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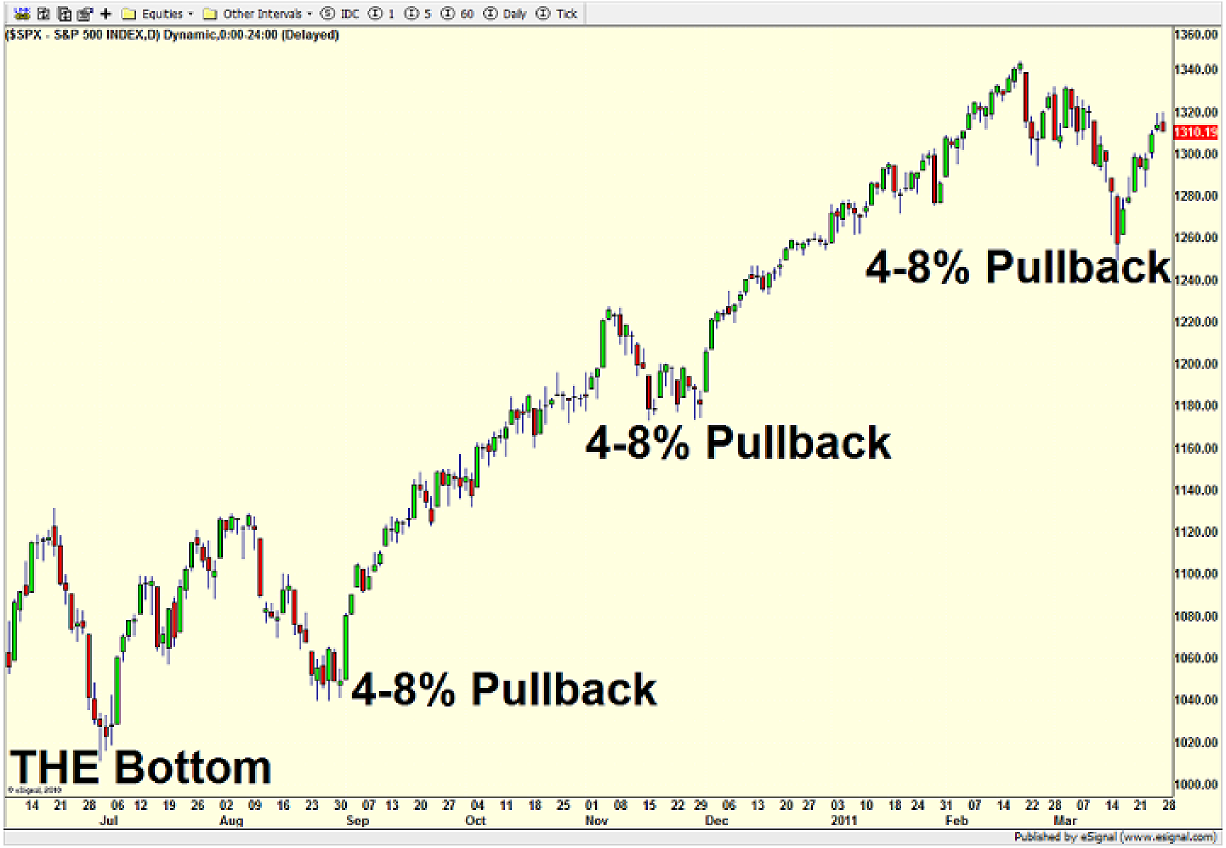
Flying Through The Airport

As I have discussed over the past few weeks, the stock market continues to come to various forks in the road, which I have diagramed in the charts. Having rallied nicely in the last week or so, I find another interesting crossroad this week. From high to low, the S&P 500 declined about 7%. This is the third 4-8% pullback (less than 10%) since THE correction bottom on July 1, 2010 as you can see from the chart below.

Unlike the previous two pullbacks, the most recent one has done some significant technical damage to the markets. By damage, I am referring to key price points on many stocks and sectors being breached that normally shouldn't in a healthy bull market. That serves as a warning shot across the bow, but by no means, an all out sell signal. If there is additional danger over the horizon where a correction (10-20%) looms, history says there should be at least one more rally that is glaringly weak. I think that is a possibility during the second quarter, but let's wait and see what the market has to say.



Having now regained more than half what the S&P 500 recently lost, this is the ultimate area for the bears to put up or shut up. Over the years, I have found that if the first rally fails after a pullback from a multi year high, the market is vulnerable to an elevator shaft decline. Remember, I said "vulnerable" not probable or guaranteed. But, liquidity remains strong as seen in the performance of junk bonds and small cap stocks, and Ben Bernanke does not seem to be wavering in his commitment to the markets through Quantitative Easing, which you will read about below.

Contrary to what you may have read or heard about all month and quarter ends being seasonally positive, March is the exception to the rule. So given how much stocks have bounced so far and the seasonal tailwind for the bears this week, some weakness should not come as a surprise. On the flipside for the bulls, if they can hold their ground until next week, it could spark another good move to the upside as frustrated bears throw in the towel. Keys to the future include the behavior of high yield bonds, sector leadership and reaction by the bulls as the major indices approach prior highs.

What an incredible March Madness (NCAA basketball tournament)we've had so far! As I was filling out my brackets, I kept wondering if this could be the year when three or four number one seeds make the Final Four. HA! Not a single number one seed is left!! And of course, it's the year I have UCONN losing early. So much for my picking prowess. Glad my livelihood doesn't depend on it. It should be two amazing games this Saturday. If your team has been eliminated, come on over to the Husky Nation. All are welcome!

FYI, I will be on CNBC's Worldwide Exchange on March 30 at 5:35am and 5:50am. To pack the most into my day, I am going to try to catch a 7:00am flight to Atlanta right after. That ought to be an interesting dash through the airport!

My wife's family is probably gasping right about now as they are the ones who like to arrive at the airport hours before flight time to sit around and do nothing. I, on the other hand, try to time it perfectly to arrive at the gate just in time to board. As you can imagine, there is no way our whole family can travel together. So they go to the airport with hours to spare and I show up as the gate agent is doing last call! And everyone is happy...

Time to Add Inflation to Your Financial Plan?

Would you purchase $10 billion of five-year U.S. Treasury inflation protected securities (TIPS) at auction with a yield of negative 0.55%, in effect, paying the U.S. government to take your money?

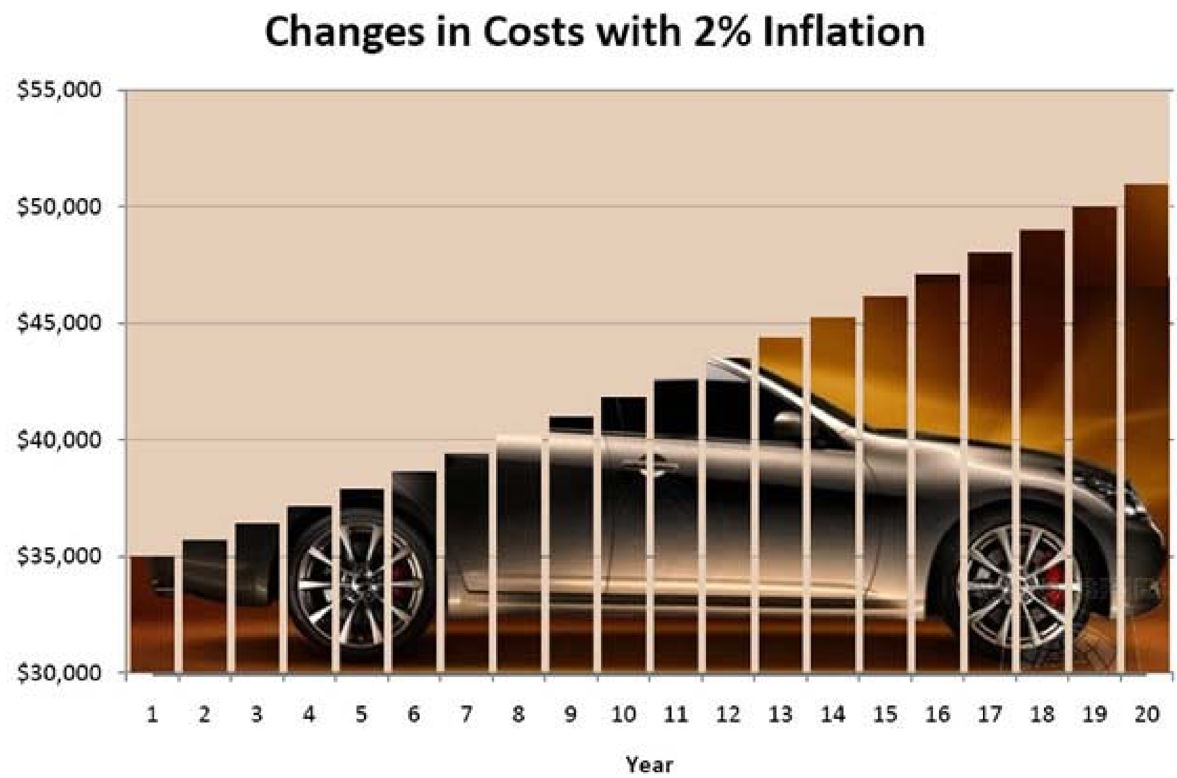
When that happened October 25, 2010, the message was clear. Investors expect the Federal Reserve's announced intention to create inflation will be effective. Effective to the point of substantially recovering the loss incurred at the initial purchase of the securities through the TIPS' increase in yield over time to match inflation.

After two years of government intervention to get the economy back in gear and lower unemployment, the Federal Reserve stepped in at its November meeting to initiate Quantitative Easing II (QE2) with a very specific goal - to spur inflation at a sustainable rate of 2% and continue to flood the financial system with liquidity. In comparison, for the first three quarters of 2010, U.S. inflation, as measured by the Consumer Price Index, averaged just above 1%.

Inflation at its most basic is a broad rise in the prices of goods and services that reduces purchasing power. Inflation encourages people to buy more today, moving purchases forward in time. When it works as intended, inflation-produced demand drives a ramp up in production, creating new employment opportunities from the manufacturing floor to the sales room. Extending this same reasoning to the housing market, inflation could stabilize sales prices and create increases in housing prices, spurring a recovery in an area viewed with the most concern by many economists. If foreclosed homes can be sold for higher prices, losses will be less for banks, mortgage investors - including Freddie Mac and Fannie Mae - and ultimately the U.S. taxpayer. With sufficient improvement in home values, home building will make sense again, generating construction jobs.

Inflation will be good news for borrowers because they can repay their debts with currency that is worth less. Higher inflation also tends to push up wages, making it easier to pay off fixed-rate loans. For local, state and federal governments, higher wages mean increased tax revenues, providing more funds to pay off accumulated debt and to fund increasing costs.

Inflation is not such good news if you are retired, however, even if 2% may seem like a manageable annual increase.



2% inflation adds up over time. A car that cost $35,000 in year 1 will cost $37,000 in year 5, $41,000 in year 10 and $45,000 in year 15.

Inflation erodes the value of savings. Deliberately creating inflation could open Pandora's box. Will the Fed be able to thread the needle by controlling inflation at its 2% target? In targeting a sustainable 2% rate of inflation, the Federal Reserve uses the median Consumer Price Index. The median CPI disregards price changes in food and energy, two factors that have considerable influence on household budgets.

Another issue is the tool the Fed is using to create inflation - quantitative easing. QE essentially floods the market with excess cash by creating money to purchase federally insured debt. The first round of Quantitative Easing took place throughout 2009, as the Fed bought up distressed mortgage-backed, agency and treasury securities from banks in exchange for cash, taking the Fed balance sheet of securities from $800 billion to $2.2 trillion.

In addition to spurring inflation, QE II was expected to drive long-term interest rates lower and continue the decline in the value of the U.S. dollar. While lower interest rates benefit borrowers, they penalize creditors. Many investors are creditors through their investments in income producing bonds and debt securities. A lower U.S. dollar will make U.S. exports more attractive in international markets but has the potential to increase imported energy and food costs as well as the costs for a vast array of products imported from other nations.

By lowering the yield of Treasuries and other safe debt instruments, the Fed encourages investors to put their money into different, potentially higher-yielding investments. Investment in equities and high yield debt will increase funds available to businesses to expand. The risk to investors in moving from relatively low risk/low return securities to higher return/higher risk investments is that they fail to understand the risk they are assuming for that higher return.

In uncertain times, however, capital preservation has to be a primary consideration. The current market uncertainties will pass and there will be opportunities to profit with lower risk, but only if your capital is kept intact. Preserving and optimizing capital through risk managed investing is essential.

Investments cannot be selected based on what has worked in the past, but what is working now. Any investment in equities must be made with an exit plan in place. Short-term debt, which gives the investor the flexibility to reinvest when interest rates rise, Treasury Inflation Protected Securities (TIPS) that adjust to keep pace with changes in the consumer price index, and floating-rate debt are tools to consider.

These are tricky and challenging markets to negotiate. Before you invest in these or other investments suitable to inflationary or deflationary times, pick up the phone and call us or hit reply to email us, understand your risk exposure and remember, times change. Don't lock yourself into positions from which you cannot recover.

Use First Time Jobs to Fund a Roth IRA for Your Teen

Was the teenager in your family employed in 2010? If so, it may be a good time to fund a Roth IRA for that individual. To fund an IRA, your teen must have earned money in a manner that can be substantiated, whether from a summer job or part-time work after school. The lesser of the total amount earned or $5,000 can be contributed to the Roth IRA.

While the same amount could be contributed to a regular IRA, a Roth has some advantages that work better for young savers. With a Roth IRA, contributions are after-tax. The contribution to a regular IRA can be deducted from current income. The lack of a tax deduction for a Roth contribution typically doesn't matter for young earners, however, whose income is likely to be taxed at very low rates, if at all. (An unmarried dependent child's standard deduction will automatically shelter up to $5,700 of earned income - for 2010 and 2011 - from federal income tax.)

In addition, Roth IRAs have some special provisions that can be very beneficial for young savers. The first benefit is simply the ability to potentially accumulate a substantial nest egg by retirement through compounding over 50 years. A $5,000 annual contribution made for five consecutive years, compounded at 6% annually would be worth $411,240 in 50 years. Under the Roth IRA structure, the original $25,000 in contributions and the accumulated earnings will be free of federal income taxes. Second, after five years, a Roth IRA account holder can withdraw all or part of regular Roth contributions -- without any federal income tax or penalty -- to pay for college or for any other reason.

Roth earnings can be withdrawn tax-free if they meet the five-year test and one of four types of qualified distributions:

- Distributions made on or after the date the accountholder reaches age 59½.
- Distributions made to a beneficiary after death.
- If the account holder becomes become disabled, distributions attributable to the disability.
- "Qualified first-time homebuyer distributions."

In addition to helping a young person accumulate funds for retirement, a first home, or a serious need, establishing a Roth IRA is a great way to start a teenager on the path of saving. While a parent or someone else can provide the money used to fund a Roth IRA (provided the individual in whose name the account is set up has verifiable earned income), it's important to make certain the individual contributes funds as well. You want them to take a sense of ownership in the account and the actions that cause it to grow in value.

To Your Financial Success,

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