



Q2 2008 Review and Commentary

Published Quarterly by AFCG, LLC

Counting Our Blessings

A Bit of Perspective Regarding the Energy "Crisis"

Charles B. Atwill, CFP®

AS WE HAVE ALL BEEN TOLD, we are in the midst of an energy "crisis." Merriam-Webster defines "crisis" as:

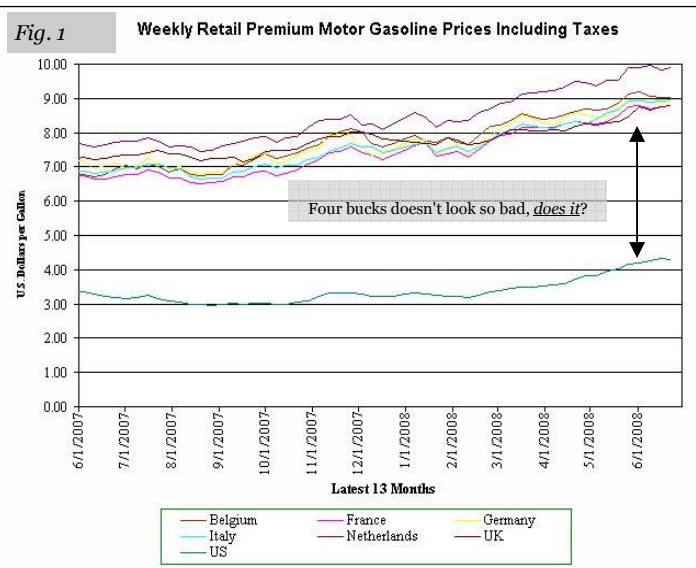
- 1 : the turning point for better or worse in an acute disease or fever
- 2 : **a decisive or critical moment**

Every day, millions of Americans are filling up their cars and trucks with \$4/gallon gas or diesel. We are angry—no—*apoplectic* over the cost of fuel. Whose fault is it? Big oil, Congress, Bush, the greedy speculators? Who is going to fix it?!

In a rare quiet moment at home, I was watching one of the cable business channels and saw a bold, colorful caption on the screen which read: **America's Oil Crisis**. Next to the caption, the current price of crude oil (something over \$140/ barrel, as I recall) was displayed on an alarming orange background. *Ladies and gentlemen (cue menacing TV news music), we are in the midst of a full-blown...dun, dun, dun, duh...oil crisis! Your only hope of survival is to stay tuned to our channel for second-by-second updates and expert analysis....*

The media is ADDICTED to crisis. Without a good compelling crisis somewhere, people won't tune in. Politicians, the other purveyors of the crisis mantra, try to make us believe that they are "one of us" - that they "care." They propagate the fear and the myth that a crisis exists purely for political expediency.

Continued page 4



Capital Markets Outlook

Charles B. Atwill, CFP®

Interest Rates

The ECB (European Central Bank) has raised rates again, and the U.S. Fed will eventually have to follow suite—or risk having the flaccid dollar fall even further. Inflation continues to chug along. In May it ran at an annualized rate of **4.2%** for all items (**2.3%** w/o food and energy). The FOMC maintained its current Fed Funds target rate of **2.0%**, but highlighted the risks posed by increasing consumer prices. Best guess, barring a recession, rates are going up by year's end.

Credit Markets

The 10-year U.S. Treasury Note retreated a bit over the last quarter, with 3.5% yields moving up to around 4.0%. As we

move ever closer to a Fed in the monetary policy tightening mode, long rates on investment-grade debt should continue to rise.

One potential bright spot that we have been following is the increasing money flow into high-yield debt, which is often a sign that investors see the credit markets, and by extension the economy, improving. We shall see.

Stocks

Our prediction for a rally in equities appears to have been a bit...premature. With the S&P 500 sitting near a 2-year low of 1250, and European and Asian shares not fairsing much better, stocks certainly have room for improvement. We still believe stocks to be oversold, and given a 3-5 year time

Continued page 3

Investor's Corner

Dollar's Fall No Accident

Kristine M. Lansing, CFDP®

The U.S. dollar has fallen in rather dramatic fashion against other world currencies over the last 5 years (see chart, page "3"). Have you ever wondered who is allowing this to happen, and why?

Some argue that maintaining the dollar's value is the responsibility of the Federal Reserve (the Fed); others, believe it to be the role of the U.S. Treasury (the Treasury). In fact, neither the Fed nor the Treasury has sole responsibility for the Greenback. A review of the last twelve months helps to highlight each agencies' involvement in the dollar's decline.

First, let's take a look at the tools available to policymakers to influence the relative value of the dollar.

- The Fed can sell some of its foreign currency reserves (in exchange for Dollars), through the New York Federal Reserve
- The Federal Open Market Committee (FOMC) can raise short-term interest rates, attracting foreign investment in the dollar

The inverse of the above is true if the policy is to *weaken* the value of the dollar.

Over the past 8 months, as the U.S. Economy slowed and a mortgage crisis ensued, the Fed lowered interest rates seven times. Simultaneously, it injected cash into the economy by increasing the frequency, raising the dollar amount, and extending the terms of its Term Auction Facility auctions in order to stave off an emerging liquidity crisis among large financial institutions.

The Fed also extended lines of credit ("swaps") to the European Central Bank and Swiss National Bank to fund any foreign liquidity crises. All of these Fed actions have, among other things, caused the value of the U.S. dollar to decline precipitously during the last 12 months. To have strengthened the U.S. dollar, the Fed would have needed to raise U.S. interest rates which would have potentially caused the foreign exchange value of the dollar to rise. An increase in the foreign exchange value of the dollar, in turn, would raise the price in foreign currency of U.S. goods traded on world markets and lower the dollar price of goods imported into the United States. By restraining exports and boosting imports, these developments could lower output and price levels in the economy. Although the Fed's primary responsibilities are focused on domestic economics, it does take international economics into consideration.

During the same 12 month period, the Bush administration and the Treasury have maintained a policy of encouraging

the decline of the dollar to bolster the U.S. economy, improve the balance of trade, and forestall the economic and political consequences of rising unemployment, price deflation, and low growth rates. Although the Treasury has espoused a strong dollar, its definition does not include its strength relative to other currencies, but rather as a currency of global significance that can not be disputed and a currency strong in the face of counterfeit activities. The Treasury has not, of late, adopted any policies that would strengthen or propose to strengthen the U.S. dollar.

Lastly, the Fed, acting jointly and in close cooperation with the U.S. Treasury, carries out foreign currency operations. Although millions of dollars of foreign currencies are traded each day, the U.S. dollar has continued to decline in value. It is quite apparent that the U.S. foreign currency exchange policy, executed by the Fed under the direction of the U.S. Treasury, is currently passive with respect to the U.S. dollar.

In short, the declining dollar is not the result of the actions (or inaction) of any one government agency. The Fed and the U.S. Treasury have taken considerable steps over the last 12 months to promote and implement domestic financial policies to avert numerous financial meltdowns and possible economic recession. The decline of the U.S. dollar did not happen by accident. The Fed and the Treasury have been in lockstep during these difficult economic times and the strengthening the U.S. dollar has not been high on their agenda, yet.

The Economy

Charles B. Atwill, CFP®

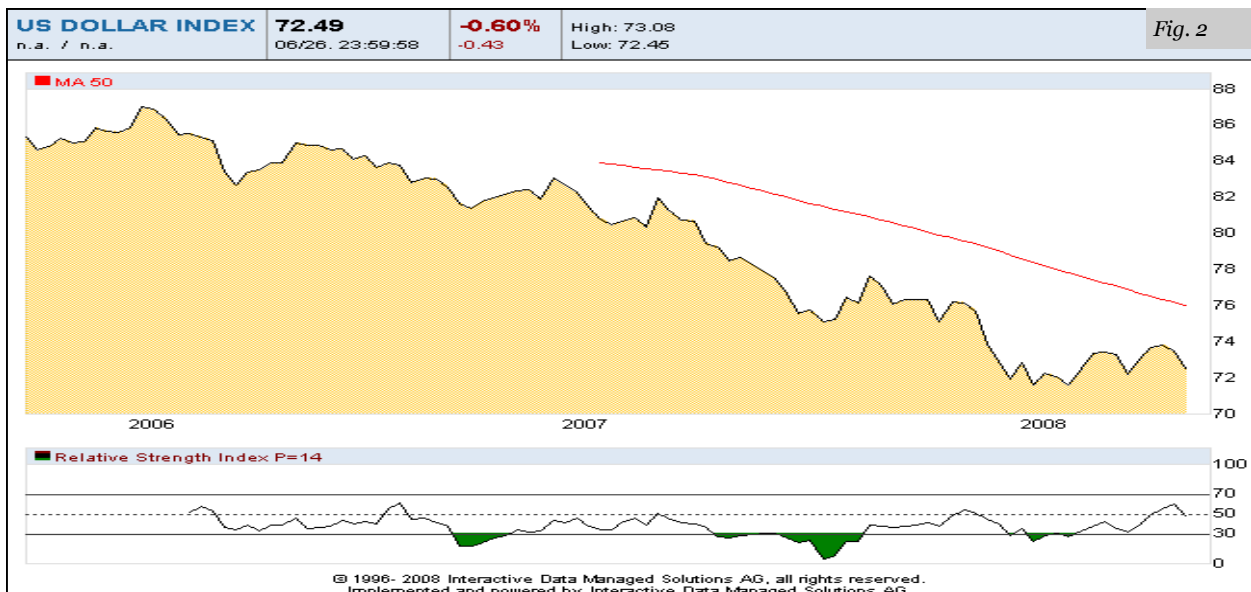
IN THE FIRST QUARTER OF 2008, U.S. corporate profits grew by an anemic—but still positive—**1.00%**. Likewise the U.S. economy, as measured by the Gross Domestic Product (GDP), grew at an annualized rate of **1.00%**. This tells us two important things:

1. The U.S. economy is expanding *very* slowly.
2. The U.S. economy is expanding, and therefore, NOT in recession.

The *National Bureau of Economic Research's* Business Cycle Dating Committee (which has the honor of officially christening a new recession) has not elected to meet—yet. This might suggest that they aren't fully invested in the idea that the economy is in contraction. Interestingly, *NBER* economist Martin Feldstein has been saying for several months that we are already in a *deep* recession. Thus far, the “official” numbers don't bare that out.

On the job front, the U.S. unemployment rate held steady at **5.5%**, not exactly a recession-like number. That said, 62,000 non-farm jobs were lost in June, according to the Labor Department. The bulk of these losses occurred, no surprise, in construction and manufacturing.

All in all, this U.S. economy has taken a number of body-blows recently (housing, higher gas prices, institutional collapses), and has still managed to stay on its feet. The *stagflation* risk is still a concern; un-checked inflation with no economic growth is a lousy combination. The Fed has paid lip-service to the inflation risk, but probably not consistently enough to have established credibility with the markets—as evidenced by the flagging dollar in the chart below. It will have to do a better job of communicating its position on inflation, or risk losing the high-ground on price stability altogether.



Continued from page 1 “Capital Markets Outlook”

horizon, an asset class with a good deal of risk-adjusted value for the investor.

Commodities

The run-up on commodity prices, crude oil, corn, gold—you name it—really starts to look to us like a bubble. And we all know what bubbles eventually do. It doesn't appear, strictly from a supply and demand standpoint, that we are facing real shortages in any of the key commodity index components.

It looks more likely that this sharp upward price movement is being caused by a) *the weak dollar* and b) *increased institutional investment in commodities*. The

latter, much like the force-feeding of a goose to make foie gras, is pumping a tremendous amount of money into a relatively small market (in comparison to the equity and credit markets).

The reason for this increase is at least partly due to money managers' interest in hedging against inflation. Commodities are a great way to do that. The more commodity prices go up, the more they suck new money in—a feedback loop of sorts. Fortunately (or not, depending on your point of view), these cycles don't last forever. When/if the dollar ever gets up off the mat (see “Fig. 2”), it's a safe bet that we see a correction in commodity prices. Eventually, *all* bubbles burst.

Continued from page 1 “Counting Our Blessings”

None of this, however, serves to advance the understanding of our economic/energy nexus, nor does it help us to plan for our future energy needs.

Let me be clear about one thing. In the immortal words of a former Commander-in-Chief, I feel your pain. We are all paying a lot more for gas at the pump than we ever have—even adjusted for inflation. The lack of foresight shown by our politicians, corporate heads, and yes, the American people in general, has been breathtaking. High oil prices are a drag on the economy, about that there is no question.

That said, it’s worth putting this cost in perspective before we declare a “crisis” which, according to some, will bring our economy to its knees. A little comparative analysis is helpful; relative to Europe (and most of the rest of the world, for that matter), we’re paying bargain basement prices for gas (see “Fig. 1”).

What is truly incredible is how we continue to pay so little for energy compared to everyone else! Unlike Saudi Arabia, Venezuela, Iran, and a few other countries with even cheaper gas than we have, the U.S. government does not subsidize gasoline and diesel fuels for its citizens. Given that we still remain in the bottom quartile for worldwide automotive fuel prices—we ought to be counting our blessings.

What we are experiencing, I believe, can more accurately be termed a “shock.” The rate of change of gas prices—not the absolute cost—is what has really hit the consumer. Painful? Yes. But nothing that the largest, most dynamic economy in the world can’t adapt to. Europeans have consistently paid more than double what we in the U.S. pay at the pump, and have managed to grow their economies nonetheless.

So shall we.

Sources:

Figure 1. *theoil drum.com*

Figure 2. *Interactive Data Managed Solutions, AG*

Economic data provided by: *Bureau of Economic Analysis (U.S. Dept. of Commerce), National Bureau of Economic Research, and Moody’s Investor Services*

ATWILL FINANCIAL CONSULTING GROUP, LLC is a fee-only investment advisory firm located in Richmond, Virginia. Our investment professionals, serving in a fiduciary capacity, provide investment management, financial planning, and other advisory services to our clients.

Our Services

- ◆ Investment Management
- ◆ Modular Financial Planning
- ◆ Total Wealth Planning™
- ◆ Retirement Income Planning
- ◆ Financial Divorce Planning
- ◆ Qualified Retirement Plans
- ◆ Custom Consulting Services

Contact Us

2924 Emerywood Parkway
Suite 100
Richmond, VA 23294

T: (804) 672-0040
Toll-free (888) 300-2517
F: (804) 672-2006
E-mail: info@afcgllc.com

On the Web: www.afcgllc.com

For more information, please contact us for our brochure.