



Volume 2, Issue 7

The (not so) Almighty Dollar

October 3, 2008

Special Edition Newsletter and Update

Dear Valued Clients, Friends and Professionals,

This is a special edition of the newsletter which I am including with quarterly client statements.

Events of the last few weeks have been astonishing and distressing. The idea that Merrill Lynch, Goldman Sachs and the other investment banking/brokerage firms of Wall Street would disappear or turn into commercial banks still strikes me as unimaginable and yet this has happened.

Total return on domestic stocks year to date through yesterday is negative 19.4%. We still have another 3 months in 2008 to push past the grim return of negative 21.2% of 2002. Our friends in Washington are splashing around in an attempt to jump start credit markets which were frozen when a large institutional money market “broke the buck” a few weeks ago, in ways that might be comic if it weren’t fraught with so much danger for all of us.

The quarterly reports I am sending clients display the worst numbers I have ever delivered. About the only comfort to be found is that most of the clients who enjoyed stellar results with me in 2005 and 2006 are still “ahead” despite the crashing of international and large cap value holdings in the third quarter. Clients new to me since the latter part of 2007 are probably devising ways to punish the friend, advisor or relative who suggested they talk to me.

I don’t think we are on the verge of a depression and there is some reason for optimism down the road. I believe we are at a watershed in the way markets work and much of this newsletter is devoted to a discussion of my conclusions and how I think we should handle portfolios in the future.

Best regards,

Jeff Sprowles, CFP®

End of Quarter Update

- S&P 500 – domestic large cap
 - 6/30 to 9/30 (8.4%)
 - YTD (19.29%)*
- Lehman Intermediate Gov Bonds
 - 6/30 to 9/30 1.9%
 - YTD 4.3%
- 90 Day U.S. Treasury Bills
 - 6/30 to 9/30 0.6%
 - YTD 2.3%
- Emerging Markets ETF (EEM)
 - 6/30 to 9/30 (31.2%)
 - YTD (25.2%)
- Jeff’s Current Stock Outlook
75% of target

* Coincidence!!!!???? I hope so.

Market Comments

Several times in my financial career experts and analysts have suggested that a new economic paradigm was in place that made old ideas obsolete. I did not much buy into that idea when, for example, this was used as a rationale for buying tech stocks with price earnings ratios over 100 in the late 1990s.



A new economic paradigm might be one in which rules or structure have changed enough to degrade the value of historic performance of markets. Such a time would be 1933 when legislation creating FDIC insurance, the SEC and the Glass-Steagall Act was enacted to guard against a repeat of the crash of 1929.

I spent last week with trusted consultants discussing what is happening. With their help I have decided it is possible we are present at the start of a new paradigm. We came to some conclusions and guessed the impact they might have on my clients and how best to invest if our conclusions are correct. These are discussed on the next page. Here are the reasons behind a “new” paradigm:

1. Regulation of investment bankers by federal bank authorities.
2. “Nationalized losses, private profit” of financial companies.
3. Global reaction to U.S. increased debt, deficits and its impact on the dollar.

POSSIBLE IMPACT OF FINANCIAL EVENTS OF 2008

Here are some conclusions I came to with the assistance of consultants. There is, of course, no guarantee that we are correct or even in the right ball park. If our predictions are not completely accurate, however, I nevertheless have a foundation for amending my investment process which I believe to be better than relying on past performance of markets. Here are the conclusions and some explanation:

1. The decline of the United States as the dominant global economic power which probably started in the last few years will accelerate.
2. The dollar is more likely to decline against other currencies than not.
3. The United States is likely to have some hard times for awhile. I don't think we are going to suffer anything close to what happened during the Great Depression in categories such as unemployment but I fully expect to see relatively frivolous consumer spending decline dramatically.
4. The role of large companies is probably going to be gradually taken over by mid and small sized enterprises in the United States.
5. Interest rates are likely to go up.
6. There is a danger of inflation in a low growth environment.

The decline of the United States as the dominant global economic power which probably started in the last few years will accelerate.

Without the events of 2008 we were already on a track to lose dominance because of demographics and global distribution of technology. Consider some of the implications of data in the table below taken from U.S. Census Bureau estimates of world population mid-2008.

U.S. Census Bureau Population Estimates Mid-2008

(Population in millions)

<i>Country</i>	<i>Total</i>	<i>Total %</i>	<i>% under 40</i>	<i>% over 64</i>
World	6,707		67.7%	7.7%
Brazil	196	2.9%	68.9%	6.3%
Canada	33	0.5%	49.8%	14.9%
China	1330	19.8%	61.5%	8.0%
France	64	1.0%	51.2%	16.3%
Germany	82	1.2%	44.0%	20.0%
India	1148	17.1%	73.1%	5.2%
Indonesia	238	3.5%	70.6%	5.8%
Japan	127	1.9%	45.0%	21.6%
Russia	141	2.1%	52.3%	14.2%
United Kingdom	61	0.9%	50.1%	16.0%
United States	304	4.5%	54.5%	12.7%

Note that the population of China and India is about 37% of the world total. Compare to the United States 4.5% and combined U.S., U.K., France, Germany and Russia of less than 10%.

China and India have had an explosion of gross domestic product (GDP) in the last two decades as a combination of technology, political, social and globalization developments have unleashed consumer demand in their enormous populations.

Note that Brazil, China and India have significantly higher percentages of population under age 40 and significantly lower percentages of population over age 64 than the United States.

Further, our lead in manufacturing techniques and technology has been diluted by advancement in education and research in the rest of the

world while education of our population has not improved by most objective measures.

Our advantage in natural resources has been blunted somewhat by improvements in transportation. This is still important and countries rich in natural resources such as Brazil, Russia and Canada have advantages over less well endowed countries such as Japan and Germany.

Finally, world events of the last eight years have diminished the moral, military and financial leadership role of the United States in the global community.

I have seen credible studies that suggest the U.S. percentage of global GDP will decline from its current approximate 35% to about 10% by 2050 while that of China, India and Indonesia combined will approach 50%.

The decline of the United States as the dominant global economic power which probably started in the last few years will accelerate.

As our national budget and balance of trade deficits continue to increase our currency will continue to be devalued against other major currencies. In his recent book on China, Burton Malkiel explains this by suggesting that over the last ten years every individual in the United States has borrowed over \$4,000 from somebody in China.

Over the last few weeks the federal government has increased the national debt by something over \$1,000,000,000,000. The fiscal irresponsibility of individuals, companies and many levels of government, but especially the federal government that has run rampant since the end of the inflation scare in the early 1980s, has made us weaker compared to much of the rest of the developed world from a financial point of view. This is not to say that Europeans are that much better than we are in some respects. Nevertheless, until something fundamental changes in our trade and budget policies, I anticipate a continued weakening of the dollar against the Euro, Yen, RMB Yuan, Looney and other currencies.

The United States is going to have some hard times for awhile.

We are probably in a recession right now. I don't think we will have anything like the Great Depression. There are too many government safeguards such as FDIC insurance for that. Also there is a lot of money sitting on the sidelines awaiting investment and the growth of economies elsewhere in the world are going to buffer what happens here somewhat.

Nevertheless, people are going to cut back. Unemployment is going up and the decline in the value of investments, especially in retirement funds, is going to encourage people to tighten their belts. This isn't a good thing in the short term for our economy but I think it could be positive for our long term outlook. We have been living beyond our means for the last 25 years as individuals and as a society so cutting back, though painful, is probably going to make us stronger. This won't make it any more palatable for those who are losing their jobs, homes and savings.



The role of large companies is going to be gradually taken over by mid and small sized enterprises in the United States.



When the small and regional banks employing me were taken over by bigger banks in the 1980s and 1990s I didn't much like working for the larger companies. They were inefficient in many ways and it seemed to me that strategic and tactical decisions were made in a clumsy fashion, frequently with poor results. The demise of the steel industry and large manufacturing companies in our country is not an accident.

With the improvements in technology over the last 30 years, the capital necessary to do business is not as great as it once was. Successful companies such as E-Bay have been started using credit cards for capital. Compare that to the enormous amount of capital necessary to build a railroad in the 19th century. It is significant that the manufacturing and assembly factories in China that have taken over much of our business have an average of 600 employees each. There aren't any General Motors size industrial companies in China. I think this is a trend that will continue world wide.

Interest rates are likely to go up.

One of the factors contributing to the sub prime mess was the low U.S. interest rates in the early part of the century as the Federal Reserve Bank attempted to jump start the economy during the 2001/2002 recession. United States interest rates were low both from a historic and competitive point of view.

With the increase in our debt there will be a need to attract Chinese, Arab and other foreign pools of capital with higher rates. Further, if the dollar continues to decline, those selling oil to us — which is sold in U.S. dollars — are going to want to protect the value of their investments.

There is a danger of inflation in a low growth environment.

Until the stagflation of the middle 1970s economists didn't think it possible for there to be inflation during a recession. How wrong they were.

If the price of oil stays high, and it despite reduced demand if the dollar continues to weaken, the cost of goods may continue to go up even if our economy slows.

Investment Implications of Jeff's Outlook

It will continue to be important to determine asset allocation based on expected cash flow for each client. We will continue to tie asset allocation to risk, reward and time.

If I am correct about the changes in the investment paradigm it is less useful to base long term investment decisions on the behavior of asset classes in the past than it was previously. In the future, the importance of large cap domestic stocks is likely to be less than in the past and that of emerging market stocks more. Also, for long term goals it is important to protect against a period of low growth in the United States without neglecting the potential impact of inflation on the purchasing power of clients.

Earlier this week I sent my clients a matrix showing how I am changing the management of portfolios other than bonds and cash. The changes in both the structure and how holdings will be adjusted as market conditions change are based on these ideas.

1. International equities in general will be a better engine of growth in stocks than those traded domestically.
2. Holdings in European securities will be used to protect against the dollar weakening against the Euro.
3. Holdings in emerging market securities will be used to participate directly in their growth which will probably be higher than that of the United States, BUT,
4. Emerging markets are volatile and the index funds I use may get "oversold" periodically. When that happens, country index holdings may be sold and the proceeds kept in money market funds until they become reasonably priced again. THEREFORE,
5. When possible, emerging markets securities will be purchased in retirement accounts where short term gains are not a consideration.
6. Alternate energy is likely to be a growth segment for the foreseeable future as our economy evolves away from fossil based fuels. THEREFORE,
7. A portion of stock portfolios will be devoted to alternate energy securities on a buy and hold basis.
8. Larger companies in the United States are less likely to grow than in the past so a portion of stock portfolios will be invested in Mid Cap and Small Cap Value indices on a buy and hold basis. YET,
9. A portion of the domestic stock allocation will be allocated to the broad U.S. stock market to participate in large cap stocks when the U.S. market is attractive, YET,
10. When the U.S. market is not attractive, some or all of that portfolio will be sold and the proceeds invested in commodities indices, BECAUSE,
11. In the last two years two ETFs that track commodities indices have become large enough to be safe from a technical point of view, AND
12. Historically, commodities prices tend to have a low to negative correlation to U.S. stocks. This means that although average return on stocks and commodities are relatively similar, commodities tend to go up when stocks go down and vice versa. As of 8/31/2008 when the S&P 500 Stock Index 1 year return was down 20% the commodities indices were up over 75%.

I hope you find all of this strategy and tactics discussion interesting and useful. I will be visiting my clients over the next few weeks to review their financial plans in light of the unexpected and "off the chart" negative performance of 2008. We will also be discussing investment policy and their portfolios to make sure we are making decisions now that are most likely to help them meet their financial objectives over time.



Jeff Sprowles and Associates, LLC
Fee Only Financial Planner and Investment Advisor

945 Langhorne-Yardley Road • Phone: 215-310-9693 • Fax: 215-693-6233
Langhorne, PA 19047 • Cell: 215-630-2621 • E-mail: jsproyles@sproyles.com

