GREENWOOD REPORT

WHAT DOES THE FUTURE HOLD?

Self-confidence can be fickle and capricious. The U.S. had it so good in the 1990s – economic growth, market appreciation, and budget surpluses – and then so bad in the 2000s – wars in Iraq and Afghanistan, flat markets, budget deficits, a financial/credit collapse, and recessions. What is an investor to think? What does the future hold?

While it is hard to take a step back for perspective, long-term investors have a distinct advantage. Despite doomsday forecasts, this is not the end of the world and we do not need panic for an investment strategy. Most of us *can* have a long-term outlook, say 5 to 10 or even 30 years, given extended life expectancies and can take advantage of bargain prices and fearful dispositions.

For the short-term, two to six months, economic data is "volatility noise," exacerbated by the media anxious to sell newspapers, TV shows and newsletters. National economic data is reported three times over a 90 day period before it becomes final, and then is followed by a comprehensive benchmark revision. Unfortunately, historical data does not reflect the short-term volatility that occurred when it was reported. Even "marking" the dates of a recession can seem out of touch and frequently doesn't coincide with our personal experiences. The National Bureau of Economic Research reported in December 2008 that the current recession began in December 2007. Now, the consensus is that it ended in June 2009, but as of July 2010, it has not been announced. Making policy or investing capital cannot rely on day-to-day, week-to-week, or month-to-month data; rather, general economic trends provide the umbrella for security analysis and future investing.

Monetary Policy and all things Federal Reserve. Interest rates are low and can be expected to remain low for an 'extended period of time' according to the Federal Reserve. Deflation is the current concern because economic growth has not been as robust as desired. Inflation is no where to be seen, although inflationary expectations have begun to surface because of fiscal policy and the deficits. Under the triple mandate given to the Federal Reserve: *full employment, economic growth, and price stability*, we expect the Fed to be a follower of the private sector, not a leader, in future moves toward higher interest rates. Since September 2008, the Fed has expanded its balance sheet utilizing heretofore non-existent policy tools; understandably, a period of digestion is needed.

Fiscal Policy and all things Congressional. Government Expenditures have risen because of the credit collapse, the severity of the recession, and external wars. Government Revenues have fallen because of the severity of the recession and the tax cuts enacted in 2001-2003. Budget deficits appear intractable because of the gap between the two. In normal times, federal revenues grow about 18 to 19 percent per year, expenditures grow around 20 to 21 percent, with the gap being funded by economic growth and limited inflation. Currently, the deficit is larger than usual because of the depth of the credit collapse; but this is not unlike prior periods, particularly the early 1980s. Then, inflation and interest rates were at double digits and with 'star wars' defense spending, federal expenditures ballooned; at the same time, tax cuts and a double-dip recession reduced revenues. Together they pushed the deficit to new highs and we spent the 1980s lamenting the loss of our standard of living and the fear that our children would never own their own homes. Ah, the words of Santayana haunt us, "those who cannot remember the past are condemned to repeat it."

The Real Economy from Wall Street to Main Street. Wall Street was the epicenter of the recession and was hit particularly hard during the recent credit collapse – everything went down, there were no 'non-correlated' assets. Twenty years of financial innovation introduced new securities that did not have a behavioral history and many were illiquid, lacked transparency, accountability, risk management, and supervision. Legislation is expected to introduce changes that are comparable to the magnitude of those enacted in the 1930s and 1940s. They are major changes, some overdue and some overdone, but *investment*, not speculation, will survive and thrive.

Wall Street reflects corporate America and its health. The early 2000s were difficult for corporate America, but also very important. They streamlined product lines and cut costs, but couldn't raise prices during or after the recession of 2001-02. Then, when business could take price increases in 2007, they improved margins. Although the recession of 2008-09 flattened top line sales, 2009 and 2010 have been characterized by overlooked margin improvement, hence surprised profit improvement. In short, American business is lean, mean and prepared for the future. This is good for *investors*.

Main Street continues to hurt because of high unemployment. Unemployment benefits are intended to be short-term automatic stabilizers that mitigate the decline in economic activity. However, they are a double-edged sword when they become *extended* benefits because they may dis-incentivize workers from returning to the labor force. Additionally, employment is another area where data is somewhat murky. Self-employed, non-covered service employment, seasonal factors and the cash (underground) economy all distort the employment data. To illustrate, the current plight of fishermen in Louisiana is apparently exacerbated because many of them operate in the cash economy and therefore are unable to substantiate their claims of lost income. Acknowledged to be about 10% of GDP in good times, the cash economy can reach as high as 25% during recessions. The implications of the underground economy are many: under-counting economic growth, over-counting unemployment, and over-counting inflation. Today, unemployment is real and it affects consumer sentiment and confidence. However, *investors* who understand that unemployment is a lagging indicator will derive the benefits of committing capital during this period of disequilibrium.

So, what about the future? America is going to be just fine, it is flexible and resilient. But, make no mistake, we are in a structurally changed, digital, and globally integrated economy. Because it is global, the actions of every nation affect all other nations. For example, questions regarding the rate of economic growth in China, the level of debt in the Eurozone, and the explosion and management of data worldwide present both challenges and opportunities for all investors. Technological change is accelerating our income and growth-generating benefits. At Greenwood Gearhart, we think this is positive and we are excited about the future for investment.

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