

# Parsec Financial

## Second Quarter 2009 Newsletter

### Employer Sponsored Retirement Plans



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#### Special Points of Interest

- The economy is improving
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We have found there to be many common traits among small business owners. Of them, the desire to see the business support a retirement plan is usually within the top three or four. Herein lies one of the biggest challenges to the business owner. Along with being a proprietor, the personnel manager, and in some cases book-keeper, they must also become an expert on the complicated IRS and DOL rules for running a retirement plan.

It is an unfortunate reality that operating a small business retirement plan has become more and more difficult over the years. Although the plans are more complicated, they are not without benefit. Of the significant benefits, tax deductions and the ability to attract (and retain) talented staff members can be significant drivers to the company's success.

In most cases, the business owner becomes a trustee to the plan. In doing so, the trustee accepts the responsibilities of investment selection, choosing whom to use as a record keeper/Third Party Administrator (TPA), being a fiduciary to the plan and participants, and keeping costs low, to name a few. Many business owners are not completely comfortable in making these decisions.

When evaluating the investment manager and TPA, the trustee must review a number of factors when considering whom to hire. For instance, fee evaluation encom-

passes not only the professional oversight, but also a la carte items such as per-participant fees, application processing, website access, loan requests, and document preparation. In the case of group annuity contracts, Mortality and Expense ratios and commissions offer an additional layer of expenses. These can be as high as 3%+ annually!

Finally, one of the most difficult aspects to determine for the first-time plan sponsor is the level of service that should be provided. It has been our experience that there is often little to no ongoing education to the plan participants regarding retirement education and preparation. A study done by Dr. Greenwald, of Mathew Greenwald & Associates, suggests that there is a strong link to financial literacy and being adequately prepared for retirement<sup>1</sup>. Participants who do not have the knowledge of how to direct their savings to suit their needs will leave them woefully under prepared for retirement. This is an additional risk to the business owner because, as a trustee to the plan, not ensuring that participants are given the necessary information to make an informed decision regarding their retirement outcome could leave the trustee open to future litigation.

It is Parsec's desire to see that the investments are appropriately managed, and also the business owner is paired with a good TPA who will coordinate and ensure that questions are answered, information is provided on a timely basis, employees are educated and happy. This will ease the burden of responsibility for the business owner.

1. Preparing For Their Future, A Look at the Financial State of Gen X and Gen Y. March 2008. Pages 51 & 52.

## Dr. Jim Smith's Economic Commentary



Dr. James F. Smith

CHIEF ECONOMIST

### The Economy Is Improving—Slowly but Surely

To remember living through a recession longer than the one that began in December 2007 and probably ended on May 15 2009, you need to be as old as former Cleveland Indians star pitcher Bob “Rapid Robert” Feller, who is 90 years old. Not only is he the oldest living member of the baseball Hall of Fame, but on June 20 he took the mound in Cooperstown as the starter for the American League in the “Legends” game of Hall-of-Famers and former All-Stars.

Mr. Feller won 266 games and threw three no-hitters in his career, despite spending four years during his athletic prime serving on a U.S. Navy battleship during World War II. Before the game he was quoted as saying, “I throw just as hard as ever, but the ball used to get to the plate faster.” He’s one of the very few pitchers ever clocked throwing a 100-mile-an-hour fastball and observers in Cooperstown this year swore he could still throw in the 70-mph range.

Mr. Feller certainly remembers the “Great Depression,” which began in August 1929 (when he was 10) and ended in March 1933. At 43 months, that’s the second-longest economic downturn in the history of U.S. business cycles, with records back to December 1854. The longest one was the 65-month original “Great Depression” that ran from October 1873 to March 1879.

My expectation that the most recent recession will eventually be determined by the Business Cycle Dating Committee (BCDC) of the National Bureau of Economic Research to have ended on May 15, 2009 is based on recent research published by Professor Robert J. Gordon of Northwestern University in Evanston, IL. He has been a member of the BCDC since its inception in 1978.

On May 1, in a paper entitled, “Green Shoot or Dead Twig: Can Unemployment Claims Predict the End of the American Recession?”, he laid out the case for the recession having ended on May 15.

The gist of his argument is that for each of the last six recessions,

the peak in the four-week moving average of unemployment claims has come within a few weeks of the date the BCDC has eventually decided was the trough (bottom) of the recession. The table below summarizes his findings.

Weeks of Lead or Lag (-) of 4-Week Moving Average of Initial Claims to Recession Trough	
Recession Dates	Lead
December 1969-November 1970	4
November 1973-March 1975	6
January-July 1980	6
July 1981-November 1982	6
July 1990-March 1991	-3
March-November 2001	4

So far, the peak in this average came in the week ended April 4 at 658,750 claims. The actual number of initial claims has been lower in all but one of the ten subsequent weeks and thus the four-week moving average has declined, too. So has the eight-week moving average.

A new number is released every Thursday by the U.S. Department of Labor. You can follow it yourself on the Department of Labor website. The most recent number was 608,000 claims as reported on June 18 for the week ending June 13.

The peak this time is lower than the peak in 1982. As the labor force was much smaller then, the proportion of claims to the level of employment was much higher.

If April 4 holds up as the peak, then the BCDC should eventually determine the recession ended in May. Because we don’t have much economic data on a daily or weekly basis, the convention is that recessions end and expansions begin in the middle of the month. That would mean the recession ended on May 15.

Even if that turns out to be accurate, you’re not likely to personally notice any start of an expansion for quite some time. We won’t find out from the BEA until July 31

whether real GDP began to grow again in the second quarter or if that marked an unprecedented fourth consecutive quarterly decline.

#### Some Good News on the Global Front

On June 24, the Organization for Economic Cooperation and Development (OECD) released its latest economic outlook. For the first time in two years, the OECD has revised its growth forecasts upward from the previous report. Not only that, but for the first time in several years, they describe the risks to the outlook as “balanced.”

That means they are looking at just as many parts of the economic picture that could easily turn out better than anticipated as could turn out worse. Most importantly, they don't expect conditions in global financial markets to change much for the rest of 2009 and they expect them to return to normal during 2010. That would be wonderful for all of us if it turns out to be true.

Still, they are hardly suggesting a rosy scenario. In common with every other forecast known to me, they see the world economy declining this year for the first time since the end of World War II back in 1945. For all OECD countries, after pathetic growth of 0.8 percent in real GDP in 2008, they project a decline of 4.1 percent this year and a rebound of only 0.7 percent in 2010.

For the U.S., they expect real GDP to fall 2.8 percent this year, which is double my current forecast. For 2010, they expect a really slow recovery that would result in year-over-year growth of only 0.9 percent. Should that actually happen, you should expect to see huge gains by Republicans in the 2010 mid-term elections.

On June 22 the World Bank released its annual Global Development Finance (GDF) report with a rather gloomy prognosis that some observers don't consider gloomy enough. Their projections are for the entire world economy to shrink by 2.9 percent in 2009 after rising by 3.8 percent in 2007 and 1.9 percent in 2008. They foresee a return to growth at a sluggish 2.0 percent pace in 2010 and a better 3.2 percent rate in 2011.

The real calamity is in the volume of world trade. On average, that has grown about twice as fast as global GDP growth since 1945. It rose 7.5 percent in 2007 and 3.7 percent in 2008.

The World Bank projects a huge decline in world trade of 9.7 percent this year. They expect trade to grow by 3.8 per-

cent in 2010 and 6.9 percent in 2011.

For the U.S., they are more pessimistic than the OECD for this year with a projection of a 3.0 percent decline. However, they are much more optimistic than the OECD with a forecast of 1.8 percent real GDP growth for 2010 and 2.5 percent for 2011.

For the 16-country Euro Zone, the World Bank projects a drop of 4.5 percent in 2009 after growth of only 0.6 percent in 2008. They forecast exceptionally slow growth of 0.5 percent for 2010 and 1.9 percent for 2011. Should these forecasts prove remotely close to reality, you should expect to hear a great deal about turmoil and political unrest in these countries.

The World Bank projections for Japan are even worse. This is not too surprising, as Japan has already reported that its real GDP in the first quarter of 2009 was 9.1 percent below a year earlier. The World Bank forecasts the Japanese economy to shrink by 6.8 percent in 2009 after its already-posted 0.7 percent decline in 2008. For 2010, they expect Japan to grow by 1.0 percent rising to 2.0 percent in 2011.

They even forecast big growth slowdowns for China, which has averaged 9.2 percent a year since 1979 when it embarked on its path of “Chinese market socialism” under the leadership of Deng Xiaoping, the “paramount leader” who started China on this path. After posting robust growth of 13.0 percent in 2007 and slowing only to 9.0 percent in 2008, the World Bank projects that China will only achieve 6.5 percent real GDP growth in 2009.

That constitutes a recession for China, as they need real GDP growth of 7.0 percent to keep unemployment from rising. The World Bank only has their growth rate rising to 7.5 percent in 2010 and 8.5 percent in 2011. Many observers expect they will be able to beat those projections.

#### Congress Will Be Very Busy for Many Months

President Obama has given Congress enormous challenges on top of their normal workload. Usually they pretty much have all they can do to pass the thirteen appropriations bills that keep all the government agencies running (the so-called “discretionary” budget) before the start of the fiscal year on October 1.

They're actually running ahead of schedule on that task with three of the bills either already passed or very close. That's especially good because they had to deal with the ten bills for this fiscal year that the last Congress just wrapped up in one

huge continuing resolution.

However, President Obama is really pushing them with his plans for health care reform, dealing with global warming, a hugely complex plan for reforming regulation of the financial sector and many nominations including that of Judge Sotomayor for the Supreme Court. So far he hasn't sent them another economic stimulus plan, but that could come later.

In a very counterproductive move, he has asked them to postpone action on the highway and mass transit bill for eighteen months. The current legislation expires this year and nothing would be more useful for enhancing productivity in the U.S. than increasing infrastructure spending dramatically. An annual number closer to the \$220 billion recommended by the American Society of Civil Engineers back in January would be really helpful.

On health care, the basic problem is that Medicare and Medicaid are bankrupting the U.S. The Congressional Budget Office (CBO) has pointed out that federal government spending on health care has grown from 1.0 percent of GDP in 1970 to 5.0 percent today.

We've basically paid for much of that by reductions in the share of defense spending in GDP over the same period. However, with defense spending now down to only 4.0 percent of GDP, which is the lowest since 1940, that option is no longer available.

There are two basic problems with health care. One is that demand rises faster than incomes. The other is that Medicare basically makes no sense economically.

There is no economic theory that says that people who can survive until age 65 should have their health care heavily subsidized by people under age 65. It was proposed by President Truman and enacted under President Johnson primarily as a way to get people over age 65, who vote in huge numbers, to keep voting for incumbent politicians, most of whom were Democrats at the time.

Of course, the program is wildly popular. All people who get subsidies love getting them. Economists call that "rent-seeking behavior." The prescription drug benefit enacted under President Bush drove costs up dramatically. It's also a good example that Republican politicians are every bit as good at pandering to popular opinion, no matter how misguided, as Democrats are.

The CBO has put a big roadblock into the current delibera-

tions by pointing out the huge costs of the legislation proposed so far. Their estimates range from \$1.0 to \$2.0 trillion over ten years depending on what's in the various proposed bills.

No one has any ideas of how to pay for that. Raising taxes on households with incomes of \$200,000 or more won't even come close.

President Obama wants both houses of Congress to pass their versions of health care reform by August 1 and to have a bill on his desk before Halloween. That seems most unlikely, but if it is accomplished, it's likely to haunt the country for many years.

### The Data Are Slowly Getting Better

Levels of confidence of both business owners and consumers are steadily improving, although they are so far just about back to where they were before the bankruptcy of Lehman Brothers on September 15, 2008. The spread of 3-month U.S. dollar LIBOR (London Interbank Offer Rate) compared to 91-day Treasury bills has come down from 110 basis points in March to 43 now. That's still about 35 basis points above the old "normal," but is surely a move in the right direction.

The Federal Reserve Board reported on June 11 that consumers' net worth was \$50.4 trillion on March 31, 2009. That was a drop of \$1.3 trillion from December 31, 2008 and was \$9.8 trillion below a year earlier. It's the lowest total since 2004, but the rate of decline has slowed dramatically.

The economic news should keep getting better and better. My forecast is for real GDP to fall 1.4 percent this year. It should rise by 3.1 percent in 2010 and 4.8 percent in 2011. That's above the consensus, but in line with historic experience. Let's hope we see results at least this good as the whole world is counting on us to raise global growth rates soon.

<sup>1</sup> Member countries of the OECD are Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom and the United States.

<sup>2</sup> Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands,

## The Relationship Between Interest Rates, Government Deficits, Inflation and the Dollar



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The interplay between interest rates, government deficits, inflation and the dollar makes for fascinating economics, but to most people is largely confusing. Not to mention other variables, this set of interdependent issues will have huge global implications in the coming decade. Any discussion of global economics and the various forces that affect the direction of future growth are squarely centered on these relationships. The whole issue is similar to peeling an onion, where there is layer after layer of depth.

My hope on writing on such a vast topic is to center on the core issues and attempt to clear the air on what we expect to be a significant contributor to the success or failure of global equity markets.

**Interest rates** – The Federal Reserve has lowered short-term rates to essentially zero and is attempting to influence longer term rates by purchasing existing federal agency debt and Treasuries. The Federal Reserve has created several emergency lending facilities to help restore liquidity to frozen credit markets. The overall monetary stimulus, and in particular the quantitative easing, has the effect of increasing the money supply. Over time and left unchanged, this will affect inflation and the dollar quite meaningfully. As a result, the pressure is on Federal Reserve officials to withdraw this excess liquidity once economic conditions improve by raising interest rates. This truly tests the independence of the Fed in keeping its first mandate of promoting price stability. The reality is that political officials undoubtedly will desire to keep monetary stimulus surging while there is still high unemployment.

**Government deficits** – It took our country a long time to build up a \$10 trillion dollar national debt. With much of the total debt already owned by foreigners, we rely increasingly on these foreign governments to continue financing our deficits. The issue gets stickier when you look at the size of projected deficits that stand to add trillions this year and next. New debt issuance from the US government has

spiked, putting pressure on the ability to soak up this excess supply. It is imperative that government spending be carefully reviewed, and much to our chagrin, taxes are likely to rise in the coming decade. Many intermediate to long-term estimates for deficits rely upon increasingly optimistic assumptions to bring debt loads down as a percentage of GDP.

**Inflation** – The increasing money supply is likely a good thing in the short term as the economy is so damaged. Inflation is a concern since most of the \$797 billion dollar fiscal stimulus hits in 2010 when the economy may be well into recovery. The scary potential is the Fed is leaving their foot on the accelerator just as the stimulus gets going in earnest. Inflation does not feel like an immediate concern due to excess capacity across many areas of the economy, such as housing, factories and autos. However, as utilization improves we are likely to see inflationary pressure build. Wage pressure has not been a problem, but if commodities begin to surge, workers will require higher cost of living adjustments. When the time is best, the Fed must be willing to slow the rate of monetary stimulus, and do so quickly if necessary.

**Dollar** – Compared to the Euro zone region we enjoy a relatively low unemployment rate, lower taxes, less regulation and in relative terms, a better government budget. It will be interesting to see how the currency markets of the developed world compare to the emerging economies. China, Brazil and India are seeing economic growth rates that more than double those of the United States, Japan and Euro zone. If the dollar weakens considerably, imports would become more expensive, further fueling concern of inflation. Since the height of the financial crisis we have begun to hear a growing chorus singing the praises of a new global reserve currency. With China owning over \$700 billion of US dollar backed government debt, it will be important to watch to see how long or far that rhetoric may go.

Last fall and winter many economists and market strategists were forecasting lasting deflation, but they have become much fewer and quieter in recent months. Rising inflation has become the new more popular financial news story these days; you can hear it nearly every evening. The

conditions do appear to set up for rising inflation. As careful investors we must remind ourselves often that whatever news story, or whatever opinion we may have about an investment thesis, that there is a high probability of it being wrong. As a fiduciary we never want to be 100% wrong, thus we must diversify the outcome. Moving the investment portfolio entirely into vehicles that stand to either benefit from rising inflation or defend against rising

prices would be the incorrect thing to do. Since the theme of rising inflation is so popular in the news stories, perhaps those investment vehicles become overvalued as investors in the herd rush to the obvious. We recommend positioning the portfolio for varying future potential inflation outcomes; remember we never want to be 100% wrong. We will be watching as the next layer of the onion gets peeled off.

## Don't Forget...

We introduced our blog late last year and are finding it to be an enjoyable process. For those who have not yet read our recent thoughts, please consider this an invitation to go to our website and view the Parsec Blog. There you will find topics such as cost basis, trusts, market reaction, and other various strategies involving the financial planning

process. Additionally, please let us know if you are interested in reading the electronic version of our newsletter. At the same time it is printed and mailed, it is made available on our website. Check us out:

[www.parsecfinancial.com](http://www.parsecfinancial.com)

## Parsec Prize

The first and second quarter Parsec Prize is awarded to Mountain Housing Opportunities and Big Brothers/Big

Sisters. Each will receive \$12,500. Our sincere thanks and congratulations to each of these worthy charities!

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