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The "New Normal" Economy Continues

By Scott P. Noyes, CFA® CFP®

It appears that a long awaited market correction started in mid January. The question is whether it will be a manageable 10% setback or more. My best guess is that the correction will not be too severe because:

1. **The economy is improving** – albeit not up to past historical standards. Multiple economic indicators are improving and suggest the end of the recession is upon us.

2. **Interest rates remain extraordinarily low.** While the forces of deflation remain strong, there is a risk that corporate and consumer borrowing costs could increase due to an overload of government borrowing. This could result in higher interest rates, even in a low inflation environment.

3. **The government continues to spend to stimulate the economy**. The administration's proposals for a second stimulus bill are likely to receive bi-partisan support.

However, investor psychology remains fragile and many investors are quick to over-react or panic. Wall Street traders and their media outlets are good at manipulating this psychology to their financial gain. There is always the chance that the herd of investors will start to stampede again. We are respectful of this possibility.

In our judgment, both the potential upside and downside for the market from current levels is limited. As we come out of the recession, we are likely to enter a "New Normal" economy constrained by lower household debt, higher personal savings and less consumption. While these themes used to be seen as virtues, they work to constrain economic growth and are likely to be with us for an extended period of time. For many people, the "American Dream" was built on credit which now has to be paid back. We believe that this "New Normal" economy will create disappointing economic growth for the next three to five years.

Politically we seem to be entering a new era of public restraint. Not immediately, as the magnitude of the recession will require an expansionary fiscal policy through 2011. Once economic growth becomes self-sustaining, Congress and the Administration will have to confront fiscal questions they have long evaded – Social Security, Medicare, health care, war, agricultural subsidies, fair trade and the cost of being the global cop. These debates have vested interests are likely to be quite acrimonious. All are likely to face cost reductions throughout this decade.

Our Market Strategy

We remain focused on building portfolios that succeed in a "New Normal" economy. In this light we have three biases in our portfolios:

1) **Add more income investments to portfolios**. We seek income opportunities in the form of high dividend stocks, investment grade bonds, municipal bonds and Income Trusts. We favor high quality over high yield. We believe this strategy will help add some stability to our portfolios during choppy stock and bond markets.

2) **Underweight international equity** exposure as we believe this year's negative surprises are likely to originate overseas. We have been underweighted in European stocks since mid last year. Overseas concerns are currently causing the US dollar to rally. Foreign investors are moving to the US for safety reasons.

3) **Stay with long term equity holdings.** We believe that equities will outperform bonds over the next two years. While holding stocks may feel terrible at times, we believe that you will be rewarded for patience. Reminder – the investors who really lost in the crash were those who sold stocks and moved to CD's. When markets go back up, they do not ring a bell to let you know to get in. We remain invested, diversified and patient.

Please call me if you have any questions at 973-267-8120.

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