

INVESTMENT QUARTERLY

Progress – but a ways to go

Virtually every industry has shed jobs in the past two years, but those that cater mostly to consumers have suffered most. Employment in residential construction and auto making is down by almost a third, in retailing and banking by 8%. As the economy recovers, some of those jobs will come back, but many of them will not, because this was no ordinary recession. The overvalued asset prices, ever easier credit and cheap oil that fuelled America's age of consumerism are not about to return in the foreseeable future.

Greg Ip (Wall Street Journal economist) opines that America's economy will undergo one of its biggest transformations in decades. This macroeconomic shift from debt and consumption to saving and exports will bring microeconomic changes too: different lifestyles, and different jobs in different places. And, during this transformation, the investing landscape will change and so must investor expectations. Under what Bill Gross (manager of the Pimco Total Return bond fund) calls the "new normal" investors should prepare for lower-than-average historical returns with heightened government regulation, lower consumption, slower growth, and a shrinking global role for the U.S. economy. Huge borrowing by nations, including the U.S., can eventually lead to inflation as governments sell record amounts of debt to finance surging deficits.

The crisis and then the recession put an abrupt end to the old economic model. Households' wealth has shrunk by \$12 trillion, or 18%, since 2007. If consumers feel less rich, they are less inclined to spend. Banks are also less willing to lend: they have tightened loan standards, with a push from regulators who now wish they had taken a dimmer view of exotic mortgages and lax lending during the boom. Consumer debt rose from an average of less than 80% of disposable income 30 years ago to 129% in 2007. If history is any guide, America's consumers will spend the next six to seven years reducing their debt to more manageable levels, reckons the McKinsey Global Institute. The effect on the economy of deflated assets, tighter credit and costlier energy are already apparent. Fewer people are buying homes, and the ones they buy tend to be smaller and less opulent, while the number of credit cards in circulation has declined by almost a fifth.

So, where do we look to strengthen our economy? As consumers rebuild their savings, American firms must increasingly look abroad for sales. Competition from low-wage countries has increasingly taken over the markets of domestic industries such as furniture, clothing or consumer electronics. On the other hand, the main beneficiaries of the export boom are likely to be companies that are already formidable exporters; particularly those that reflect America's strengths in high-end services and highly skilled manufacturing such as medical devices, pharmaceuticals, software and engineering, as well as creative services like film, architecture and advertising. Two examples are the firm of architects Kohn Pedersen Fox that is designing an up-market hotel in the Chinese city of

Hangzhou, and Intel, the microprocessor giant, where 80% of its revenue comes from outside its home country. A recently updated paper by two Dartmouth college scholars showed that success in the export market comes from having experienced companies already established in the export business where America has a clear competitive advantage: sophisticated, knowledge-intensive capital goods like microprocessors, and high-end services like engineering, oil-production service and architecture.

Simultaneously with boosting export sales, American's will need to import less. A silver lining in the four-fold increase in oil prices since 2002 is that oil companies find that they can profitably extract more oil from ageing domestic fields. And, the rise in the price of natural gas is having a similar effect with the commercial development of shale fields most recently in West Virginia, Pennsylvania and southern New York State. The automobile industry is also helping to reduce our dependence on imported oil by shifting advances in engine efficiency from extra power to fuel economy.

So, the process of rebalancing America's economy has begun. Consumers are spending less, borrowing less and driving less. The trade deficit is narrowing and exports are growing. Encouraging though all this is, there are still plenty of ways that the process can be derailed. Although American consumers showed signs of life in the first quarter, with retail sales and car buying picking up a bit, housing is still struggling and consumer spirits remain low. Consumer spending will recover as employment grows, but it will no longer outpace incomes the way it did when credit was easy and home prices skyrocketing. It is not yet clear whether this transition will bring strong, steady growth and declining unemployment or – sluggish growth and stubbornly high unemployment.

In light of all this, we'll strive to design your investment portfolios to successfully navigate these uncertain times using our stock selection discipline and our process to select mutual fund managers. At the same time though, harkening back to Bill Gross's admonitions on lower-than-average historical returns, you need to review your own financial goals and expectations and see how they fit with this "new normal" vision of the economy going forward. Call us if we can help.

Year-to-date – with dividends reinvested – the Dow Jones Industrial average is up 4.82% and the S&P500 increased by 5.41%. The Barclay Capital Intermediate Government bond index grew by 1.20%.

Planning Note

2010 is finally the year when the estate tax disappears, although only for this year. There exists the potential for unintended consequences in your plans to distribute assets that could work against your spouse's interest. If your attorney has not yet contacted you to review this you might want to pose the question of how the 2010 law will impact your marital and family trust asset allocations.

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DJIA (30Mar2010)	10,856.63
S&P 500 (30Mar2010)	1,169.43
BarCap Inter-Gov't (30Mar2010)	1,488.86