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09/05/2013	Value	YTD %
Dow Jones Industrial Avg	14,937	14%
Vanguard 500 Index	153.13	17.6%
Vanguard Total Bond Index	10.47	-3.9%

SEPTEMBER 9, 2013

FIVE YEARS LATER

Today marks the anniversary of the financial panic of 2008. Our expectations of a slow, tentative, yet genuine recovery are being fulfilled.

As you can see in **GRAPH 1**, the financial markets have performed according to classic investment theory. Bonds have kept people rich, but haven't grown, while stocks have inevitably, yet fitfully, recovered from their massive losses in 2008. In hindsight, late 2008 and early 2009 were great times to buy stock mutual funds.

We now find ourselves looking at economic data which is somewhat similar to that of 2007.

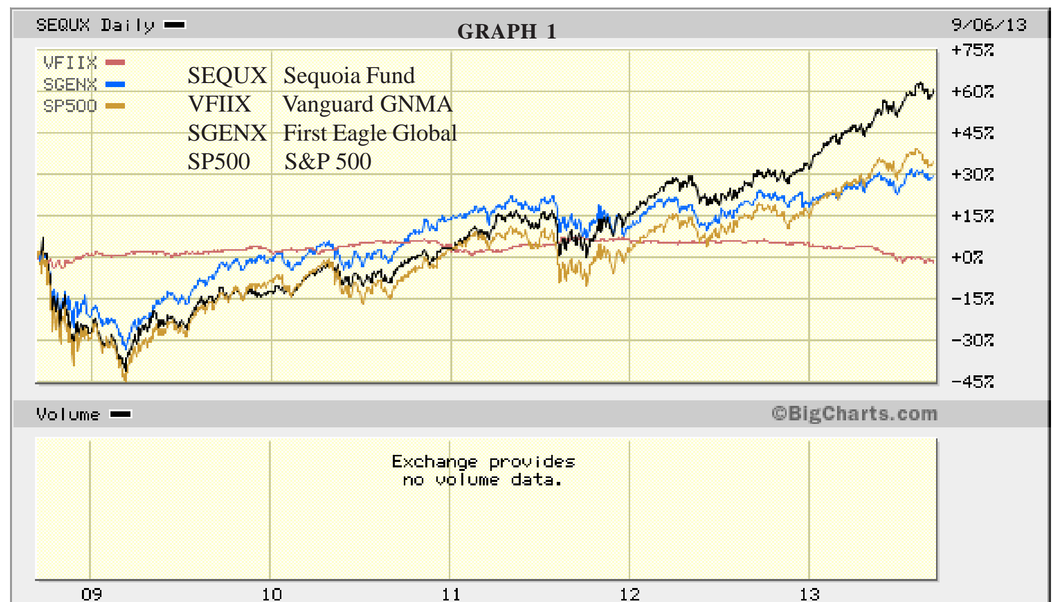
On Friday, September 6, 2013, the US Department of Labor released the August 2013 jobs report: 169,000 new jobs were created, a bit under expectations.

The unemployment rate fell from 7.4% to 7.3% because an increasing number of people have simply given up and are no longer looking for work at all. The share of the U.S. population working or looking for work is now at a 35-year low of 63.2%. Not since the summer of 1978 has such a high percentage of the American population been unemployed.

This suggests that the economy continues to bumble along at a marginal, below-normal growth rate. Even more importantly, it calls into question when the Federal Reserve might seek to end its fiscal stimulus/bond purchasing program, which has poured 2.8 trillion dollars of artificial money supply into the global economy.

What's going on? Here are two fascinating graphs which help explain. In **GRAPH 2** you can see that the Federal Reserve's drive to increase money supply, and thus stimulate the global economy, is working quite well. The basic theory here is that the more money is in circulation, the more money gets spent, and thus the economy grows.

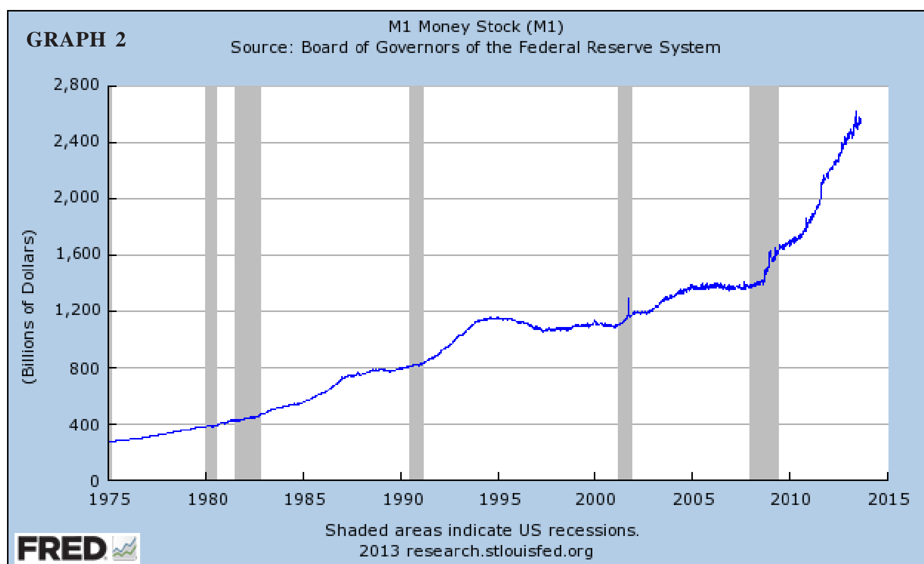
But check out **GRAPH 3**: Clearly, people aren't spending. Instead, they are hoarding. So the increase in money supply

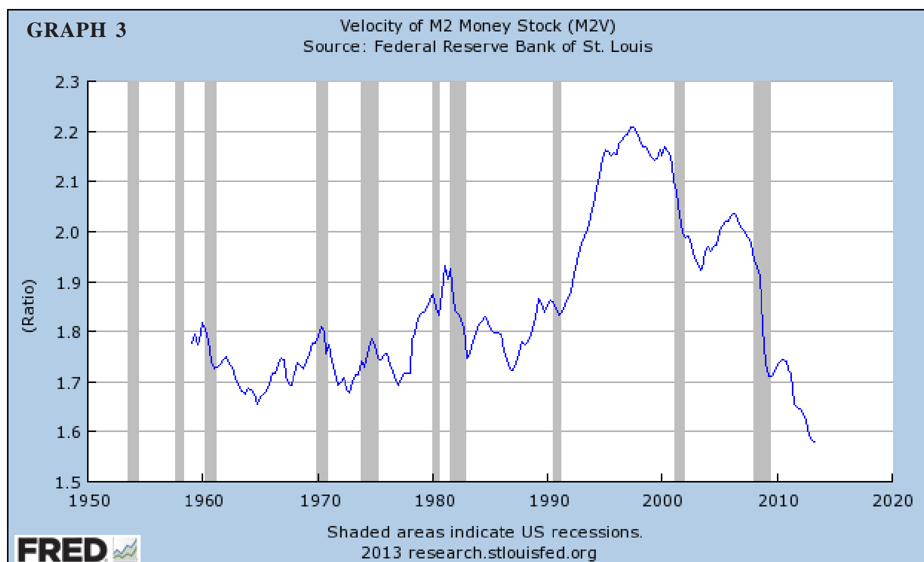


isn't trickling through to the street-level economy. Apparently, something is still broken in our economy. People are debating why we are seeing this loss of money supply effect, but we can only guess as to the true causes.

Perhaps we will eventually see the restoration of the power of capital. Perhaps we will need to go through another period of financial retrenchment first. I'm not necessarily seeing a financial catastrophe looming in our immediate future. What I'm seeing suggests that our fitful slow economic recovery will continue.

Faced with all this uncertainty, and the likelihood of the Federal Reserve terminating its bond repurchasing program, the financial markets are beginning to stir. Last year at this time, the interest rate on the 10 year Treasury was an astonishingly low 1.65%. As of today, the same maturity class of bond, the 10 year Treasury, delivers an interest payment of 2.91%.





Such a change has caused bonds, and thus bond mutual funds, to fall in value. In the past year I've moved our bond holdings into more defensive mutual funds, to reflect my concerns about rising interest rates, so at this point, I'm simply watching carefully and planning our next move. More volatility in the bond markets may be in store. I'm willing to absorb some short term small losses in our bond mutual funds in the interest of staying diversified and safe.

The "we don't know what the heck will happen" variable of a new military conflict with Syria, and perhaps Iran, is historically a non-event for the financial markets. Such political events are obviously important, but their long-term effects are vastly secondary to financial factors. So, should war loom, we should expect a financial market estrapade, and nothing more.

All of this, plus an historically high level of corporate profit margins, and a bearish Value Line Managers' Appreciation Potential statistic (VLMAP), suggests that bond market volatility might bleed over into the stock market. Yes, I know I became cautious early, back in July, 2012. The data remain compelling however: there is a strong indication that a stock market correction is out there in the future. As a result, I'm seeking genuine diversification for our portfolios. I'm explicitly attempting to avoid the crisis-based correlations which caused 2008 to be so painful for so many investors.

My expectation is that any substantial downturn will be a rare opportunity to grow our wealth. Although financial market downturns are by nature painful, uncertain, imperfect, and fear-filled, it is also true that fortunes are made in such bargain-producing events. We intend to be enthusiastic buyers in the face of a substantial stock market decline.

There's a lot of shrillness about the financial markets out there. Since we are enjoying the final days of a beautiful summer, this is a great time to turn off the noise and take a moment to appreciate the rest of life. Winter may bring storms. ■