WHAT IS AHEAD FOR THE ECONOMY AND THE MARKET?—THE MONEY MARATHON OCTOBER 2011

This is a worrisome time for an investor to know which way to turn. Many economists are saying there is a 50% chance of a double dip recession. Since we have already been through this twice in the last decade, this is not a pleasant thought, especially since the last recession, not long ago, was the Great Recession, the worst since the Great Depression. What is ahead for the economy? What are the risks? What should an investor do now?

As I see it there are three main concerns.

1) **The European Crisis**: Europe appears to be going through its own version of our financial crisis of 2008. Greece is broke and the issue for the European Union is to how best to save the Union from the problem in Greece from spilling over to other weaker European countries and the banks of all those countries. They may need their own version of our banking TARP. Leadership is needed and it is difficult to get all those different countries to agree on how best to handle the situation. If the situation gets worse it could cause a global recession which is the big worry. My bet is that there will be periodic panics for the next several months but ultimately I believe the European Union will work together to contain the problem. But it won't happen quickly. It may take a year for this issue to be somewhat resolved or put behind us.
2) **The US Budget Issues**: Washington does appear to be broken. The national debt is $14.5 trillion which is nearly 100% of Gross Domestic Product (GDP) which could make us another Greece in a relatively short period of time. No one seems to be willing to propose a way to put our entitlements programs on sound footing (Social Security, Medicare and Medicaid) which are two thirds of expenses. Without entitlement reform it is nearly impossible to get our financial house in order. Also, there is no agreement on how to increase revenue growth (more taxes and stimulus to generate spending or less regulation, more certainty and a more business friendly climate. My prediction is the budget will ultimately be addressed, but not until after the 2012 election, again more than a year off.
3) **Jobs**: With the unemployment rate still over 9% and combined unemployment, under employed, and people who have just given up, totaling over 16%, we still have a major economic crisis. Jobs are growing very slowly, if at all, and again there is no agreement as to how to improve this. Housing is still depressed and people feel less wealthy with the depressed stock market over the last nearly 12 years, and the historic low interest rates that pay almost no interest to investors. Again, there is no agreement as to how to address this and so I expect nothing to happen in the short run. Best case is very slow growth that does not put us in a double dip later this year. My best guess is again a year or more for the economy and jobs to begin to really improve.

As described above, all three of these issues most likely will not be resolved for a year or more. This means that these issues will likely overhang the investment horizon for quite some time.

Based on this uncertainty what should an investor do?

Choice 1**:** **Stay safe**. One alternative is to stay totally safe by owning only treasury bills and insured deposits. This will protect money, but may miss a market move up when conditions ultimately change for the better. Additionally, the yield on safe investments is at historic lows, so it is almost impossible to generate significant income from investments that are all safe. But if a person can afford to wait, it can make sense to wait until there is more certainty.

Choice 2: **Invest in hedges that may perform well in a downturn or panic**. Another alternative is to invest in hedges that might do well in a bad economy or panic like gold. Although gold has been a good investment in the last decade as a hedge against disaster, I generally think more than a 5% to 10% portion of a person's portfolio is too much. The reason I am not a huge gold fan is that gold has no internal rate of return, in that it doesn't produce income. But, in a panic it is considered as a safe haven and therefore merits an investment as a portion of a portfolio. Other alternate investments such as real estate, hedge funds, and private equity can all be used as at least an asset class diversification that can offer some protection in a downturn.

Choice 3: **Purchase high quality, high dividend paying stocks**. I advise purchasing high quality stocks that pay a 3% or more yield and here are several reasons for that strategy.

1) **Long term study predicts higher stock prices**. A recent study done b y financial historian Doctor Richard Sylla of New York University's Stern School of Business studied market behavior going back to 1790. Doctor Sylla is known for his prediction of a market decline beginning in 2000 based on his analysis on similar data done at that time. His studies show that markets go through consistent waves and based on these waves he now believes the S&P 500 could reach 2300 by 2020 up nearly 100% from current levels. The study shows that decades in which the market out performs with 15% or more annual returns usually are followed by significant under performance in following decades which is what happened in 2000. Likewise, decades in which the market performs at 5% or less usually outperform significantly in successive decades. Although he does not know when this will start, in one or two or three years, based on the last decade's negative returns, he believes that a decade from now, stocks should have grown at an approximate 10% annual return or 6.5% adjusted for inflation. This would double the market from current levels.
2) **Stable and increasing dividends**: Dividends from high quality stocks are actually very stable. Over the last 50 years, the S&P 500 dividends have grown at 5% per year. Excluding the last recession, the S&P 500 dividends decreased in only 5 years in its history and the maximum decline was just 3.3%. In this last recession which was a financial panic, dividends did decrease more than previously primarily as banks eliminated their dividends. However, financials only represent 16% of the S&P now and the dividends of the rest of the companies in the index are actually up 20% from their peak in 2007 before the crash. Currently S&P dividends are only 30%

of company profits which gives investors protection from potential dividend reduction and ample room for future increases. With the dividend of the S&P 500 in excess of 2% with a 5% annual expected growth rate of that dividend, this makes a very good alternative to a 10 year government bond that yields less than 2%. Additionally, selective purchase of stocks or funds can find current yields of 3% or more in high quality, household names.

3) **Investing during times of fear and uncertainty**. When all the news is bad most people are fearful and selling. It takes real guts to invest at that time but the reward is great in that usually that is when there are the best long term bargains. Conversely, when all the news is good usually stocks have peaked. This, of course is not the situation now. Recently, Warren Buffett indicated that he is having his company repurchase their own stock which means he believes it is a long term bargain. He has not done this in the past.

Of course when we look at the choices above, it makes sense to do some of all of them, some safe, some hedges, and some high yield stock investment which together offer further diversity to a person's investments based on the investor's particular financial needs and goals and specific risk tolerance. In these uncertain times, sometimes it is better to protect against fear, panic and knee jerk reactions and instead look ahead to a more positive future. I believe the future is bright, but the immediate future or the next year or so is uncertain. During these times, stick with quality and try to keep a long term perspective, which allows a person to worry less about short term price fluctuations.

Remember every investor's situation is unique and it is important to review your specific situation with a financial professional.

Ed Douglas is a Certified Financial Planner/Consultant, Chairman Emeritus of Citizens Bancshares and author of three books, "Making a Million With Only $2000-Every Young Person Can Do It", "The Money Marathon: 7 Simple Steps to Financial Freedom" and his new book " 25 Truths: Winning Wisdom for a Better Life", available at www.eddouglas.com. Ed may be contacted for financial planning services or seminars based on his books at ed@eddouglas.com or 660-646-2066 or at his office at 601 Locust, Chillicothe, Missouri.