



Current Environment – Investment Outlook for 2012

I have my suspicions that the New Year is going to bring some interesting dynamics to the stock market. I've attempted to address the Current Environment that we are in by discussing where we've been historically, why I continue to maintain a large cash position in my clients' portfolios, and where I think we're headed in 2012.

In my mind, 2008 drew a line in the sand. Everything before that – correlation of assets/how things worked – is completely irrelevant now. At this point, fundamentals are off the table. You may hear analysts on CNBC or Fox Business talk about how PE (Price to Earnings) ratios and profitability of companies are good. However, as we've seen the last few months, when the Federal Reserve or European Central Bank doesn't step in and do what the markets expect, profitability and/or PE ratios don't matter. Depending on the news, this causes both big sell-offs and melt-ups in the market, like we saw a few weeks ago.

We're seeing a lot of volatility to both the up and down side coming from what the Central Banks are, or are not, doing. At the same time, we're in the midst of a huge currency war. There has been devaluing of currencies across the globe (i.e., US Dollar, Swiss Franc, Japanese Yen, etc). The whole idea of devaluing a currency has to do with supporting exports. Devaluing makes sense to some degree for China and Japan, but a country like the US isn't export driven like it used to be. If you look at the percentage of GDP that exports account for, exports account for the smallest percent of GDP, behind imports and the US consumer economy in general.

So, how does this affect investors? Devaluing the dollar really doesn't help the average person. It actually punishes them because when you create too much money, you end up with price inflation in the end. What we're seeing is that when the US drives down the dollar, the currencies for the other countries follow suit, and it becomes a race to the bottom. The US has created more than \$2 trillion in the last 3 years, which is 2.5 times greater than what was created in the 200 years previous to 2008, which is as scary as it sounds. It's unprecedented, and we're seeing Europe being put in the same situation now to bail out their countries and banks. They're currently resisting the urge, but in the end, they're going to have to do it, which is going to cause price increases globally in things like energy and food, though not necessarily consumer items like computers.

Don't be fooled – the US dollar is exactly where the US presidency wants it because they think it's going to help US exports. The problem is that since we're not an export nation, we're throwing "savers" under the bus. Just ask any person who has money sitting in a savings account right now what type of interest rate they're getting. Inflation is running at a modest estimate 3%. However, it's closer to 6% when you look at how price inflation was calculated prior to the 1980's when the government started to manipulate how the data was put together through hedonics and substitutions.

In addition to inflation, interest rates have had a 25-year glide path down to 0%. There have been some points where rates have popped up. However, they've gone from a peak in the early 80's down to an absolute bottom, where they're at right now. There's been a very long period of time where bonds, regardless of what type (i.e., government, municipal, corporate) have all done very well. It's definitely been a bull market for bonds. The reason is because declining interest rates are very helpful for bonds. That is, until interest rates are at zero. While they can stay near zero for some time, they can't go any lower. What this means is the next 25



years will most likely be much different in terms of how you build a portfolio/allocate your money. The last thing anyone would want is to put a lot of money into bonds for a long period of time because going forward, as interest rates rise, the bond prices will go down due to their inverse relationship. Everyone has been taught that bonds are a safe/conservative investment. With rising rates on the horizon, the safe haven status of bonds just isn't there anymore. With interest rates this low, it would only take a 1% increase in rates to see a 7-10% decline in the value of a bond investment. Because of this, bond investing is going to be tricky and something that needs to be watched very closely.

You may have recently heard the term 'negative interest rates.' When interest rates are near zero, and you have inflation anywhere from 3-6%, you have what's called a negative interest rate; In other words, a negative return on your money. For example, if you put money in a bank account that is earning .01% on your savings, and inflation is running at 3%, you're upside down. The vice chair of the Federal Reserve, Janet Yellen, was quoted as saying if she could create negative interest rates, she would – and they did! They couldn't do it directly, but if you push rates low enough, and run inflation high enough, you get negative interest rates. Again, this is crushing to the people who have spent a lifetime saving money, because to save money, you have to give something up. In other words, if you're saving money for something in the future, you're giving up a current purchase. People that are retired, or nearing retirement, have spent a lifetime accumulating money and are now being treated to 30-year US Treasury bonds at 4-5%, or 10-year US Treasury notes that you're lucky to get 2% on. Since my clients' age is anywhere from 35-65, this is unprecedented in their lifetime.

The low interest rate environment is acting as a lifeline to the US banks because the banks can borrow at next-to-nothing, and can then turn around and make a small profit by buying US Treasuries. It also allows them to access money cheaply to run their business. However, if interest rates were left to rise naturally the way they should have by now, the big US banks would've gone bust; Europe is now experiencing the same problem. The fundamental problem here is that there are natural tendencies which are being pushed in the opposite direction. In 2008, when we had the big stock market drop and debt problems, the natural tendency would've been for deflation to happen so individuals and banks could get rid of their debt. However, the Fed doesn't want deflation because it's not good for the Fed, or treasury bonds, or borrowers. The Fed's only option was to loosen credit and to try and re-inflate the debt market. They've done their best to do this (QE1 & QE2), though it hasn't been very successful at this point. Could there be QE3 in 2012?

In light of all of this, where is the risk for investors in 2012? Prior to 2008, there had always been some extent of inflation risk and interest rate risk, but it had been at manageable levels. It became very apparent from the dotcom blowup that when we see a crisis in the stock market or economy, or both at the same time, the Fed will step in and lower interest rates to boost the economy. However, what we're experiencing now is the risk has been transferred from companies to countries. The PIIGS (Portugal, Italy, Ireland, Greece, Spain), as well as almost all of Europe, and even the US for that matter, have absorbed the bad debt of the banks/companies, which is why we're seeing countries all over the world being downgraded by S&P and Moody's. Risk now lies with countries, and countries control the currencies; now you have a country and currency problem. These are not good problems to have because they are at the top of the food chain. When you have problems at the top of the food chain, it trickles all the way down.



The glaring risk that comes from all of this is the loss of purchasing power. Purchasing power has been destroyed in the US by the Federal Reserve. From 1913 until now, the US dollar has lost 98% of its purchasing power; the last 2% doesn't mean much! The reality is that investors are looking to be able to preserve the purchasing power of their money going forward. Historically, one way to do this has been through precious metals because they're not a type of debt like the US dollar is. A dollar is a debt/note owed to the Federal Reserve. If you don't believe me, pull out a dollar bill and you'll see it says right at the top "Federal Reserve Note." The US owes the Federal Reserve something back for that dollar.

In the past, you could build a balanced portfolio with stocks and bonds and that would do the trick to maintain purchasing power. However, as I've already laid-out above, bonds are a very risky investment at this point, and you have to be extremely careful. I'm not saying you can't still invest in bonds – I'm just saying you have to be very aware of what kinds of bonds you're using, and how you use them in your portfolio. For the time being, a small amount of bonds in particular areas that are watched closely are not bad investments. You have to pay very close attention and monitor them because the volatility of bonds now equals the volatility of stocks.

The environment has changed. If we look at all the risks, to protect purchasing power, precious metal investing is the answer. Whether we continue in the current inflationary environment, or we go into a deflationary period, you can look at the history of the US and see precious metals have done well in either environment. A deflationary period example is The Great Depression, at which time gold and gold mining stocks both did well. An inflationary period example is the 70's, when again gold and gold mining stocks performed very well. So long as the political and economic environment remains status quo, precious metals are a good investment in my mind.

So what about investing in stocks? For now, everyone will be just fine until the next stock market crisis is upon us. However, the next crisis looks like it will be sooner than later. If it hadn't been for the Federal Reserve still having a few bullets left, we most likely would have already had the next crisis, last year. The benefit of stocks at this point is that they are healthier than countries. What that means is, the balance sheet of companies (Exxon, Proctor and Gamble, Coca Cola, Wal-Mart, etc.) are better than the balance sheet of countries (United States, France, Spain, Greece, Japan, etc.). I feel safer holding high-quality stocks than I would the debt or currency of foreign countries at this point.

Do you really want to go all-in with stocks at this point? Keep in mind you're always going to have ups and downs in the market. However, my answer is 'no' because I sense the next crisis is not far away. The next crisis could be a currency collapsing, problems in China, problems in Europe, or anything else that takes the stock market down further. If we look back at the dotcom crash, the economy came crashing down with the market, and unemployment started to rise. When that happened, the Fed used the tools they had available to lower interest rates to re-inflate the economy, and then real estate took off. However, we know what happened to real estate when the bubble burst in 2008.

What happens if Greece or Italy announces next week that they're leaving the Euro Zone? Banks all across the world are going to lose enormous amounts of money and you'll see another major crisis. So considering that we're sitting on a razor's edge in terms of risk – the markets could go either way (though the upside appears to be much more limited than the downside because of the debt and money printing going on) – going all-out into stocks at this point does not appear to be prudent. It's not all bad news as I do feel there will be a fantastic



opportunity in the not-too-distant future (i.e., next 12-months) to buy stocks cheap across all sectors, with the exception of maybe oil companies and gold miners.

I'm not trying to sound doom-and-gloom; I'm just being realistic in terms of the grave danger that exists in Europe right now. For the banks in Europe to raise capital, they need to either borrow money from the Central Banks (which the Central Banks said no to already), they need to issue more stock (but no one wants to buy it), or they can sell assets. I believe this is a large reason gold and silver have been under recent pressure. The European banks are selling anything they can to raise cash (stocks included), which I think is causing pressure to build, and why we'll continue to see more downward pressure in stocks. Once that threat breaks, it will be the time to come in with cash and buy-up undervalued stocks.

In conclusion, while I don't like sitting on cash in client portfolios, in the environment we're currently in, you're not safe anywhere else. Just like in 2008 when the stock market sold off, so also did the bond market and precious metals – everything went down. In my view, the likelihood of that happening again is fair since European banks need capital, and the way to raise capital is to sell assets. Because of these risks, I've kept a very conservative portfolio for all of my clients. I've maintained a large cash position because I know what to do; not because I don't. As a fiduciary to my clients, I'm being prudent and thoughtful in addressing the risks that we currently face. I'm not looking to address the risks that we faced 5 or 10 years ago. Those risks are gone, and we have a whole new set of risks that we have to address appropriately.

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