Tarheel Advisors Newsletter

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Is there a Silver Lining?

There is no way to spin the fact that the third quarter for stocks was ugly. According to Dow Jones Newswire, the performance of the 55 largest worldwide exchanges in the third quarter ranged from down .4% (Peru) to down 45.3% (Greece), with the US coming in near the top third at down 15.7%. I guess we can find some comfort that it wasn't as bad as any of the European stock exchanges or that it didn't reach 2008 financial crisis levels, but then again, we have had all this negativity and we still haven't seen the supposedly imminent Greek default yet!

So, will things get better? Yes, they will, but probably not before they get worse first. Sorry for the pessimism, but it's important to be realistic given the current set of facts:

Fact: The U.S. stock Market has pulled back 20% (typical indicator of a "bear" market) from it's recent highs in April 2011.

Fact: U.S. economic growth is slowing (GDP is falling quarter over quarter and we could technically be in a "recession" very soon).

Fact: Greece cannot pay its debt service without further bailouts (Will European bailouts and the kindness of strangers continue forever?).

As sobering as the macro-economic picture is, there are some positives to mention and certainly ways to address one's portfolio composition to better prepare for what lies ahead.

In the plus column, corporate profits and margins have remained robust. With layoffs and advances in technology, companies have become leaner and meaner and are continuing to provide solid results. Additionally, company balance sheets from the banks to tech companies have never been stronger. Furthermore, P/E (price to earnings) multiples on a trailing basis have rarely been this cheap over the past 20 years. Given this, why not buy companies you like at cheap valuations in the face of this macro uncertainty?

Definitely something to consider, but beware of potential value traps that are abundant. Value traps are when one buys a company based on a "cheap" P/E valuation and either the "E" component can't keep up because the economy/business is slowing, or the "P" component drops because overall confidence is down. Either way, the stock price that looks "cheap" may get cheaper. So, how does an investor deal with this situation?

In our opinion, the best way to invest in this environment is to only own those securities that you have complete conviction in. This means selling anything you have doubts about, and holding on to only a core group of select stocks and bonds that you feel comfortable owning for the next 24 months. Inherently this means having more cash on hand for opportunistic purchases and being nimble to take advantage of volatile swings in the Market. On a big down day you may nibble at dollar cost averaging into your conviction list, and on a positive surge you may trim a little off the top. Thus, you keep your core long-term positions intact while making a little short-term money on the side.

As mentioned in our August 12th Market commentary, we are fighting an important technical battle here between 1000 and 1100 on the S&P 500. It is not likely to end soon, and those that prepare for this battle accordingly will reap the most profits when the war is over. **-Walter Hinson, CFP®**

2011 Market Update

S&P 500	**-8.68%**
DOW	**-3.90%**
NASDAQ	**-8.98%**
MSCI World	**-17.4%**
BONDS	**+6.69%**
GOLD	**+28.36%**

Mortgage Rates

15-Year	**3.42%**
30-Year	**4.125%**
5/1 ARM	**3.00%**

Did You Know?

The Individual Tax filing deadline for those who extended in April is October 17th.

In September, the 10-year Treasury Bond hit an all time low yield of 1.695% . With that rate it will take 42 years to double your investment.

The term "bear" for someone who profits when stocks fall, dates to the early 1700s. "To sell the bear's skin before one has caught the bear" was an early description of a short seller, who borrows shares and then sells them, hoping to buy them back at a lower price.

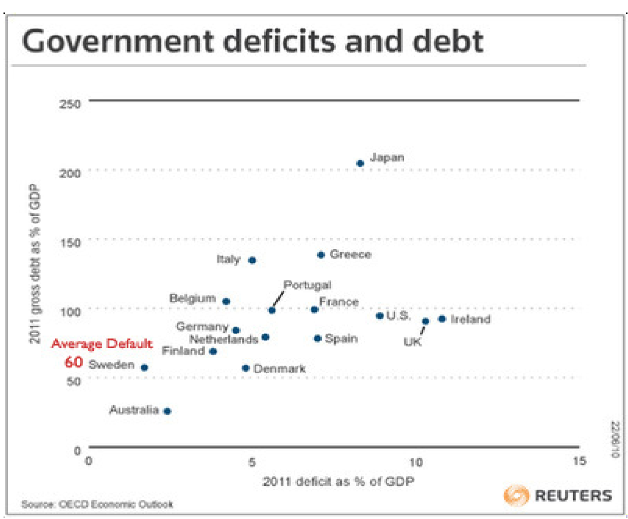
Portfolio Strategies for a Currency Crisis

Is the global monetary system as we know it sustainable? Unfortunately, warning signals of a problem are flashing all around us, and to ignore them could be detrimental to one's investment portfolio.

Greece and the fate of the Euro are two of the most apparent warning signals. Short term Greek Treasuries are yielding over 100%, meaning the bond market is assuming a total default is imminent. Default is nothing new in Greece as it has done so 5 times since 1826. However, defaulting as a member of the Euro would be new, and the ensuing chain reaction is without precedent. So, why is the imminent sovereign default so meaningful? The main problem is European banks own a substantial amount of Greek debt on their balance sheets. If this debt is now worth somewhere in the neighborhood of 0-25 cents on the dollar rather than 100 cents on the dollar, then there is a big hole to plug in the majority of European banks just to bring capital levels up to the point of solvency. Thus, best case scenario, a Greek default will cause a crisis of confidence in the European banking system (think US subprime circa 2008), and at worst, contagion will spread to other larger European countries and lead to further sovereign defaults.

The current crisis has highlighted some interesting structural problems with the Euro as well. Countries entering the Euro abandoned their old currencies, making it extremely difficult for them to leave (or be kicked out). When entering the Euro, these countries also gave up the right to print their own currency, and thus the right to inflate/deflate themselves out off any debt problem. Only two options remain for any Euro based country to escape unserviceable debt. The first option is to default (either partially or fully) and live with the painful depression to follow. The second option is to leave the Euro and create a new currency and deal with the even more painful depression to follow. In other words, the only choices left are between bad and worse.

Currency problems created by massive sovereign debt levels are nothing new. If it were only Europe in trouble then the current problems would hardly be worth mentioning. However, while the current headlines are mainly focused on Europe, the rest of the world is not far behind.



Because economies come in different shapes and sizes it's hard to simply look at the total amount of debt accumulated. Instead we must look at the size of a country's debt in relation to GDP. The graph below focuses on the ratio of government debt and deficits in relation to a country's GDP. According to data accumulated by esteemed professors, Reinhart and Rogoff, the average ratio from which countries have defaulted in the past is a 60% ratio of debt to GDP. Many countries in Europe are currently over this magic number, while the US is hovering around 100% ,and Japan is at an eye-popping 220%. This means the three dominant currencies of the international monetary system are all plagued by crippling debt loads that they are unlikely to "grow" out of. Unfortunately, the implications of this problem are with little precedent. Global currency problems have occurred in the past (as recent as WWII), but there has always been the gold standard to fall back on. After relying on paper currencies for decades, what now?

Should a currency crisis occur it will be more difficult to protect one's assets, but not impossible. The historical areas of safety (bank deposits, cash, and treasuries) may not work as well as in past times of uncertainty. Keep in mind, all this debt is the problem, so buying more of it isn't a good solution for your portfolio. If you look over the centuries there are two assets that have held their value under crises of any variety, and those are real estate and gold. It is no coincidence that we have seen gold prices triple over the last few years, and were we not just exiting a real estate bubble, you would have seen an explosion in these prices as well.

Diversifying currency exposure is another way to smooth the ride of a currency crisis. Most US investors are 100% dollar denominated through their stocks, bonds and cash in their bank accounts. This could be a dangerous allocation should the crisis of confidence in Europe spread across the Atlantic. Purchasing fixed income denominated in foreign currencies is a good way to diversify this risk. European countries not using the Euro and other healthy countries in the South Pacific are good starting places for diversification. However, as this crisis progresses, don't be surprised to lose money on these investments in the short term as the dollar does have the tendency to be considered a safe haven and appreciate in the face of fear.

Finally, this is a problem that is likely to play out over a fairly long time period (if we're lucky), so don't expect a quick fix. World leaders have had a predisposition to try and kick the can down the road as long as possible. So, should the headline risk die down, be ready to jump back into equities — Just be sure to take profits as you make them because this story is a long ways from over.

-Ryan Glover, CFP®

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