

## Scared to Debt

Oh my! The shift, the tectonic shift in consumer behavior since the credit crisis erupted is massive. With consumers adopting a foxhole mentality in their spending and the fear of insufficient savings, the economic recovery will be slow. Thrift is in; consumption is out. There are so many items to worry about:

- Deteriorating house prices
- Unemployment
- Inflation
- Government interference
- Losses--real loses from stock and bonds
- Budget deficits
- Trade imbalances
- Energy dependence
- Global warming

I feel like Dorothy in the *Wizard of Oz*, eyes bulging, shrieking, "Lions, tigers and bears. Oh my!"

Most of the talking heads and pundits believe we'll have a strong second half recovery in 2009. I say that when everyone has a consensus opinion...they'll all be wrong and it won't happen. Further, every client we talk with and those who want to become our clients are scared to death about inflation. It's as if the inflation boogeyman is around every corner, under every rock and inside every closet. Yet the increase in money supply isn't being circulated--that's not inflationary.

With over capacity in every sector of the economy--housing, auto, retail, manufacturing, services, you name it--inflation is not around the corner. It's not even on the horizon. Many of our job losses are permanent in this new, slimmed down economy. That's because credit is so difficult to obtain. Banks certainly aren't lending. Corporations are permanently reducing their operations, their head count and their once lofty ambitions.

With the massive monetary and fiscal stimuli, if there was inflation, wouldn't we begin getting a whiff of it by now? We haven't. That's due to over capacity and a lack of consumer spending. Don't forget that consumers account for over 70% of GDP.

Certainly, this scenario won't last forever. But it will last through 2010 and probably into 2011. Our investment plan for corporate bonds is to stay in the front part of the yield curve. That means bond maturities of seven years and shorter. We'll buy value if the maturity stays within ten years though. We'll find bargains and add them into your portfolios.

Corporate bond spreads are reflected in higher bond prices. Municipal bonds have rallied. California continues its legislative struggle. For munis, the front end of the yield curve pays almost nothing. We'll keep our durations short, but not too short.

Most investors use experience as their navigational guide to the future. My instinct says that none of our past recessions or economic downturns have given us an inkling of how we will emerge from this one. That's because most lean on the old manufacturing inventory cycle as their guide. But this recession is all together different. It's a deleveraging of credit--excessive credit. So, if banks and finance companies don't or won't lend, the recovery will be slow and fragile.

Equity investors are always betting that monetary and fiscal stimulus will work over time. I agree. Just not to the extent that we've seen in the past. Why? Because this bear market in stocks and real estate along with the worldwide economic downturn is like nothing we have ever experienced. It will stick in our psyches for a long, long time. There is some good news. Personal financial responsibility is here to stay. Embrace the delevered society, the delevered balance sheet and pray that our federal, state and local governments step aboard. If your prayers aren't answered then vote the rascals out of office. Period.

The bond market has rebounded since the depths of its lows. Still there are credit problems. Hopefully we'll find solutions to them.

As always if you have any questions or just want to chat give us a call.

Have a wonderful summer,

