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AUGUST 21, 2009

If we resume our nationally profligate ways and thus create the same red-hot economy we enjoyed a few years back, then the new recovery will be based on hot air, as was our last boom. It will inevitably burst.

In my opinion, what seems to have happened is that we have taken from future years' productivity to buy a bit of upward bias in Gross Domestic Product.

Citizens across the political spectrum might disagree about whether the stimulus packages have been necessary. But what we can't dispute is that the stimulus is potentially expensive in the long run.

The "cash for clunkers" program is an example of a program which is pulling economic growth from the future and transplanting it to 2009 at greater long term cost. People are buying next year's cars now. Yes, it is working. Perhaps it is necessary. These issues aren't really the point. The point, from my perspective, is that economic growth is being moved from there to here, at higher costs.

2. What I see as most probable and most attractive is an economy which recovers modestly and then goes gently upwards for a time, perhaps a few years, while the economy stumbles back to its feet.

If we've really learned our lesson, which is by no means certain, savings will stay at current high rates and consumer spending will recover grudgingly. That's ok, because such a slow recovery is probably much more sustainable. What could derail this recovery are uncertainties about health care and taxes.

We can debate forever about health care. Yes, the U.S. in general has superb health care, and yes, in many ways the system is broken. However, as an investment advisor, my concern is that big changes or uncertainties about the health care system may dampen the economy by restraining job creation.

08/20/2009

	Value	YTD %
Dow Jones Industrial Avg	9279.16	5.7 %
Vanguard 500 Index	\$92.13	12.2 %
Vanguard Total Bond Index	\$10.31	4.1 %

RIDING THE WAVE

As I write this, the financial markets are in the process of recovering very quickly. As I pointed out last year, this is normal. Yet today's report from Bank of America indicates that financial professionals are more optimistic than at any time in the past 6 years. In March, they thought the world was ending. Things change.

What this means to me is that we've careened from irrational negativity to irrational optimism. That doesn't mean they're wrong. It just means that they are behaving viscerally. Nobody, not even financial professionals working on Wall Street, can predict the future.

If we look at the economic numbers, we are clearly just beginning a recovery from one of the worst recessions of our lifetimes.

From this point we might experience a spectrum of possible outcomes. These can be sorted into three big baskets of possibilities.

1. A quick recovery. Historically, this is the most likely outcome. Sharp downturns are usually followed by sharp upturns. However, as a nation we are carrying way too much public and private debt. We probably need to pay it down a bit, or have the financial system absorb it via bankruptcies and foreclosures.

Likewise, taxation is a big unknown right now. Data from 2006 indicated that the richest 1% of the American population made 19% of the income, but paid 37% of all federal income taxes. The top 10% paid 68% of all federal income taxes. The lowest-paid 50% of the American work force made only 13% of the income but also paid only 3% of the taxes. So the top 50% of all American earners pay 97% of the federal income taxes. These people are historically very reactive to an increase in tax rates. Some of them react by choosing to earn less, which has a tremendous trickle-down effect.

If marginal tax rates increase, those with investments may move money from productive venues which earn taxable returns, like stocks, bonds, and real estate. Instead, they may invest in more sterile, less productive assets, such as municipal bonds, collectibles, or an unrented beach house. In other words, those citizens who pay most of the taxes tend to react to an increase in taxes by reducing the productivity of themselves and their investments. Both choices result in a slower-growing economy. Thus a potential increase in taxes will possibly slow the economy down.

Higher marginal taxes appear to impact economic growth when TOTAL TAXATION including corporate, social security, state, local, and federal approaches 40% to 50%. Top tax rates currently being discussed by both parties with nary an open mouth vary between 60% and 75%. There is a potential for economic stagnation if these rates are instituted.

3. Thus, it is also possible, albeit less likely, that the economy might stall and fall back into recession. A careful reading of the Great Depression reveals that this happened in 1933. The economy was recovering, and then higher income taxes and trade barriers smothered it. A recovering economy is like a person recovering from the flu: slowly getting well, but vulnerable to new infection.

Geopolitical or fiscal changes could have unexpected consequences on a recovering economy.

We don't know what will happen. I expect that the MOST PROBABLE but by no means certain path of the S&P 500 over the next 10 years will be the fitful, uneven delivery of an average rate of about 10% or so per year.

In other words, I expect some great years, some bad years, and some muddling years. Something unexpected could easily throw this expectation on its head. But unless something changes, this will not be a golden decade in the history of the stock market. However, as always, pockets of brilliance and opportunity will emerge domestically and globally. We need to invest in diversified mutual funds to capture those opportunities.

For what it's worth, I expect even less from real estate.

Therefore, this quarter, we are looking to asset allocation funds to buttress our flexibility and emphasize investments which deliver income. We intend to move only about 10% of the portfolio for most investors, and weed the garden a bit in the process.

If you are a lower-risk or moderate-risk client, you will see a mix of more short-term bond funds and a few conservative asset allocation mutual funds. These favor flexibility and income, so that in a sideways scenario we can still access cash flow.

If you prefer a higher risk portfolio, you will probably see a few aggressive but very flexible funds appear in your accounts. These will be purchased in small amounts to provide both risk-reducing diversification and opportunity for potential gains. And as always, we will continue to stay the course.

INVESTMENT SEMINAR

"The Economy and the Bond Markets"

Thursday, September 24, 2009 5:30 - 7:30 pm

158 W. Gabilan St. Salinas, CA

The guest speaker will be Philip Hodson of Mainstay Investments.

Please RSVP

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A light dinner will be served.