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Investor Alert!

Is a Recession on the Horizon?

By: Stephen R. Arnold, Financial Planner

If you believe the Consumer Confidence Index, which in June fell for the sixth consecutive month to it's fifth lowest rating ever, then a recession is likely lurking in the shadows. In a May report of economists from the National Association of Business Economics, 56% of the respondents believed the economy was either already in a recession or that it would be by year end – a significant upward trend from 10% of respondents in January and 30% in March.

Federal Reserve Chairman Ben Bernanke has spent much of the last year staunchly defending the U.S. economy, but under pressure from lawmakers, Bernanke finally acknowledged what too many of us already knew. In congressional testimony in early April, Chairman Bernanke said, "a recession is possible." Now, several months later, after a series of rate cuts by the Federal Reserve and congressional passage of an economic stimulus package, little has changed relative to economic growth. In May, the economy eeked out a meager 1% annualized growth. With the vast majority of economic stimulus checks already spent, that weak growth is likely to become negative growth over the next few months.

Now, the Fed finds itself in yet another crisis – this time fighting inflationary conditions brought on by soaring energy and food prices. The predicament facing the Fed is that a war on inflation will almost certainly have an unintended casualty – economic growth. With the economy already teetering on the brink of contraction, fighting inflation could easily lead to or worsen a recession. Thus, the Fed finds itself between a rock and a hard place. Which will it fight? It would appear, based on the Fed's recent language and policy-making, that it will elect to take on inflation. That will come as a relief to many Americans who are struggling to pay for needed food and fuel, but a worsening of economic growth and stock market volatility could be at stake. We certainly live in volatile times. With every release of new economic data, comes a greater degree of uncertainty in our markets. What factors are behind the pessimism? Let's look at a few of the culprits.

ENERGY PRICES: The most obvious factor to anyone pumping gas in the last 12 months is fuel prices, which are up 33% since February – an increase of 79% annualized. The astounding rate of inflation in fuel prices is contributing heavily to inflationary concerns, and not just at the pump. Even in a slow retail sales environment, manufacturers and retailers are being forced to raise prices on their goods and services in order to recoup increased costs associated with transportation and manufacturing. Adding fuel to the fire, consumers, being faced with these soaring fuel costs, are slowing discretionary spending. Let's face it. Does anyone expect to see $3.00 a gallon gas again?

FOOD AND BEVERAGE PRICES: The energy sector, through the government-mandated shift toward bio-fuels, is also having an adverse effect on food and beverage prices. Increased production of Ethanol is depleting supplies of agricultural products, thus driving up the price of grocery items. And, food and beverage prices, already up 5% since 2007, are sure to climb even higher as a result of Ethanol production, draught conditions in some farming regions, and in response to the recent flooding of the farm-saturated mid-west.

REAL ESTATE: The Wall Street Journal recently opined that inflation is only being held in-check by plummeting home prices – not a good thing when so much of our nation's wealth is tied up in home equity. A May report released by the U.S. Department of Commerce shows new housing starts fell to their lowest levels since 1991. The latest Standard & Poors/Case-Shiller home price index is reporting that home prices are falling at the fastest pace on record – in some areas by 30% or more. In addition, tighter credit restrictions have resulted in fewer eligible buyers and a record-setting

supply of homes for sale. As of April, foreclosures were up 65% over last year. This dramatic increase in foreclosures, coupled with tighter credit restrictions, and an excess supply of homes, is responsible for the downward pressure on home prices. Of course, the driving force behind the increase in foreclosures has been the much-discussed sub-prime debacle, which has also punished financial stocks, bond funds and the bond markets. Why bonds? Most sub-prime mortgages were funded by the issuance of mortgage-backed bonds, which now account for the single largest sector of the bond market. With many of those mortgages now in default, the bonds backing them are now decreasing in value.

UNEMPLOYMENT: According to government statistics, payrolls have fallen every month since December. Unemployment rates now hover around 5.50%, but many economists project that number to 6.00% or more by early 2009. As evidence in support of those projections, one-third of top U.S. CEO's say they expect to cut payrolls in the next few months. They cited sluggish sales, increased operating expenses and increasing inventories among the reasons for their cutbacks. If the unemployment numbers continue to erode, the Fed will find it difficult to implement the rate increases needed to fight inflation, which could result in consumer price increases at levels not seen since the late 1970's. As a side note, the Federal Reserve has never raised rates while unemployment rates were climbing.

HEALTH CARE COSTS: Health care costs are up almost 9% for 2008, a staggering increase from 6.9% last year. A recent report released by PriceWaterhouseCooper (PWC) suggests that health care costs will jump by 10% in 2009. The PWC report also revealed that since the 1960's, the biggest leaps in the percentage of GDP allocated to health care always happen during or leading up to a recession. Additionally, as unemployment grows, we can expect exponential increases in the numbers of uninsureds, thereby raising health care costs across the board. Politics will also play a role in the costs of health care in the coming years. With a presidential election at hand, its anyone's guess where our health care system is headed and what impact that will have on prices.

THE MARKETS: Bank CD rates are at historic lows – most with negative real rates of return after taxes and inflation. Meanwhile, some market experts predict the S&P 500 will fall by 20% or more within the next few months. The Dow, S&P 500 and NASDAQ are already down more than 13% since their October 2007 peaks. Another phenomenom could also take place in the coming months. Historically, bonds have always carried the day when stocks prices have suffered. Bonds, however, are already under attack due to the sub-prime debacle. As foreclosures increase and home prices fall, expect bond prices to suffer. It is entirely likely both equity and debt securities will suffer in the coming months. Of course, as investors grow increasingly more pessimistic regarding the economic outlook, we should expect an increasing volume of sell orders in the markets, probably resulting in depressed stock prices.

SPEAKING OF DEPRESSION… Are you depressed yet? I certainly am! Even so, investors who educate themselves, obtain sound professional advice and make well-informed decisions should have no reason to panic.

WHAT TO DO… For instance, those in or near their retirement years should take an objective look at their investment portfolios to determine if they are sufficiently recession-proof. Those same investors should also decide whether or not they can afford to take losses. If not, then allocating investment portfolios toward more conservative strategies should be the order of the day. For some, locking in guarantees may be appropriate. Others may need some degree of growth, but cannot afford to realize losses. Yet others may only need to re-allocate their portfolio in order to make it more recession-friendly. Some who have been conservative investors in bank CD's and government bonds may need to consider some safe money options that will allow them to beat inflation and maintain their purchasing power.

Regardless of your situation, *there are solutions to fit your needs*. If you would like to discuss your situation, Storehouse Advisory Group offers a free, no-obligation consultation to discuss your concerns. Just call **(865) 850-6529** to schedule your in-home appointment.

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Advisory Group
Faith. Family. Finances.

12501 Coral Reef Circle
Knoxville, TN 37922
Ph. (865) 850-6529
Email: steve@storehouseadvisors.com