

GETTING BACK TO NORMAL – THE OUTLOOK CONTINUES TO IMPROVE

Finally, we get a Great Depression comparison we can all enjoy: the biggest stock market rally since the 1930s. Many investors are now wondering where we go from here.

You probably have lots of questions about investing today. We try to answer some of the biggest and most important questions on the minds of investors today. Hopefully this can help provide some perspective on current events to help you remain focused on your long-term goals.

Q: What is the outlook for the economy?

A: We believe the recession is already over. However, it's unlikely that the end of the recession will be recognized for many months. The first estimate of gross domestic product (GDP) showed the economy fell at an annualized rate of 1.0% in the second quarter. This marked the fourth consecutive quarterly decline, an event unprecedented since quarterly record keeping began in 1947. Economists now project, as we do, that the economy will grow at an average 1.5% pace from July to December, according to a Bloomberg survey taken in early July. We believe the pace of recovery should return to a "normal" growth rate of 2.5% – 3% by the second or third quarter of next year.

Q: Which indicators suggest the economy has turned?

A: Here are two examples:

- The Index of Leading Economic Indicators¹ has risen for three straight months (through April, May and June), meaning the economy, according to this index, will likely expand in the coming months.
- Other indicators, such as consumer confidence and factory orders, have sharply rebounded after reaching unprecedented bearish levels in March.

Q: What about economists who say things will not improve until unemployment and the housing and auto industries must improve?

A: First, unemployment is a lagging indicator. It almost always peaks well after the stock market and the economy begin to recover. As far as autos and housing are concerned, these industries were hardest hit during the recession, but the rate of decline has slowed dramatically, so the weakness is having a much smaller negative impact on GDP. We think both industries have hit bottom.

In fact, the auto sector will likely be a major contributor to growth in the current quarter. Motor vehicle production is poised to jump sharply from the depressed levels of the second quarter, lifting industrial production. Car and light truck sales are already improving due to the federal government's Car Allowance Rebate System (known as the "cash for clunkers" program) and various automaker sales incentives. Of course, there is still pain in the housing industry, but the inventory of unsold homes looks like it has peaked.

Q: Does a better economy necessarily lead to a better stock market?

A: It almost always does. If we're correct in thinking the recession has ended, then history is on our side. According to Ned Davis Research, the stock market has followed recessions by rising in nine of 10 cases, both six months and 12 months after the recession ends. The stock market most likely hit bottom in March and has now risen 45%, as measured by the S&P 500, in anticipation of the recovery that we believe is on the horizon.

Investors who have participated in the rally most likely were confident that "staying the course" was a better strategy than trying to jump into and out of the market. Investors who missed the rally may have listened to the skeptics who suggested it was just a bear market or "short covering" rally, or insisted that a "second stimulus" was needed. Of course, a correction is possible at any time for any reason, but we think that, longer term, the market will continue to recover.

Q: Should we be worried about inflation?

A: Investors should always be worried about inflation. We're talking about the persistent inflation of 2% – 3% that eats away at your purchasing power. Every investor needs to guard against it, because inflation has been a fact of life for most of the past 200 years. With an inflation rate of just 3%, everything you buy today will cost twice as much in 24 years. One way to combat persistent inflation is to own equity investments that offer the potential for rising income: those that pay a dividend and offer the potential to increase dividends on a regular basis.

The second type of inflation is what we would call runaway inflation. While it can happen, it's very rare. Those who are worried about runaway inflation point to the actions by the Federal Reserve (Fed), which has been aggressive in its response to this crisis. We believe the policy response has been appropriate. The greater risk, in the short term, was deflation (falling prices) and subsequently an economy in serious trouble, such as what Japan experienced in the 1990s.

For instance, the Fed cut rates 16 months after the peak in housing and took official rates below 1% in just 31 months. In comparison, in the 1990s, the Japanese took twice as long (69 months) to lower rates below 1%. The result was an economic quagmire in Japan that lasted more than a decade.

But now, due to our soaring money supply, doubling of the Fed's balance sheet and the Fed's purchase of some government debt, some investors worry that "printing money" might cause a serious inflation problem. While this is a risk longer term, currently this money isn't circulating in our economy, which is why inflation has dropped from 5.5% to near zero. Therefore, we have a long way to go before inflation rises to average historical levels.

We also believe the Fed understands its position: It knows it has to pull back these programs as the economy recovers in order to keep inflation under control. It will also gradually raise interest rates. Although higher inflation is a risk longer term, nothing has occurred so far to indicate we're destined to experience out-of-control inflation.

Q: What if investors want to own a hedge against runaway inflation?

A: Two examples of investments that perform well during inflationary periods are commodities and real estate-based mutual funds. But you have to be careful because, in the wrong hands, these investments can do more harm than good.

- From January 1999 through December 2008, the average real estate fund rose 90%, but real estate fund investors lost \$5 billion because many bought high and sold low.²
- In 2007 and 2008, 78 commodity funds launched amid great industry and media fanfare – just in time for a 46% drop.²

Because these funds are very volatile, we recommend they be purchased through an advisory program or an asset allocation fund. The key is to hold these investments in appropriate amounts for the long term.

Q: What about the deficit?

A: Deficits alone aren't inflationary. If the Fed prints money to buy the debt, that is inflationary. There are only three groups that can buy the debt: U.S. investors, foreign investors and the Fed. We've met with members of the Fed and heard them reiterate emphatically that once this crisis has passed, it won't monetize the debt longer term and will pull back on programs designed to stimulate the economy. It will be like walking a tightrope, but the Fed always faces the difficult task of balancing inflation risk against the risk of further economic weakness.

The larger question regarding the deficit is that current levels of taxing and spending are simply unsustainable. That's the bad news. The good news is that two veteran senators, Ohio's George Voinovich and Connecticut's Joe Lieberman, have introduced a bill to establish a commission to examine the

nation's tax system and the rapidly growing entitlement programs of Social Security and Medicare. The commission would have 20 members from both parties, as well as the legislative and executive branches. The goal is to draft a proposal to fix the long-term fiscal imbalance. While Congress' previous efforts to address the deficit have often been disappointing, establishing this commission would be a step in the right direction.

Q: Considering the budget, are tax rates likely to rise?

A: Yes, we believe this will be the case for many investors, especially those in the higher tax brackets. That's why it's important to consider tax-saving investment opportunities, including the following:

- Municipal bonds, which can offer interest that is free from federal tax and possibly state and local taxes as well³
- Equities, whose dividends and capital gains have historically been taxed at lower rates
- Annuities, which offer certain tax advantages
- Retirement plans such as 401(k)s and IRAs that offer the potential to protect investors from potentially higher tax rates

We believe it's important to review these options with your financial advisor to determine which, if any, might be appropriate for your situation.

Q: Any final thoughts?

A: We think this financial crisis will totally reshape many people's attitudes toward money and investing. The effect may be similar, though not as dramatic, as the impact of the Great Depression. Unfortunately, too many people learned the wrong lessons after that financial crisis. The Dow Jones Industrial Average hit bottom (at 41.22) in July 1932, well before the Depression had ended. It then proceeded to rise (with quite a few bumps along the way) until it reached nearly 1,000 by the end of 1965. No matter how bad things seem, we believe betting against our country in the long term has always been a bad bet.

Of course, investing always involves taking risks. However, not investing can also be risky, because it can result in a failure to achieve long-term financial goals. Ways to help reduce your risk include investing with a long-term perspective, diversifying your portfolio⁴ and focusing on quality investments. These principles may not always pay dividends in the short run, but they are more dependable than the alternative. Talk with your financial advisor about how these principles can help shape your financial strategy.

1 Measurable economic factor by the Conference Board that changes before the economy starts to follow a particular pattern or trend. Leading indicators are used to predict changes in the economy.

2 Morningstar

3 May be subject to the alternative minimum tax (AMT).

4 Diversification does not guarantee a profit or protect against loss.