



The Missing Silver Bullet

We are a nation that likes to rapidly resolve problems and then move on; however, sometimes we face a complex crisis that cannot be resolved easily or quickly.

Over the past nine months we have seen the government and the Federal Reserve deliver several supposed balms for what ails us, and yet the world's markets are all continuing their ongoing malaise. In fact, it seems that the more the government says and does, the worse the stock market behaves. Given the pending passage and implementation of a new financial recovery plan, we thought we would provide an overview of the two major economic challenges facing the nation (fixing the financial system and stimulating the economy) and assess potential consequences for investors.

Fixing the broken banking system

Job one for new Treasury Secretary, Tim Geithner, is to find a way to stabilize our banks and insurance companies. We have already seen over one trillion dollars in bad debts absorbed by the system, for which half of our TARP money (about \$350 billion) has gone to support.

The challenge is that we still have somewhere between \$1 trillion to \$2 trillion in bad loans to absorb, according to some estimates. Unfortunately, after massive declines in their stock prices, the banks themselves no longer have the capital base to allow for further writedowns of this magnitude. Therefore, there is now a choice for the Government to either take over the banks or buy out the bad debt from them. There is now a real possibility that **a large part of our banking system will need to be nationalized.** While our government might stop short of taking over the banks due to political fallout, we still may do so functionally, much as we did with the world's largest insurance company American International Group (AIG). American taxpayers have already pumped well over \$150 billion toward the support of AIG.

The other option is to create a market for the bad loans and take them off the balance sheets of financial institutions. Our government might have to massively increase the TARP program if they take this path.

As the government weighs the pros and cons of each strategy, investors' patience is being sorely tested. The stock market hates indecision and is probably pricing in an outcome that is worse than either alternative.

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Stimulating the economy

President Obama has pushed to pass an initial \$750 billion stimulus package to reflate the economy. While many expected a plan of this size, investors have shown concern that the stimulus package will not provide the kind of economic lift that had been anticipated, as too little of the plan goes toward high impact government spending.

There are three major components to the plan. Below, we discuss each component, along with the expected impact on the economy. With each, we look at the potential "multiplier effect"; referring to the number of times a dollar in stimulus is circulated, providing a "boost" to the economy.

1. **Tax breaks for individuals and families.** This makes up as much as 40% of the plan. While we are looking at anywhere from \$400 to \$800 in tax breaks for the majority of American families, this money will have very little benefit, in a stimulus sense, since most Americans are saving more now than we have in decades. **Our savings rate as a nation has surged to over 3% in the past few months, a level not seen for many years.** This means that we are taking our savings and placing them in the bank, and the banks are not lending this money out because of their current precarious situation. We already had a tax refund stimulus last year and an added benefit from the collapse in oil prices, both of which had a very muted response in our economy. Unlike the shallow recession following 9/11, **the consumer is too concerned about the future to spend the money they manage to save.** Therefore this stimulus has a very small multiplier effect, for every dollar the government returns we might only get a 70 cent offset in stimulus.
2. **Infrastructure spending.** About \$150 billion is being spent on building roads, buildings, etc. Done prudently, this should have the highest multiplier effect, because nothing impacts our economy like new jobs. If these projects are carefully selected we should see many new jobs created. Those hired then rent homes, buy cars and stimulate whole regions and sectors of the economy. Unfortunately, Washington is back to its old tricks and this part of the package was smaller than many had hoped and includes several pork barrel projects that do not create jobs. Late last year, China approved over half a trillion dollars in spending on infrastructure alone and their market has held up quite well in comparison to the United States. China has focused on job creation as the singular focus of its stimulus, and their investors are reaping the rewards.
3. **Economic hardship support (largely State and homeowner support).** Several states, especially California, have gaping budget deficits and are receiving billions of dollars in Federal aid to maintain services and jobs. Also, a significant amount of the money is earmarked to help struggling homeowners (including a firsttime homebuyer tax credit). These are probably the least effective in stimulating, because all they are intended

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to do is to lessen the impact of the recession. To illustrate the limitations of this, California's budget shortfall of over \$40 billion will be reduced with government support of over \$10 billion; however, the gap is still so wide that state benefits will still be reduced and taxes will almost certainly increase, offsetting the entire federal stimulus tax break in the state.

First and foremost, we should remember that all of this new spending by the government will help to soften the slow down and accelerate the recovery. The potential relative effectiveness of the plan will not change the fact that we are going to spend a lot to reinvigorate the economy and it will have an impact, though perhaps not as much as it could have.

What's an investor to do?

The market is weak because **of the banking mess. Until clearly resolved, everything else takes second place.** Investors want to know whether we are going to nationalize the banks or buy out the bad debt, in the meantime we have a period of painful meandering. The market (as measured by the Dow Jones Industrial Average) is back to the lows reached last November, however, that is not the case for many individual stocks.

In the long term, the amount of money we are pumping into the system to offset the loss in debt circulating in the economy is simply staggering. However, without banks lending money, the impact of the stimulus is muted.

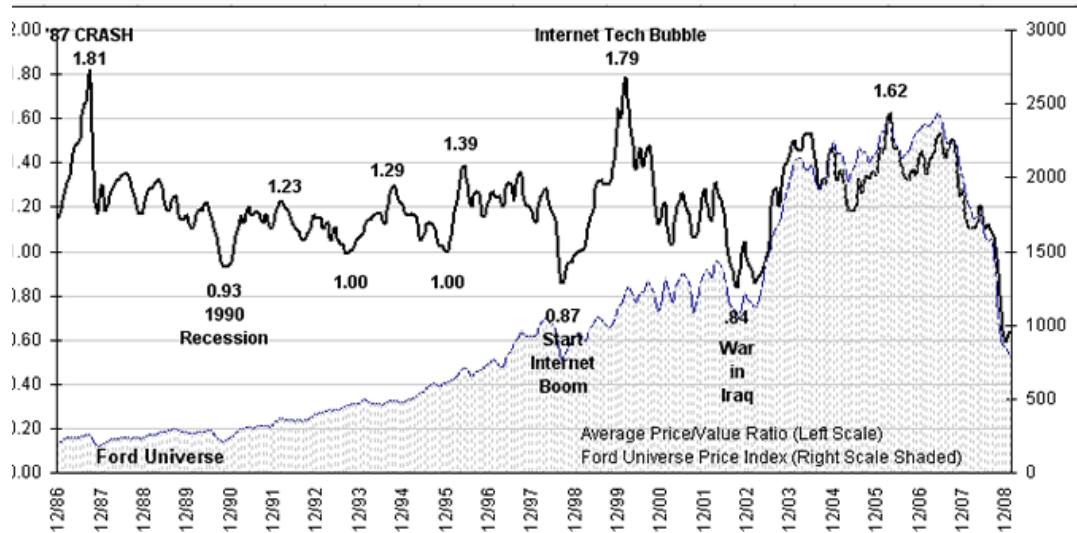
In the meantime investors would do well to position their portfolio to avoid the major blowups occurring every day, by minimizing exposure to financial stocks and by making subtle shifts to their portfolio. There are some very important subtle improvements occurring in the markets.

Not out the woods yet, but there is a clearing

The credit markets have stabilized significantly. **Fixed Income, especially corporate and municipal bonds, have been behaving quite well in the past few months.** The good news is that, since late last year, we have added corporate debt in many of the portfolios where we have discretion, and we continue to find this part of the market most interesting right now. While it's important that every portfolio be well diversified, yields are very attractive for corporate debt.

Even within the stock market there are interesting things occurring. Rather than the indiscriminate selling which occurred last fall, we are seeing clear winners and losers. **Large-Cap and Mid-Cap growth companies are performing very well this year, the NASDAQ was actually positive for the year going into last week, and several emerging markets have been behaving very well too.** Where we have discretion, we have been tilting toward Large-Cap and Mid-Cap Growth companies and are looking at select Emerging Markets.

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Over the last 33 years, stocks have never been cheaper, according to Ford Equity Research, a respected resource of market data. The Ford graph (above) is comprised of an equal weighted universe of roughly 4,500 stocks depicting the price to the intrinsic value of the stock market universe. As of Friday, February 13th, the price to the intrinsic value of the stock market was 0.64, meaning for every \$1 of value, you are paying 64 cents. This is an unusual time, but eventually valuations return to the mean (in both directions), which suggests that over time stocks should eventually appreciate.

The development of a discerning market, a period where not everything is sold and buyers begin investing in select opportunities, is a very encouraging sign that perhaps we are approaching the final trough in this particular bear market and dreadful market crash. With that in mind, it should be remembered that even with big bear markets, like the historic one we have experienced, you should not simply rollover and die. There will be no silver bullet, simply a slow, gradual mending that leads to a real lasting recovery. A large portion of the recovery occurs in the first twelve months after the market bottoms. **In fact, according to our research, over the preceding six bear markets, the market has increased in value by more than 36.5% twelve months after a market bottom.**

As you know we are a different kind of wealth counseling firm, because we not only have our own investment folks, but we also partner with other managers at some of the most respected firms in the country. **Over this past year, our firm has been hard at work developing unique investment solutions that your adviser has access to.** These services are in place to take into account the unique nature of the markets and provide shelter from the storm. Your adviser can help determine whether some fine tuning of your portfolio may make sense given what we are experiencing.

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A time for personal adjustments

This decline will perhaps require meaningful adjustments for you and your family to assure that your family's financial goals are still on track. **The worst thing you can do is simply ignore how this market decline may have affected you.** If you have not yet completed a Financial Control Scorecard® with your adviser, we urge you to do so. This will help you to determine how this decline might affect your personal situation and ensure that you stay invested in a way that keeps you comfortable. Please know that we are all overseeing your portfolio throughout this challenging time.

Thank you for your trust and confidence,

Joe Duran, CFA®

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