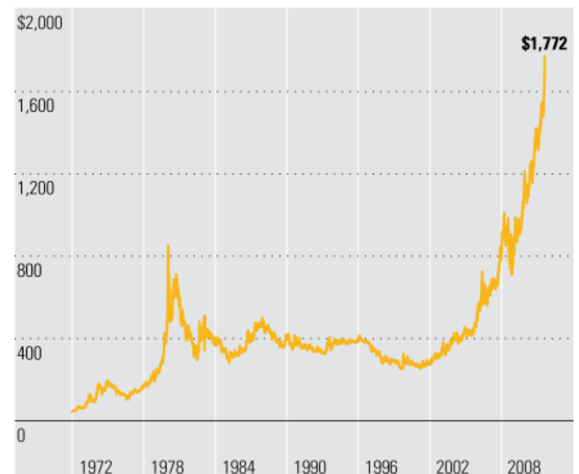
Investor Insights & Outlook

August 2011 | Vol. No. 1 | Investment Updates

Gold Rush

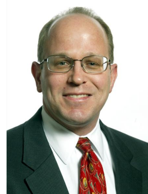
Gold (London PM price per oz.)



In mid-August gold prices spiked to over $1,700 per ounce as investors, weary of volatile equity markets and a U.S. credit downgrade, poured money into tangible assets.

Predicting commodity returns is normally difficult enough given the very broad spread, high volatility and problems associated with rolling over futures contracts on returns. It has become even harder as a result of the uncertainty created by the growing risk of a U.S. recession and E.U. sovereign debt issues. Gold, however, could remain favored by many investors worried that a far worse fate awaits. Scarce supply and strong demand should keep prices rising until sentiment turns. Even so, investing in gold can be speculative and the role of commodities in a long-term asset allocation is typically in small proportion to that of equities and fixed income.

Advisor Corner



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Bill Roller is experienced in financial planning and investment analysis. He focuses his consulting practice on estate, retirement, and financial planning for businesses and individuals. Bill started BR Capital Inc. in 2003. Before that he worked for a large Wall Street firm for over nine years. He served for seven years as a U.S. Army officer in Infantry and Special Forces (Green Beret) units. Bill is a Chartered Financial Analyst as well as a Certified Financial Planner. He is the VP of the Estate Planning Council of Southwest Washington. He earned a Bachelor of Science degree from the United States Military Academy at West Point in 1982, and a MBA from the Wharton School of Business in 1991. He provides the morning and afternoon market reports and financial commentary for AM 1360 KUIK. A link to Bill's articles and interviews is available at http://brcapitalinc.com. To subscribe to articles and daily market updates go to http://brcapitalinc.com/subscribe/

U.S. Debt Ceiling and the Credit Downgrade

The first week of August has seen unsettling domestic news that have all but shattered hopes of a sustained recovery. There is even talk of a new recession. Although the Aug. 5 employment report was positive (117,000 jobs added in July, unemployment rate at 9.1%), it was not enough to balance the effect of all the other disquieting events.

Debt Ceiling However unthinkable a U.S. debt default may be, national borrowing has reached the $14.3 trillion limit (or debt ceiling) this year. In response, President Obama and leaders of both parties announced (on July 31) and passed (on Aug. 2) a last-minute agreement that would raise the debt ceiling by as much as $2.4 trillion. This measure would enable the government to keep borrowing until 2013, but it requires major spending cuts that may slow down the already-weak economic recovery.

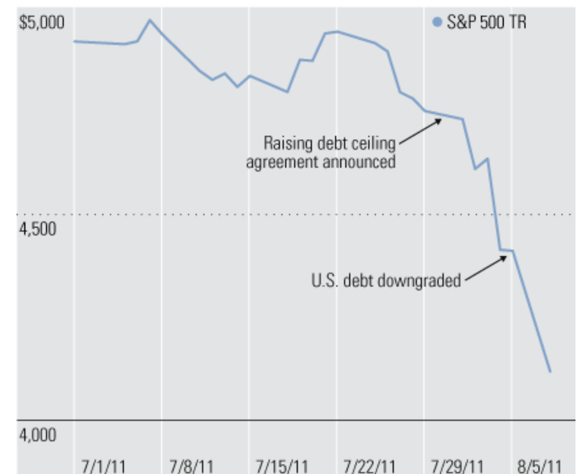
Although expected to restore confidence in the markets, the signing had the opposite effect, mainly because it offered a short-term solution to avert the immediate crisis instead of a long-term plan to reduce future indebtedness. The proposed spending cuts have not been clearly identified or assigned to specific sections of the budget; instead, a bipartisan committee is supposed to make recommendations and submit them to Congress later this year. Markets fell in response to this uncertainty and the political gamesmanship that created it.

Credit DowngradeOn Aug. 5, U.S. debt was downgraded by Standard & Poor's to "AA+" from its coveted "AAA" credit rating for the first time in history. Reasons cited include increased political risk and rising public debt burden as challenges to sustaining an appropriate debt/GDP ratio in the next decade. The first reaction of the market to such news can be observed by looking at Treasuries; surprisingly, Treasury bond yields went down and prices went up. Lower bond yields, despite the downgrade, showed that investors still felt U.S. Treasuries were a safe haven compared to riskier assets. Global equity markets, however, plummeted on Aug. 8, as the downgrade catalyzed a flight to safety because of ongoing concerns with the U.S. and global economy.

Investing InsightsInvestors' portfolios may be looking pretty bleak in light of recent market volatility, with falling stock prices and dreadful returns. Panic selling, of course, is not a solution, but neither is sitting patiently and waiting for everything to go up again. In times like these, it is important to have a baseline amount of liquidity to cover near-term expenses, particularly for people who are retired. The next important step is to realign your long-term asset allocation according to your risk tolerance, and then, if you have some money left over and are thinking about putting it to work, an interesting idea would be to look for pockets of the market that appear undervalued right now.

The graph shows the performance of the U.S. market from July 1, 2011 through August 8, 2011. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. The Standard & Poor's 500® Index is an unmanaged group of securities considered to be representative of the U.S. stock market. Past performance is not a guarantee of future results.

U.S. Market Drops in Reaction to Debt News



How to Invest in a Deflationary Environment

While inflation was the hot topic not too long ago, it's downright tame right now. Instead, some market participants are now concerned that we could confront a period of declining prices, particularly if unemployment stays high and the housing market stays in the doldrums.

Declining prices may not sound that bad, particularly for consumers who might be able to take advantage of lower prices for everything from groceries to televisions. But a persistent need to slash prices can be bad for businesses and could ultimately lead to layoffs, reduced consumer spending, and declining prices for assets ranging from real estate to commodities. Those forces, in turn, could put pressure on corporate profits and stock prices. Inflation is a force to be reckoned with, too. But it's deflation that really makes economists shudder.

It may not be a good idea to go overboard in anticipation of one specific economic scenario or another. For such a bet to pan out, you'd need to get your arms around numerous difficult-to-predict factors, including growth rates not just in the United States but overseas, as well.

If you're truly concerned about deflation, you can take comfort in knowing that the investments that will tend to perform best in a declining-price environment are probably already in your portfolio. The classic deflation hedge is a simple fixed-rate investment—cash or government-issued bonds (corporate bonds will tend to be more vulnerable in a deflationary period because charging lower prices will tend to cut into the profitability—and viability—of many companies). Because their payouts are fixed, the cash you receive via income from such vehicles is effectively worth more and more each year as prices fall. For the same reason, fixed annuities can also be attractive in such an environment.

And while bonds will typically hold up better than stocks in a period of declining prices, it should be noted that dividend-paying stocks should hold up better than non-dividend-payers in a deflationary period.

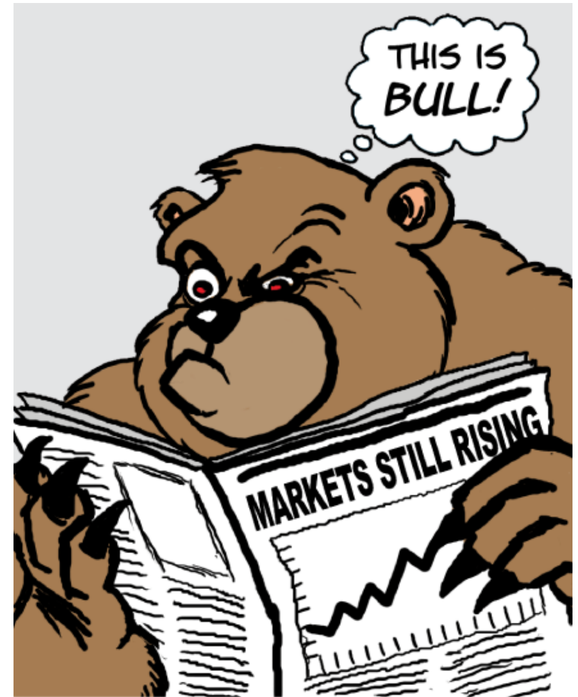
Although these investments are mainstays for investor portfolios regardless of the economic environment, it can be a mistake to go full-throttle into deflation-protection mode. That's because the to-avoid/downplay list for deflationary times is a pretty long one, encompassing equally important investments such as most stocks, corporate bonds, commodities, real estate, and inflation-protected bonds.

And over the long haul, it's also worth noting that inflation has been a bigger issue in the U.S. than has deflation. So hedging your portfolio against the former threat, particularly if you're retired and relying on fixed-rate investments for much of your day-to-day income, might be a better bet than getting too fancy about defending your portfolio against deflation.

Finally, bear in mind that the usual prescription for a deflationary period—government bonds and cash—aren't currently offering much in the way of yield today. Cash investors are lucky to earn 1% on their money, whereas investors in intermediate- or long-term government bonds would be grateful to pick up 3% or 4%. Those yields would shrivel to next to nothing if inflation were to pick up.

Government bonds and Treasury bills are guaranteed by the full faith and credit of the United States government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than other asset classes. With corporate bonds, an investor is a creditor of the corporation and the bond is subject to default risk. Transactions in commodities carry a high degree of risk, and a substantial potential for loss. In light of the risks, you should undertake commodities transactions only if you understand the nature of the contracts (and contractual relationships) into which you are entering and the extent of your exposure to risk. The annuity income guarantee is based on the claims-paying ability of the insurance company that issued the annuity product.

This is Bull



Financial news often refer to a "bull market" (when the market is doing well) or a "bear market" (when the market is doing...not so well). These terms may have originated from the animals' styles of attack. A bear mauls (downward movement), while a bull thrusts its horns (upward movement).

Whether you're reading news about a bull market or a bear market, always be mindful of the source. There are many financial wizards out there who are ready to promise you 20% returns, so it's best to always check the credentials and reliability of a financial professional or information source.

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