

Planning & Investment News

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WHERE WE ARE...

Unfortunately we do not have much more clarity on this market than the last time we sent out a newsletter. With the S&P down approximately 40% since September 15 (the day the world changed with the failure of Lehman Brothers and implosion of AIG), one would think the market could not go much lower. However the market continues to show us how low “low” can be.

It is becoming more and more apparent that businesses, individuals, and yes Wall Street, incurred too much leverage (i.e. debt) over the last thirty years. We are in the painful process of “deleveraging”. Past deleveraging “events”, for example the 1990’s for Japan, have been protracted events. No one knows what the current crisis will eventually look like – whether we are in a recession or depression. As Bill Gross, manager of PIMCO’s Total Return Fund recently stated:

Recessions are cyclical downturns of a relatively brief time frame, characterized by inventory corrections and addressed by low interest rates and mild doses of fiscal stimulus. Depressions are more extreme with double-digit levels of unemployment but defined more importantly by credit contraction and debt liquidation. The deflation that normally accompanies a depression is dangerous not because prices are going down, but because the “for sale” sign goes up on the credit markets which have always made capitalism possible. At the moment, you policymakers are attempting to prevent that. We shall see.¹

Our government is taking unprecedented steps to avert a depression, but this crisis has developed fast as further explained by Gross:

Trillions of dollars of credit have been sucked out of the financial system over the past 12 months. Banks may be lending but the larger shadow banking system is not. All of those SIVs and credit default swaps that once generated credit are now contracting and pulling the real economy down with them. Think of it this way: If you had three or four pints of blood drained from your body you’d be on life support, very quickly. Same thing now. The solution is for government spending to simulate a transfusion of whole blood, plasma, or whatever’s available.²

Nobody knows what a “worst case scenario” would look like, but again Gross provides some enlightenment:

If the government cannot substitute credit to the same extent that it is disappearing from the private system, then the U.S. and global economies will retreat. If the economy is viewed as a bathtub filled with water (credit) at two different times with two different levels, then draining it back down to the lower first level might reduce economic activity proportionately. Liquidate debt (credit) to 2003 totals and you just might reduce economic activity (GDP) to 2003 numbers as well. Whoops! That would mean a 10%+ contraction in the economy with unemployment approaching the teens. Keep that bathtub full!³

Two ways of looking at this market are in reference to the effectiveness of the government stimulus packages. One group, the pessimists, do not see the various intervention efforts having much effect. The more optimistic group claim the power of the U.S. Government and the resiliency of our capital system will ultimately return the markets to a more “normal” status. Bill Gross and PIMCO are more aligned with this optimistic group.

If the “pessimists” turn out to be correct, we will at best “muddle through” for the near term with the threat of deflation. Deflation means the purchasing price of a dollar is increasing (the opposite of inflation). As prices drop, purchases are delayed due to this expected price drop, dropping consumer demand, dropping production, causing additional lay-offs, and further reducing consumer demand due to loss of jobs. It is a dangerous cycle.

The optimistic group feel that inflation is more of a concern as the government floods the system with funds to take the place of the now gone shadow banking system (as described above by Gross). Mild inflation is a best case scenario for everybody. The government has to walk a fine line to provide just enough capital to reignite the economy without overdoing it. The general consensus is that the threat of inflation for the near term is minimal. If government actions and the natural strength of our capitalist system are powerful enough, the stock market could rebound nicely and sharply.

We have attempted to structure portfolios with both scenarios in mind, but with a conservative emphasis on the pessimistic scenario. At times we feel like we have one foot on the dock and the other in a boat that is slowing drifting away! These are challenging times. We remain committed to vigilance as we navigate this difficult period. Please do not hesitate to contact us at any time to discuss your portfolio and its position relative to changing conditions.

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¹ “Hairy Lips Sink Ships” *Bill Gross’s Investment Outlook* (03/01/09)

² Ibid.

³ Ibid.