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SENIORS/BOOMERS NEWSLETTER

"THE RETIREMENT EXPERTS"

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IF YOU TORTURE THOSE POOR LITTLE STATISTICS LONG ENOUGH .....THEY'LL CONFESS TO ANYTHING

Every time I begin to get optimistic about the long-awaited recovery in the economy, something comes along to temper my enthusiasm. When I listen to the cheerleaders in Washington & on Wall Street tell me the economy is getting better, I say, I sure hope so…but is it? When the economists and the Treasury people declare an end to the recession, I say, please let it be so...but really? Have we actually been saved from global annihilation? Maybe yes, maybe no. Here are some of the recent 'feel good' reports that we've all heard or read.

In January it was reported that manufacturing activity climbed for the 6th straight month. The ISM index rose to 58.4 for the month – up from the 54.9 reading in December. That was the best clip going all the way back to August 2004. FANTASTIC!

According to the Commerce Department, Consumer Spending was up for the 3rd month in a row (0.2%... but Up is Up). Fourth Quarter GDP surged to 5.7%. The University of Michigan Consumer Sentiment index also hit a two year high of 74.4. Things must really be looking up.

After these uplifting pieces of good news, I received my monthly report from the American Institute of Economic Research showing that 10 of the 12 Primary Leading Indicators are positive and expanding. This would corroborate the statistics for the 4th quarter earnings season on Wall Street. 78% of the S&P 500 companies beat their earnings estimates. This must be the time to pull out our kaleidoscope sunglasses! Right?

But, hang on. Before we all jump on that bandwagon and grab some sheet music, perhaps we should look to see what lies on the other side of the piano. This is where Main Street meets Wall Street. I've always found it helpful to balance reports that are delivered by people on Prozac, with a little dose of reality.

I'm reminded of a joke about an old reprobate who said that he had been reading so much bad news about the effects of eating too much, drinking too much and smoking too much that he finally gave up …reading.

For those of you who know me, I spend about 80 hours a month reading financial material, and, in addition, I receive between 400-500 e-mails every day covering securities we own and industries we cover. I guess my problem is that I also *read too much.* Here's a look at what I've been reading lately.

First, let's examine the GDP number of 5.7%. Inventories, which were slashed to the bone as companies were trying desperately to cut costs in 2009, had to finally be replenished. This contributed 3.4% to the top line number. (This is not likely to be repeated any time soon). And, then we have government spending which probably accounted for a good chuck of the leftover 2.3% of GDP. For the calendar year of 2009, the U.S. economy actually shrank by 2.4% -- the worst since 1946.

The Conference Board, which is a private research group, reported that consumer confidence dropped 10 points in February from 56.5 to 46. I'm still not quite sure what happened between this group and their February report, and the University of Michigan January report. I guess statistics, like beauty, appear to be in the eye of the beholder.

According to numerous industrial reports, small business owners, which employ about 70% of workers in this country, say their number one concern is sales…they just don't have enough;

certainly, not enough to start hiring again. They have cut staff and other expenses; can't get money from the banks; are having a hard time collecting their receivables, and the American consumer has headed for the bomb shelter. Even those with money to spend, are afraid to spend it.

So, here we have a bit of a dilemma. Small businesses are in a contraction mode (70% of our employment) and consumers are unwilling or unable to spend (67% of consumption). What's not to like about this recovery? Let's say, that for now, I'm not quite ready to bet the farm on this economic turnaround.

In fact I would go one step further, *and go way out on a limb here*, and say that we are never going to see a meaningful economic upturn or recovery until people have jobs to go to and money to spend.

Another very interesting statistic came out in January. The U.S. economy shed 20,000 jobs for the month and…the unemployment rate **fell** from 10.1% to 9.7%. Can you hear those poor little government statistics confessing again? This comes hot on the heels of a revision by the Bureau of Labor Statistics where they report an additional 1.2 million extra souls lost their jobs since the recession began. So the job losses aren't the 7.2 million we thought, but actually 8.4 million, and still counting.

Oh, and thank goodness government statistics don't count the people who have stopped looking for jobs (because they are so depressed & discouraged), and those coming off 3rd Tier Emergency Benefits which have now been exhausted and, those folks who were never employed in the first place – entrepreneurs – well, again thank goodness they all don't count…that'll keep the score down. Now we know how easy it is to get unemployment rates to fall. With this kind of magic, at some point we'll be back to full employment with 30 million Americans prematurely and permanently retired.

You can see how pliable statistics can be. Here's another example. A recent government press release said that our politicians have either created or saved several million jobs in 2009. Don't they realize that people can get fired for drinking so heavily on the job? Are they that much out of touch? Oh well, November is just around the corner and we'll get a chance to explain some grass roots reality in terms they can understand.

Every time I read another jobs report, I get depressed. 182,000 people were part of, what the government calls, 'mass layoffs' in the month of January. A Gallup Poll the same month came up with a real unemployment figure of 19.9%. This is very close to the shadow figure of 21.2% compiled by John Williams of Shadow Government Statistics.

The banking front is not looking much better either. There have already been more than 20 banks fail so far this year. The FDIC has **702 banks** on its troubled list. And, did I mention that the FDIC is broke…flat broke! In fact, it was $20.9 billion in the red during the 4th quarter of 2009. They are now in the process of collecting "3 years" worth of advance payments from its member banks, approximately $45 billion. That may be enough to get them through another year. Then what? Another ward of the state?!?

It used to be that government's role was to encourage business, support the markets and promote profitable investing. Today, they seem to be **the** business, **the** market and **the** investments.

Housing & real estate are still not showing any real signs of a recovery and the U.S. government has basically taken over the mortgage market. According to the Wall Street Journal, Fannie Mae & Freddie Mac (both owned by the Treasury) and the Federal Housing Administration now back nearly 9 out of 10 mortgages in the country.

• Sales of new U.S. homes built in January plunged 11.2% to an annualized rate of 309,000 homes. That's the lowest rate on record dating back to 1963 when our population was 2/3rd of what it is today.

• 6.5 million home borrowers are in serious delinquency or foreclosure. That's nearly double the number of homes in America's MLS system.

• The percentage of loans that are behind at least one payment is at 15.2%. That's the highest since records began in 1972.

• As of the 4th quarter 2009, there were an estimated 11.3 million homes that were upside down on their mortgages. That represents 24% of all residential mortgages in the United States.

• Reuters reports that more U.S. consumers are paying credit cards before mortgages. Could it be

that they consider eating more important, and need their credit cards to do that…or why pay down a mortgage on a house worth less than they owe?

- A report released by the Congressional Oversight Panel forecasts _losses of up to $300 billion_ for banks holding commercial loans. Elizabeth Warren, the head of the oversight panel, warns that the 3000 small banks across the country doing commercial lending "are about to get hit by a tidal wave of commercial-loan failures.

Then, we come to government spending. Heaven help our children. Our Washington elite have O.K.ed a new debt ceiling which will allow the government to spend over $14 trillion dollars of money they (we) don't have. Between the Federal deficit of $1.4 trillion and the $2.6 trillion of U.S. Treasuries which mature this year (and have to be borrowed all over again), we'll see $4 trillion of government re-financing in 2010.

Who is going to buy all that debt at interest rates of 3.68% for 10 year notes? In 2006, China lent the U.S. 47.4% of all the money our government borrowed. That number is now down to 4.6%. As I've written before, even if the Fed keeps short term interest rates near zero, the International market is going to drive rates higher. Inflation is on the way!

In an ABC news story, former U.S. Comptroller General David Walker stated that within the next 12 years, the largest line item in the federal budget will be **interest payments on our national debt!!!** He went on to say, "Irresponsibly spending someone else's money when they're too young to vote or not yet born is immoral".

Have they been spending it prudently? You be the judge. The 2009 American Recovery & Reinvestment Act (ARRA) just celebrated its one year anniversary. Of the $862 billion authorized under the Act, $200 billion (23%) was spent in 2009. The Congressional Budget Office recently explained that five programs accounted for more than 80% of these outlays: Medicaid, Unemployment compensation; Social Security; grants to local/state governments; and student aid. This, in my humble opinion, does not look like stimulus for job creation. This was nothing more than a stimulus to *government transfer payments.*

Amidst this smoke & mirrors charade, how did Congress spend our other money? Jim McTague, in a recent Barron's newspaper article said it best. "while businesses were laying off workers and slashing expenses; when households were penny pinching to keep food on the table; when charities were being overwhelmed by pleas for bread and shelter…**the legislative branch raised outlays for itself by 10%"**. So here we have a case where our Washington representatives felt that the recession was meant for us, the little people…not them.

This is a lot of shaky news to absorb, but I still believe there's money to be made in the market …if it's done properly.

WHAT TO DO NOW?

1) **Stay away from Treasuries.**
2) **Stay away from Real Estate Investment Trusts (REIT's)…although I do have one Buy I'm recommending.**
3) **Stay away from the banks.**
4) **Stay away from bond funds (more on this to follow).**
5) **Buy companies with little or no debt and don't pay too much for them. Remember a P/E of 10 means that it will take ten years to get back your original investment. A P/E of 50 means….**
6) **Stock up on 'safe dividend' paying stocks.**
7) **Focus on cash in companies, not earnings. There is still some financial magic going on in many boardrooms when reporting profits. Cash on a company's balance sheet, however, doesn't lie.**
8) **Focus on trends: Examples,**
   - China's economy is expanding rapidly and they are creating an enormous middle-class & doing a tremendous amount of buying across many spectrums in the process. So, buy what China is buying.
   - Obama is pushing for more nuclear.
   - 70% of prescriptions were filled with generic drugs in 2009.
9) **Diversify across asset classes.**
10) **Diversify within those classes.**
11) **If you're thinking about what you should do with current holdings, ask**

☺ Would you buy it again now?
☺ Is it fully valued or is there more upside?
☺ If it has more upside, how much more?
☺ Is its industry in an uptrend or downtrend?
☺ Are the original reasons for buying still valid?

☺ Can you find something better to buy?
☺ How would you feel if it dropped 10%, or more?

MISCELLANY

• Boston College is offering a free guide on how to take Social Security benefits. You can download a copy at http://crr.bc.edu/social_security_guide.

• Are you looking for information regarding opportunities of volunteering for seniors? Go to www.getinvolved.gov

• You can find thousands of forms from the IRS, Social Security and other Federal agencies. Go to www.forms.gov

• Looking for product manuals on line? You can find over 100,000 manuals for downloading at www.retrevo.com/samples/index.html

• The Eldercare Locator offers help and tips on how to save money on prescription drugs at www.eldercare.gov

• State Treasuries are holding nearly $33 billion in unclaimed assets. Do you own some? Find out… www.missingmoney.com

• Don't forget that if you bought a new vehicle in 2009 between February 17 and December 31 you are eligible to deduct the state sales tax from your tax return.

• In 2010 you and your spouse are able to give away $13000 worth of assets as gifts to any number of recipients.

AVOID LOSING MONEY IN BONDS

I have written on several occasions that certain bonds, and bond funds, could be hazardous to your portfolio. I have received quite a few questions about this. So, I decided to explain this in more detail this month.

Most investors have been shell-shocked and whipsawed by the stock market over the past 18 months. The result of this has been massive inflows into bonds where money is considered ultra safe. In fact, last year alone, investors piled almost $400 billion into bond funds. But, unfortunately, they're not as safe as one would think.

Let's begin with some bond basics in the simplest form:

Most bonds are issued at a 'par rate' of 100 with a coupon which pays a specified yield…usually on a quarterly basis. Example: a 6% coupon yield would pay 1.5% four times a year.

Although bonds are usually quoted at a par rate of 100, bonds sell for $1000/bond. So a 6% yield on a bond would pay you $60/year, usually over 4 payments of $15/quarter.

Bond prices & yields work in inverse order. In other words, if yields go up, prices must come down.

The reason for that is once a bond is issued, the coupon interest rate is fixed. In other words, if you buy a bond with a 6% coupon, it will always pay you $60/year for the life of the bond.

Let's say that interest rates are rising, and the bank is now willing to pay 6% interest on a certificate of deposit. No one is going to pay you a par rate to get a 6% yield when they could do so risk free at the bank. Therefore, if you wanted to sell your bond, you would have to discount the par rate of 100…perhaps down to 95 in order to have someone willing to buy it.

Now, here's where it gets a little tricky and gets people a little mixed up. If you sell your bond at a value of 95, and it still yields $60/year, the yield now goes from 6% to 6.3%. Remember 95 represents $950. So, if you get $60 on a $950 investment you divide $60 by $950 to determine your current yield=6.3%.

Conversely, let's say that the bank is now only paying 1% on your C.D. Investors will usually pay you more than par 100, in order to get such an attractive yield of 6%. So, here's the example.

Let's say that an investor is willing to pay you 105 of par. Now, the bond is being sold for $1050 and still getting the same $60/year as when it was issued. So the yield is determined by dividing $60 by $1050, which is = 5.7%. It may not be 6% but it's a heck of a lot better than what the investor could get at the bank…which is why he'd pay more than par in the first place. The price went up and the yield came down, but he's still ahead.

So, now you know why yield and price work in inverse order. I think it must be physics!?!

There are several other **COMPONENTS** that you need to be aware of when it comes to buying & selling bonds.

- Issuer
- Maturity
- Duration (not the same as maturity)
- Ratings
- Coupon
- Yield
- Price

Next, there are 7 different types of **RISK**.

⊗**Inflation**. High inflation=bonds worth less.
⊗**Interest rates** High current rates=bonds worth less
⊗**Default**. Company defaults = bonds worth 0.
⊗**Downgrades.** Company downgrade = price falls.
⊗**Liquidity.** Low market volume = harder to sell.
⊗**Reinvestment.** Called bonds = lower interest rate.
⊗**Rip-Off.** Heading into the secondary market alone.

O.K. it's time to set up the scene. Between now and the end of 2010 the government has to borrow $4 trillion to refinance **Treasuries** and, to fund the **budget deficit**. Massive bond supplies may outstrip demand which means rates must rise in order to induce buyers to buy.

Tax revenues are down for more than the just the Federal government. How about State, County & Cities? They are also suffering from drastically reduced taxes coming into their coffers. (Unemployed people not paying taxes will do that to you). The states will have to add to the bond supply to pay their bills by issuing, you guessed it, more **Munis.**

Due to the fact that banks are still not lending, corporations are having to go into the bond market to finance their needs for growth or liquidity. We can expect a flood of **Corporates** this year & next.

The same situation applies to companies with low credit ratings. The only place they can expect to raise money will be in the bond market**. Junk** bonds will get junkier as interest rates rise and they will be forced to issue their bonds with even higher coupon rates.

Finally, when interest rates are at 0 (where they currently sit) they have nowhere to go but **UP!** Remember what happens when interest rates rise?

So, let's look at the 5 main bond classes:

TREASURIES

When I look out in both the Treasury and Government Agency markets I do not see prices quoted at par '100', but upwards of 106-108. When you calculate the yield to maturity on many of these bonds you will discover that they are either 0 or negative. Unbelievable!

We are lending the government money for free. The shoe drops however, when (not if…but when) rates rise. Remember interest rates of 0 can only go up! Prices, then, are going to fall through the floor. So, unless you are prepared to hold these bonds till full maturity, at tiny rates of return, this may not be the place to park your money.

MUNIS

Do you ever question the safety of Municipal Bonds? If not, you Must. States & Municipalities across the county are NOT making end meets. And, to make matters worse, the Federal Reserve won't give them a printing press like the one they have in Washington. So, those poor souls have to make due the old fashioned way. Cut expenses or keep spending until you go bankrupt.

Today, the states have about a $200 billion shortfall projected for 2010. And, another $150 billion coming in 2011. (This is provided nothing gets worse). These same states also have a $1 trillion funding gap on their state pension plans and other worker obligations. Harrisburg, PA is actually looking into an obscure part of the bankruptcy laws which gives municipalities creditor protection, called Chapter 9. Other states are leveraging their highest grade portfolios 20% in an effort to juice returns.

Over the last two years, $14.5 billion of Munis went bust…leaving their bond holders with 'zip'. Based on today's prognosis, we may see a lot more. The only quasi-safe Muni out there is one which is pre-refunded. Even then, the issuer may be forced to dip into the reserve to make interest payments. Also, they pay a miniscule yield and will fall in price as interest rates rise.

INVESTMENT GRADE CORPORATES

Investment grade bonds carry a rating of BBB up to AAA. Their default rate has historically been less than 1%. For that reason they can generally borrow money by issuing bonds and pay a reasonable rate (coupon).

In this low interest rate environment, bond prices can only go lower as interest rates rise. Aside credit quality, one of the other biggest factors affecting why bonds rise or fall, is their maturity.

For example, an investment grade bond maturing in 2012 will be less affected by rising interest rates than would be for a bond maturing in 2020. Let's face it, if current interest rates rose to 6% and, you were sitting on a bond with a coupon of 6%...for ten more years, why would anyone buy your bond? They would only if rates were falling, not rising. Therefore to make the sale, you really have to drop your price to make it worth their while.

Another factor here with Corporates is, once again, heavy supply. Because the banks are afraid to lend, more and more companies are being forced into the bond market to raise their needed capital. More supply will mean higher coupon rates to entice investors. Bonds with lower yields are going to get crushed. Tread ***very carefully.***

JUNK BONDS

Junk bonds are rated BB down to D. A rating of BB is considered speculative and a D rating is for a company already in default. The default rate is much higher for junk bonds than all other classes of bonds. As of December 2009, it was at 13.9% in the U.S.

The only way these companies can float a bond issue is by offering very high rates of return (coupons). That means that they borrow money at 10%, or perhaps even higher. That puts a great strain on the firm's financials…which are already considered weak to begin with (ergo, their junk bond status).

A rise in interest rates just worsens the financial burden for these companies. Then you also have the risk of a ratings downgrade. Frequently that's enough to put them in default. One default is often enough to put your portfolio in arrears. If you had 10 bonds at $10000 each, and your yield was 12%, and one defaulted, you basically break even for the year. Two defaults will put you under water.

BOND FUNDS

When buying funds, most investors look at past returns. There's a reason the main disclaimer for mutual funds is, "*past performance is no guarantee of future results.*" An average of 90% of mutual funds underperforms their benchmark.

Bond funds have a lot of money they **need** to invest, which means they need to go further out on the maturity spectrum in order to buy yield. When I look inside these funds I generally find a hodge-podge of bonds ranging in maturity from one year to twenty years. Once again…if rates rise, these things drop like a stone. Unless you're prepared to really examine the fund's portfolio, tread cautiously.

Just look back to 2008.

If you would like free information on any of the subjects discussed in this month's newsletter, please complete the enclosed reply coupon or call my office for a free consultation.

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