Special Update – No Double Dip Recession
November 5, 2010

Over the last several years, we have closely followed economic indicators. In a period of sub-trend economic growth, in which we remain, economic growth is especially important because the economy and markets move in lockstep. When the economy slows down, stock prices tend to fall. When it picks up, stock prices tend to rise.

While we are not in a period where the economy is growing at an increasing pace, it is no longer likely that the US economy will turn negative. Lakshman Achuthan, of the Economic Cycle Research Institute (ECRI) unequivocally said, "*We will not have a double dip recession in the United States*."

See Link to ECRI Interview on No Recession Call and Fed Policy Timing
http://www.businessinsider.com/goldman-heres-why-inventory-growth-boosting-last-quarters-gdp-was-actually-a-good-sign-2010-11

This is important especially in the context of the Quantitative Easing (QE) 2 program undertaken by the US Federal Reserve yesterday. ECRI believes the QE is unnecessary and may result in "*unintended consequences*." According to ECRI, the QE, if needed, should have been done about a year ago in order to prevent the slowdown that occurred over the summer. At this point in the cycle, unintended consequences are likely.

This makes it more important than ever to have a Margin of Safety strategy for Long-term investments (for Retirement Expenses. In equities and other risk assets, bubbles arise, where prices go up far above intrinsic value. This can cause inflation and thereby, a rise in interest rates.

I teach a class at the Furman Osher Lifelong Learning Institute, attended by retirees. These retirees, at the beginning of the class, were invested about 60% in bonds. This is no surprise. The flow of money from equities and cash into bonds was higher over the last two years than the flow of equities into stocks during the internet bubble, according to the Investment Company Institute*. Investors are once again chasing past performance, but this time in bonds*!

When interest rates rise, bond prices fall – causing investors to lose. If your clients own bonds, please understand this risk. The table below illustrates the effects of rising interest rates on "safe" bonds of differing maturities. For example, if interest rates rise 2%, a 10-year treasury bond (a "safe" bond) will fall in price by 17%. With interest rates at historic lows, it is not a question of if but when rates will rise.

How Much do Bonds lose when Interest Rates Rise?				
	Interest Rates Rise 1%	Interest Rates Rise 2%	Interest Rates Rise 3%	Interest Rates Rise 4%
2 Year Treasury Bond	-2.0%	-4.0%	-5.9%	-7.9%
10 Year Treasury Bond	-8.4%	-16.7%	-25.1%	-33.5%
30 Year Treasury Bond	-16.9%	-33.7%	-50.6%	-67.5%

Source: Eaton Vance interest rate solutions

http://win.eatonvance.com/interest.php

For this reason, our Retirement Expense strategy (appropriate for 3 years of retiree spending needs) continues to avoid duration risk. Instead our volatility control managers strive to reduce volatility through careful forensic and fundamental analysis in an attempt to reduce downside volatility and beat bond returns over the long run, something they have been successful at doing in the past and we believe will continue. Our long-term strategies (appropriate for assets needed 4 or more years from now), however, are focused on beating the broad market over a full cycle.

Ken Moore, CFP®