

By The GGM Investment Team

What is Going on With the Markets?

The GGM Investment Team answers your questions surrounding the markets' latest events.

Throughout July and into early August, market participants grew increasingly apprehensive about global economic weakness, the spread of sovereign debt risk in Europe, and the U.S. debt limit and downgrade circus.

The unprecedented volatility has many investors rightly concerned, which is why the GGM investment team chose to dedicate this quarterly newsletter to addressing the questions and concerns most frequently raised by clients.

1) Should I be worried about my investment portfolio?

Jeff: The simple answer is, no. In our latest investment strategy piece (found in your quarterly review packet), we stated, "the global economy is facing a very difficult period of uncertainty" and "adjustments over the past several quarters have prepared portfolios for the present environment."

One of the most important considerations for an investment portfolio is one of "allocation" between "stocks" and "bonds." Stocks (also referred to as "equity") will provide greater growth opportunities in rising markets, but will also experience increased risk of loss during a market downturn. For instance, from the highs in late July to the recent low, stocks or equities as a group **fell a whopping 17%**. Conversely, the conservative bond category (also called "fixed income") actually **rose about 1.5%** over the same time frame. Consider the following three allocation examples:

a) 80% equity	- 17.0%
20% fixed income	+ 1.5%
portfolio return	- 13.3%
b) 50% equity	- 17.0%
50% fixed income	+ 1.5%
portfolio return	- 7.75%
c) 20% equity	- 17.0%
80% fixed income	+ 1.5%
portfolio return	- 2.2%

This example clearly demonstrates the time proven fact that **asset allocation, not "stock picking," drives returns and controls risk.** Thus, the structure of an investment portfolio should 1) be custom tailored to meet each client's objectives and expectations and 2) be adjusted in response to changes in market conditions or client circumstances.

As economic fundamentals have continually weakened over the past several quarters, **GGM has shifted asset allocations to a more conservative posture.** For example, on the equity side a new "enhanced income" category has been introduced in order to reduce typical "equity-like" volatility while substantially boosting income.

2) Does the recent volatility impact the decision making process for my portfolio?

Mike: While it may be tempting to exit the market completely or "buy the dip" during wild, short-term market swings like we have experienced recently, it is very important to avoid making long-term decisions under these conditions. Remember, it is fear, anxiety, and greed that fuel such exaggerated price actions, not fundamentals.

To give an example, on July 22nd Exxon Mobil Corporation's stock traded intraday at a high of \$85.41. However, by August 10th the stock had sunk to a low of \$67.46, a 21% drop. Did the intrinsic value of Exxon really decline by approximately \$87 billion in less than 3 weeks? The rational answer is "no," but it clearly demonstrates what happens when investors react with panic and speculation instead of sticking to a consistent investment discipline. In market environments such as this, it is prudent to remain patient until a clear picture or direction arises.

Whether markets are advancing or declining, **investment decisions must be based on discipline rather than raw emotion.**

3) With current interest rates at low levels, where is GGM investing my portfolio to generate reasonable income?

Chris: This is unquestionably one of today's most pressing questions as the baby boomer generation shifts into retirement mode. For those that witnessed 16% coupons on both the 5-year and 10-year Treasuries back in 1981, it's hard to fathom today's basement levels of .96% and 2.2%, respectively. Since that peak some 30 years ago, bond investors have been riding a declining trend line in rates, enjoying the higher coupons as well as the bonus of capital appreciation that resulted from falling rates and higher bond prices.

Unfortunately, the Federal Reserve's most recent pronouncement forecasts a continuation of low rates well into 2013. Even as the rate bottoming process is ultimately completed, we are still likely to see meager fixed income returns as rising interest rates and the resulting principal erosion eats into already modest coupons. One can reasonably argue that, factoring in 3% annual inflation, today's Treasury rates virtually guarantee a negative after-tax, after-inflation real return.

At GGM, we are finding the answer to the question outside the traditional bond market. While some portion of an income-oriented portfolio can be allocated to floating rate or "inflation-linked" securities, the solution to generating higher income is not extending bond maturities or loading up on "high-yield" junk bonds. Instead, **we are turning to high dividend-paying blue chip equities, preferred stocks and specialty categories such as oil and gas royalty trusts and master limited partnerships.** While a blend of these categories can provide an income stream nearly double that of high quality bonds, the to-be-expected trade-off is a higher level of market volatility. Thus, we are also marginally adjusting client portfolio asset allocations in order to maintain appropriate risk levels.

4) On August 2nd Congress passed and President Obama signed into law legislation that raised the federal debt

ceiling while reportedly cutting the deficit by \$2.1 trillion over the next 10 years. Three days later, Standard & Poor's lowered the U.S. government's credit rating from AAA to AA+. What did Congress achieve and what does the credit downgrade mean to me as a consumer or investor?

Chris:

The Budget Ceiling Battle

To begin, the act of raising the government's debt ceiling is not a new idea. The Feds have run out of borrowing room on the nation's credit card before, in fact 74 times since 1962. And since the government has the power to print money, the solution has always been to simply boost their own borrowing authority. This time, however, the process deteriorated into a partisan battle over the government's deficit spending. To nobody's surprise, a compromise bill was passed and enacted just in time to beat the deadline alarm and conveniently allow Congress to recess for their month-long vacation. Whatever one's view of the legislative wrangling, here are the results:

The Congressional Budget Office's "baseline" budgeting process calls for an average annual increase of 7% in spending over the next decade. Legislated spending cuts are, in fact, reductions from the baseline.

The projected Federal budget for fiscal 2012 is \$3.6 trillion. Spending cuts for 2012 are \$22 billion, less than 1%, again from the baseline increase. The projected budget deficit for 2012; still over \$1 trillion.

A bipartisan joint committee of Congress now has until Thanksgiving to come up with its proposals for an additional \$1.2-\$1.5 trillion in cuts which will be voted on by Christmas. If the committee fails to agree on a plan or the plan fails to pass Congress, \$1.2 trillion in across-the-board cuts will kick in – evenly divided between defense and non-defense spending.

Bottom Line: So far, no tax reform, no entitlement (i.e. Social Security, Medicare) reform, no deficit spending solution.

Standard & Poor's Downgrade of U.S. Debt

After telegraphing the possibility of a credit downgrade via a "negative outlook" on April 18th, Standard & Poor's downgraded U.S. debt to AA+ for the first time in history on August 5th stating, *"Since then, we (S&P) have changed our view of the difficulties in bridging the gulf between the political parties over fiscal policy, which makes us pessimistic about the capacity of Congress and the Administration to be able to leverage their agreement this week into a broader fiscal consolidation plan that stabilizes the government's debt dynamics any time soon."*

Market Impact

While the short-term market impact of the credit downgrade was an emotion driven 7% sell-off in the Dow, the DJIA fully recovered to its August 5th closing level within six market days. More important has been the injection of economic uncertainty which triggered four consecutive days of 400+ point up and down swings in the Dow, an event never before experienced. As we stated in our most recent update, **now is not the time to either panic or speculate. It is, however, the time to recognize the fragile nature of the current investment environment.**

Consumer Impact

The impact of the credit downgrade on consumers is yet to be determined. As of now, only Standard & Poor's has downgraded U.S. debt while Moody's and Fitch, the remaining two credit agencies remain at AAA. Without a credible outcome from the bipartisan Congressional committee, there is a substantial risk that they, too, will follow suit with their own downgrades. Although we have seen no impact on the interest rates on Treasury securities to date, an across the board downgrade would likely boost the government's borrowing costs. And, since consumer rates are traditionally benchmarked to the "riskless" Treasury rate, any increase would flow through to virtually all consumer rates from mortgages to car loans to credit cards. Consumers would be wise to take advantage of today's rates to lock in mortgage refinancing as both credit availability and cost are not likely to improve.

5) Is the United States headed into another recession?

Jeff: The GGM investment team continually monitors a vast array of economic and market statistics. Recently, a host of recession warning "*indicators*" have turned negative and signal the potential for an oncoming economic downturn. This composite of "*indicators*" has been observed in **every recession since 1950, and has never been observed except during or immediately preceding a recession.**

Perhaps the simplest of such "*indicators*" to monitor would be both the trend and current level of GDP or the U.S. Gross Domestic Product, which refers to the market value of all final goods and services produced in a country in a given period.

Recent GDP quarterly readings have been 3.8%, 2.5%, 2.3%, 0.4% and the most recent 2nd quarter 2011 GDP of 1.3%. Not only has the trend generally moved downward, but the latest preliminary* level of year-over-year growth (1.3%) has historically been slow enough to anticipate an oncoming recession. **Needless to say, our concern over potential economic weakness is a main factor in our cautious investment posture.**

* Because of the complex calculations and methods of data collection involved, GDP figures are initially released as "preliminary" pieces of data, which are later subject to revisions. For instance, the "preliminary" 1st quarter 2011 GDP was 1.9%, but later revised to just 0.4%. We await the potential 2nd quarter revision to give a clearer picture of the economy's direction.

6) Can the sovereign debt crisis that began in Greece spread into the major European nations of Italy, Spain, etc.?

Mike: The phrase "sovereign debt crisis" currently refers to the ongoing challenges with government debt in the "PIIGS" nations of Portugal, Italy, Ireland, Greece, and Spain. Back in 2010, with their outstanding government debt at 120% of GDP and the rating agencies having assigned "junk" status to their bonds, the interest rate on Greek two-

year bonds surged to over 15%. Rather than allowing an “orderly default” where debt holders would incur a 25-50% “haircut”, the European Union elected to fund a bailout by providing 110 billion euro in financial support at below market rates and with extended maturities.

Given the overall size of the Greek debt, this solution should have been viable but the problem continues to reappear. The issue is that Greece not only has massive debt but is continuing to run large budget deficits. With government imposed austerity measures slowing any economic growth and lowering tax revenues, the country cannot grow itself out of this debt dilemma.

The real problem, however, is the developing risk of “contagion” expanding to the rest of the euro-zone, particularly the much larger economies of Italy and Spain. Bond yields for both countries have risen significantly since June, a signal that investors are nervous over their ability to grow their economies and meet their debt obligations. This has forced the European Central Bank to intervene and begin purchasing Spanish and Italian bonds in order to push yields back down. However, the sheer size of these economies makes this a short-term fix at best. Again, as with Greece, European leaders have decided to treat the symptoms and not focus on finding a cure.

At GGM, we are concerned with the spread of sovereign debt issues throughout Europe. Italy is the world’s third largest bond market and though it more likely than Greece to grow its economy and revenue, signs of a global slowdown will make this more challenging. Furthermore, the reluctance or inability of European leaders to come up with a long term solution remains a major roadblock.

Our response is to be conservative and remain defensively postured until a solution to this uncertainty presents itself.

7) The financial press has continually touted the BRIC markets of Brazil, Russia, India and China. Given the worldwide turmoil, are emerging markets and developing economies still attractive?

Chris: The BRIC designation was first coined by Jim O’Neil of Goldman Sachs in a 2001 paper titled “The World Needs Better Economic BRICs.” As early as 2003, Goldman forecasted that China and India would become the first and third largest economies by 2050, with Brazil and Russia capturing the fifth and sixth spots.

While there are a host of other promising emerging markets, the four BRICs comprise more than 2.8 billion people, or 40% of the world’s population, cover more than a quarter of the world’s land areas over three continents, and account for more than 25% of global GDP.

Investing in emerging markets must be a part of any long-term investment strategy. China has already demonstrated its capability to capture and dominate manufacturing while India has focused on the service sector. Russia and Brazil are blessed with enormous natural resources which will be drivers of global economic growth.

However, investing in emerging markets is not without its own set of challenges. For example, there is sovereignty risk associated with the ever-changing political climates along with the added exposure to potential currency instability. Quite predictably, these markets have experienced extreme volatility as dramatically demonstrated during the 2007-08 global market meltdown when the Xinhua China 25 Index fund fell 75% and the closed-end India Fund plummeted over 80%.

Still, we at GGM believe that, for long-term investors, participating in the evolution of these emerging markets, which will someday become the developed markets of the world, will be well worth the exciting ride.

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