Paul R. Ried Financial Group, LLC
Security for your future

A MESSAGE FROM YOUR FINANCIAL TEAM
Fourth Quarter 2009
October 8, 2009

Dear Clients,

As the third quarter came to a close in September, it marked the strongest two-quarter rally since 1975. Having overcome the losses since the start of the year, the market (as measured by the S&P 500) is up approximately 20% for 2009. However, it remains down nearly 32% from the market peak reached in October 2007.

It appears that this advance has not only changed the direction of the market but has caused nearly a 360 degree turn in attitudes as well. It seems that to market pundits everything is either black or white. Their recommendations are often similarly extreme. We would suggest that, more often than not, the issues involve much more gray.

THE RECESSION

While opinions vary widely, the growing consensus among economists is that the recession ended in the third quarter. Indeed, even Ben Bernanke recently stated that "from a technical perspective the recession is very likely over". While Bernanke doesn't have the best record regarding the recent direction of the economy, his statement does represent quite well the consensus among economists.

Even if it is determined by the committee which dates recessions that the third quarter marked the end of the current recession, it will likely wait some time before making an official declaration to insure that all the facts are in. Regardless of the eventual determination, 200,000+ jobs are still being lost monthly. Towards the beginning of the recession Warren Buffet said that "By any common sense definition, we are in a recession." This statement still seems appropriate today.

If this is "officially" declared to be the end of the recession and job losses do not end quickly, it would appear that the "technical" definition of a recession does not fit the "common sense" definition. It also ignores what the end of a recession has historically meant to people and to jobs.

EMPLOYMENT VS. UNEMPLOYMENT

As the media discusses the economy, employment is commonly portrayed as a lagging economic indicator. While the unemployment rate has a longer lag, employment (as measured by non-farm payrolls) is only a slightly lagging indicator, and its lagging effect is often greatly exaggerated.

An analysis of non-farm payrolls going back to 1939 reveals that employment has never lagged the end of a recession by more than three months (except in 2001). Many times a bottom in employment coincides with the end of recessions. In fact, of the ten recessions prior to 2001, there were five times when employment bottomed the same month the recession ended and only one time when it bottomed three months later. The average lag from the end of the recession to the bottom in employment was just under one month.

In 2001 jobs were still lost for another 21 months after the recession ended. The recession was declared over even though only 60% of the eventual job losses had occurred. The market did not reach it's low until 11 months after the 2001 recession had "officially" ended. In fact, the market lost just over 30% from the end of the recession to the market bottom.

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Employment is officially one of the four main economic indicators used by the committee which dates recessions. However, the 2001 experience and the recent calls that the recession has "technically" ended, raises the question of whether employment is being given its proper importance as a measure of recessions. After all, we need jobs to consume in a consumer driven economy.

THE ECONOMY

Many are predicting this to be the third "jobless" recovery, pointing to 1991 and 2001 as the other examples. The 1991 recovery seems to fit the term jobless recovery quite well. Jobs stopped being lost two months after the end of that recession, but the creation of net new jobs was a slow process, making the recovery "jobless".

However, it might be argued that a better term for the 2001 recession would be a "job-loss" recovery since jobs were lost for another 21 months. Whether we eventually get a "jobless" or a "job-loss" recovery, it should be noted that the implications can be much different this time since unemployment is nearing 10% today instead of the 5-7% rate that prevailed during the 1991 and 2001 recessions.

The good news is that regardless of the term given to the current state of the economy, job losses have at least slowed from their unprecedented pace. Also, other economic indicators have improved and even turned positive. It is important to be aware, however, that statistics can be interpreted in a variety of ways leading to widely different conclusions.

Complicating the matter has been the massive government stimulus. As mentioned in our last letter, while the continuing progress of these programs has been welcome news, these artificial boosts give false signals about the underlying health of the economy. In fact, the government's distortionary effects on various economic indicators through the use of temporary stimulus programs has increased over the last few months.

EMOTIONS

The market rally of the last seven months has been encouraging and has added much-needed relief to investors' nerves. The rally has also been broad based across many asset classes, which is a positive sign. A market rally of this size can bring out different emotions in different investors. It is important to recognize what may influence your perceptions.

One concept, called mental anchoring, is heavily studied in the field of behavioral finance. Mental anchoring is a bias in which the mind is focused on only one simplified reference point. The mind focuses on this one point even though there may be a variety of factors to consider. This can greatly affect an individual's perception about a situation. In fact, two individuals can perceive the same situation entirely different based on what they use as their mental anchor.

Two common anchors for investors are recent market highs and recent market lows. If an investor is told that the market has rallied over 57% since early March (using the March low as their anchor), they may be more prone to conclude that a decline is likely. However, if the same investor were told that the market is still down over 32% from its peak (using the 2007 market high as their anchor), they may be more prone to conclude that the market will keep rising. Investors tend to "anchor" to a particular number and draw their conclusions based on their anchor.

In reality, there are countless factors to consider when viewing the economy and markets. Recent market highs and lows are likely the least important.

IN CONCLUSION

While the recent market rally has been encouraging, we continue to believe that during these uncertain economic times, continued caution is warranted. In hindsight, it may be declared that the third quarter marked the end of this recession. However, if jobs continue being lost then it would seem the technical definition of a recession has lost much of its meaning and distanced itself from common sense and historical experience. While we are hopeful for a further advance, we are even more hopeful for an end to the job losses as that is a foundation for a sustainable economic recovery. We also recognize that increased stock prices without corresponding increases in fundamentals implies higher risk.

We continue to believe a well diversified portfolio consistent with your goals is the key to mitigating risk and accomplishing your objectives. Should you have any questions or concerns, as always, don't hesitate to contact us.

Sincerely, your Financial Team

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SAVE THE DATE
CLIENT ECONOMIC UPDATE SEMINAR
TUESDAY, NOVEMBER 10, 2009 at 10:30AM OR 2:00PM

For Early Registration, please call
Glenda at 425.646.6777
or email at glendag@paulried.com