meaders, J.D., CFP®, ChFC, CLU

January, 2009 - The state of well being is so elusive these days, and especially so if you have been watching the news. Yes, it is true that we are facing the worst financial crisis since the Great Depression. I can list off a hundred statistics that would make you want to go to bed, close the curtains, and cry yourself to sleep.

Make no mistake; the days of buying stock and holding it indefinitely are over. Today, Ford is \$2.42 and GM is \$3.64. Do you remember when these stocks were this low? The shareholders who bought these stocks and held them probably don't. The titanic losses of a few individual stocks like these underscore the need for diversification all too well.

The broader market, as represented by the S&P 500, is back to where it was in 1997, and again in 2002. Should we really be that surprised that the market re-tested those lows? In economics, cycles are the rule—even now, when all the other rules have been broken.



Thus, the good news is that in the face of continuing bad news, the market has held on rather heartily. And, because of its cyclical nature, the market will surely—eventually—return to its highs. Surprisingly, it may not take as long as you think. The lower band in the chart above represents the yield of the S&P 500 (since 1998, when they started tracking it). Note that yield has risen above the 2% mark for the first time. High stock yields indicate low stock prices.

As I have explained before, generally when stocks retreat, higher quality bonds will advance. This was obviously our expectation when we reallocated all of our accounts to a heavy bond allocation, foreseeing the collapse of the equity markets—and particularly China & India. Back on August 17, 2007, I wrote:

“I don’t think I need to remind you that countries such as China and India have experienced growth on an almost mind-boggling scale. This type of growth cannot sustain itself indefinitely, and there will come a time of reckoning for China and India that will be reminiscent of 2000 and 2002 for the NASDAQ....”

And so it was. Since I wrote that, China¹ and India² have experienced more than a fifty percent drop off their highs. However, for the first time, bonds did not react inversely to stocks—nor did anything else. Bonds, gold, oil, diamonds, copper, wine, you name it... everything took a bath... a blood bath.

Some clients have remarked that “there is no good news out there—nothing’s gonna turn this market around.” This line of thinking is logically flawed because it assumes that all news is already known, which is never the case. Today I am much more optimistic about the next five years than I was in August of 2007, when I feared that the bull market would run longer and harder, and thus the impending bear market would be even more severe.

It is important to remember that our domestic economy has been transitioning from a manufacturing economy to a service economy for some time now, and that as our national economy has morphed into the largest part of a global economy, the global economy will allocate manufacturing jobs where labor is cheapest. This will only continue—and indeed, accelerate. Though this is necessary in a free economy, it is painful nonetheless.

Looking around, people are losing their jobs, losing their homes, filing bankruptcy, and losing their health insurance. Meanwhile, the Governor of Illinois is trying to sell that state’s U.S. Senate seat, and Detroit begs Congress for a taxpayer bailout on a losing business model. Even if—as I expect—this current financial crisis abates by autumn of 2009, the longer term repercussions and the recent rewriting of the economic rules will have a more significant impact on investing in the future.

Certainly the short term has been, and is going to continue to be, very difficult. But already we are thinking about the longer term effects of our current crisis—particularly inflation. The Fed is pumping so many dollars into the world economy, that as investors eventually unwind their zero-yielding defensive positions in Treasuries, the dollar will fall and consumer prices will again rise.

Though this is certainly not a headliner concern today, you are almost certain to hear about it as our “next economic crisis” in the years ahead. In the meantime, it has been necessary for the Fed to shore up the liquidity in the banking system as worried institutions (and people) started hoarding cash.

More significant and enduring to us is the new paradigm of investing that has been borne out of the flames of this recent financial crisis. I can summarize this lesson very succinctly now: “*All corporate decisions are made for the good of the top executives, and there is no system in place to detect insider fraud.*” Essentially, “corporate governance” is a big joke, and “fiduciary oversight” is an illusory legal fiction.

Thus, how do we, as non-insiders, invest in a market where dishonesty and failed governance is so prevalent? Obviously a fundamental change is needed. This will be the topic of my next letter, as indeed it has occupied my thoughts for the better part of 2008.

In the meantime, here are a few things that we know to be true:

1. Oil has dropped significantly from its high and will certainly rise again, especially as Israel confronts enemies whose *raison d’être* is the annihilation of that nation’s very existence. I believe Israel is waiting on their upcoming general elections on February 10 to take action against Iran. Already we see action against Hamas in the West Bank.

¹ As determined by the Hang Seng Index.

² As determined by the Sensex Index.

2. The Fed has been pumping out Treasuries as fast as countries and institutions can buy them. This will unwind sometime in 2009 as these positions are reversed, and thus money will flee from Treasuries and likewise the U.S. dollar.
3. Triple-A municipal bonds and other investments touted as AAA, are not, and never were. In fact, we have seen that the market has priced these instruments as though they were junk bonds, below the investment grade of BBB.
4. Municipal bonds, government agency, and higher-quality corporate bonds are undervalued, and are the likely recipient of massive amounts of cash as the near-zero yielding Treasury positions unwind.
5. The baby went out with the bathwater, and there are several quality stocks that have been guilty solely by association, whose share price is just a few times earnings. These stocks are oversold, and will return to a higher multiple of earnings in a few months, assuming earnings don't also collapse.
6. The falling price of oil has increased the profitability of many companies who have already adjusted their pricing to the \$140 barrel. Even in the wake of falling consumer demand and dividend reductions, we estimate that 2009 will see surprising earnings results, thus leading to higher demand, thus leading to higher share prices.
7. China and India are not done growing, expanding, or modernizing. They're simply taking a breather. Thus, as the commodity-consuming countries recover first, so will the commodity-producing countries such as Russia and Brazil soon follow.

These nuggets of knowledge are easy to perceive, but what is not so easy is what happens in the longer term. For certain, inflation and a falling dollar are on tap for the future, but what about corporate governance and the role of government in the no-longer free market?

It is already easy to see how politics can warp, and even negate, normal free market economic behavior. For instance, if the government uses taxpayer dollars to bail out the American auto industry, shouldn't those companies be required to buy their parts from American plants, rather than the less expensive Asian plants? Remember, politics is the reason why Medicare pays more per prescription than a Canadian citizen—no power buying there.

In any event, the first order of business is to reestablish the credit markets, which have not yet really recovered. Don't forget that the underlying financial markets are dependent on credit—both short term and long. The longer term debt is issued in the form of bonds. That's right, those same culprit bonds that we all thought were Triple-A; the ones that should have gone up when the market went south. All indications are that these will recover first.

To bring this all home in a succinct “what do we do now” statement: What we do now is: 1) wait for bonds to recover, 2) take income in the meantime, 3) when bonds recover, if it is suitable to your particular portfolio, reallocate a percentage from bonds back into stocks, 4) take advantage of obvious price anomalies when possible.

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Kevin Meaders graduated from Oglethorpe University in Atlanta with a double B.A. in Philosophy and Political Science, and then obtained a law degree from Georgia State University College of Law, focusing on estate planning and trust law. He has earned the designations of Certified Financial Planner (CFP®), Chartered Financial Consultant (ChFC) and Chartered Life Underwriter (CLU). He holds a General Securities Principal and Registered Representative registration and Investment Advisor Representative registration through ING Financial Partners (member SIPC).

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