# Have we Booked Passage on the Titanic or a Sailboat?

Recent newspaper headlines tell us that the world economy is the *Titanic* heading for an inevitable collision with an iceberg and that our captains (U.S. policymakers) are asleep at the helm. Growing concern that Europe's debt crisis will spread and the failure of American policymakers to reach an agreement to reduce the federal budget led the S&P 500 4.7% lower two weeks ago to its worst Thanksgiving-week loss since 1932 (*Bloomberg*). Then last week, the S&P 500 rallied 7.4%, while the Russell 2000 Index of small-cap stocks soared 10.34% (Louis Navellier *Marketmail*, December 5, 2011). As the seas ebb and flow, so does investor sentiment, alternating from despair one week to jubilation the next. Headlines foretell the sinking of America's economic ship due to a worrisome lack of leadership in Washington and Europe, the likelihood of a "double-dip" recession and the imminent economic doom in Greece, Portugal, Spain and Italy.

While investors face real problems in these turbulent seas, we believe that the global and U.S. economy has more in common with a sailboat than the ill-fated *Titanic*. Navigation matters, but ultimately, both headwinds and tailwinds can and do affect our sailboat's voyage. While icebergs and obstacles certainly exist, we can make course corrections to avoid them or lessen their impact and we make small course corrections that keep us headed in the right direction and allow us to turn our sails to catch the wind.

In this ***E-Update***, we return to our sailing analogy to discuss the dominant headwind investors face and some of the tailwinds that should help keep our economy sailing forward. While Europe's debt crisis creates powerful headwinds that make it difficult to focus on any other economic or market data, there are some countervailing themes currently in play that should help keep us moving forward while avoiding icebergs.

***The Prevailing Headwind: Europe's Unresolved Debt Crisis.*** The European debt crisis continues to fester and if, when and exactly how it will be resolved remains very much anyone's guess. We have not ruled out any scenario as the situation is fluid and fraught with difficulties, not the least of which is the number of separate political entities involved. Although it may seem hyperbolic to say so, what is at stake is the very survival of the European monetary union. Can and will the Euro continue to be the common currency of the European Union when each EU country has its own fiscal and political policies? Countries like Greece, Italy, Spain and Portugal have very high national debt while countries like Germany and Finland appear to be fiscally sound.

Europeans have some very tough decisions ahead. Europe's political leaders will need to come to some consensus about fundamental issues like what kinds of political, economic, and social structures they want, how closely integrated they want to be, and how much sovereignty they are willing to share. Whatever these diverse political leaders decide, their choices likely will have profound global implications. The world waits. Meanwhile, we see the action by Europe's six central banks led by the U.S. Federal Reserve to lower the cost of emergency dollar funding for financial companies as a positive step (*Bloomberg*). Given the sheer magnitude of the crisis and the degree to which European economies are already intertwined (as evidenced by the number and diversity of European banks who hold Greek and Italian debt), we believe that any solution to the European debt crisis would have to include a much closer monetary *and* fiscal union of the remaining countries in the Euro zone.

## *Themes in the market*

**1. This time it's different – *not.*** Three years after the inception of the 2008 global financial crisis, we still face enormous sovereign debt issues and subpar economic growth. The lack of a robust recovery has made many people wonder if we have the ability to ever recover from our problems. Investors seem worried that our economy will not recover for a generation or longer.

In a groundbreaking and comprehensive study of a variety of earlier financial crises – covering 66 countries on five continents and some 800 years of data – economists Kenneth Rogoff and Carmen Reinhart concluded that financial crises have been remarkably consistent in their frequency, duration and ferocity (Kenneth Rogoff and Carmen Reinhart, *This Time is Different: Eight Centuries of Financial Folly,* 2011). Although some suggest that the current crisis differs from earlier ones, Rogoff and Reinhart's study does not bear this out; the events and recoveries studied were similar to our present crisis, sometimes eerily so. The good news is that the trajectory of this current economic recovery appear to be typical of other economic recoveries over the last eight centuries. According to this study, a recovery from debt burdens and credit bubbles typically takes 6-10 years; moreover, following each such recovery, the countries and economies affected recovered and grew. If the current recovery follows historical patterns, we are halfway to the average recovery time.

Of course, no one can guarantee that our current economic recovery will follow the pattern of recovery seen in Rogoff and Reinhart's study, but we think it would be financial folly to ignore 800 years of historical data. We choose to believe it is not different this time.

**2. The U.S. economy is growing.** While Europe appears to be headed into recession, U.S. economic growth has accelerated at a 2.5% annualized pace during 3rd Quarter '11 and incoming data continues to meet or beat expectations. Other positive data include:

a. ***Consumer spending is up.*** Surprisingly, the "spending spirit" of US consumers continues to overshadow the near-record low in consumer confidence. On November 27, the National Retail Federation reported that Thanksgiving Holiday sales at shopping malls gained a robust 16% year-over-year (*Bloomberg*).

b. ***Consumer confidence is up.*** Conference Board's confidence index increased to 56 from a revised 40.9 reading in October, suggesting Americans may feel more upbeat about the employment and income prospects (*Bloomberg*).

c. ***Initial jobless claims are down.*** Last week's fall in initial jobless claims to the lowest level since April 2011 offers optimism for employment conditions (*Bureau of Labor Statistics*).

d. ***Inflation remains subdued.*** The Headline price inflation continues to moderate as energy prices remain tame (*Bloomberg*).

**3. Fed policies continue to protect the U.S. economy.** Our central bankers have been proactive in stabilizing the U.S. economy and driving interest rates to record lows via non-traditional monetary policy. In fact, there are a growing number of Fed officials who appear more comfortable with pursuing additional quantitative easing should they believe economic conditions warrant intervention.

**4. Corporate America is growing.** As third quarter earnings season comes to a close, U.S. corporations appear healthy and wealthy despite the economic turmoil. There is lots of good news coming from America's boardrooms:

a. **American corporations have increased their earnings.** Third quarter earnings for the companies that compromise the S&P 500 grew 18% (year over year). That tremendous growth rate is 5% better than expectations at the beginning of reporting season. Stock prices have yet to appreciate in response to this near-record earnings growth, suggesting that equities may be attractively valued (*Yahoo Finance*).

b. **American corporations have raised their dividends.** More than 200 of the companies in the S&P 500 companies have raised their dividends, compared with just two that have cut their dividends. Dividends give weary investors cash and suggest that corporate America is feeling confident about future earnings (*Bloomberg*).

c. **American corporations are buying back their own stock.** More than 70% of the companies in the S&P 500 have repurchased their own shares, highlighting the robust health of corporate America and the confidence of its directors in the third quarter over last year (*Bloomberg*).

d. **American corporations are investing in capital.** Business spending by corporate America continues to support economic growth as capital spending has increased 8% year-to-date (YTD). U.S. Equities continue to outperform the world market indices, so far this year, due to this fundamentally strong data (*Deutsche Bank*).

**5. Wisdom and productivity are up.** Based on conversations with many of you, we know many of us have gained some hard-earned wisdom in the last three years. I hope we have learned to focus on our true wealth instead of just our monetary wealth; I hope we have learned to find confidence in our faith, talents, and networks instead of our investment account balance; and I hope we have learned that the markets can surge one week and fall back the next, but that short-term performance rarely affects our long-term investment success. As a society, we hope our banks and businesses have learned to be more cautious and more concerned with the potential for fraud and the risk of credit bubbles; we hope investment gurus have learned from their experience with credit default swaps that there can be a severe downside to new investments; and we hope policymakers have learned when and where regulation might be able to prevent future bubbles and how better to avoid future financial crises.

We believe that increased globalization and new technology have boosted both productivity and efficiency at revolutionary rates. Because we have been able to integrate these new technologies and new global opportunities so quickly and so seamlessly, we tend to overlook just how incredible they are. In just the last several years, technology has evolved tremendously to allow the "little guy" to compete with the "big guy". For example, the introduction of the iPhone has allowed many smaller companies to create applications and compete globally. Of course, we cannot ignore the negative impact productivity gains have had on our nation's workforce. Change is often difficult; retraining and redeploying American workers into new jobs at workplaces that are constantly evolving and becoming increasingly global will take time. The good news is that these changes have created new services and new industries and we have confidence that the creative human mind will, as it has done for centuries, continue to find new ways to improve our day-to-day lives and new, engaging work for our displaced workers.

We understand and acknowledge that we are living in troubling times, and that the world economy and the U.S. economy are suffering from the aftereffects of a massive global credit bubble. We accept that it likely will take some time to work through the effects of this credit bubble and that in the near term; the markets may continue to be volatile and scary. However, we also understand and appreciate that this financial crisis is not the world's first – and likely, not its last – credit bubble. We continue to have confidence that we will survive this crisis just as we have the many crises that preceded this one, and we continue to look for opportunities for our investors.

As we contemplate the current economic and market conditions, we see that the equity markets appear to be historically inexpensive on a variety of valuations. Despite the serious and ongoing disturbance in Europe, many public companies have nevertheless managed to post tremendous earnings. Many public companies are highly profitable, increasingly productive, and despite having made substantial capital investments, still holding large amounts of cash.

The markets can be buffeted by short-term noise and, to some degree, short-term randomness. The more you focus your attention on short-term returns and short-term market fluctuations, the more likely you are to experience periods of underperformance that leave you feeling anxious, insecure, and unsure how to proceed. No matter how well your portfolio may perform over the long term, at any given time, one or more of your individual money managers, separate accounts, or specific asset class is likely to be underperforming. If you focus on your individual accounts, money managers and asset classes, you are more likely to feel anxious and unhappy. Nervous investors are more likely to make the Big Mistakes that can impact their long-term financial goals.

The good news is that we believe there is a better way of looking at your investments that can lead to increased confidence and less worry. You can begin to change this negative mindset by understanding that you have built a substantial financial foundation and that you have sufficient resources to create a diversified portfolio that protects you against a wide variety of investment risks. Keep in mind that it does not matter if you beat the market, suffer a short-term decline in your portfolio, or even if you have the perfect investment strategy. What really matters is that you have a portfolio that is designed to give you the income you need in the short to medium term and the purchasing power you need over the long term.

If you feel nervous, try shifting your focus from the short-term noise to the long-term trends. When you stop imagining the worst-case scenarios about what *might* happen in Europe and instead consider the recent positive performance of American companies, do you feel more anxious or more confident?

If you would like more information or you would like to explore more of the tools we have developed to help you combat your financial anxieties so you can face your future with greater confidence, please contact your GV Advisor.

We wish you happy holidays and a prosperous new year.

Sincerely,

David Geller, *CEO*

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