Quarterly Newsletter,
1st Quarter 2009
4/21/09

Congratulations to Brian. He was quoted in *Smart Money Magazine* in the May 2009 issue on page 67, discussing asset allocation.

We hired an intern to work with us. Her name is Chris Remedios. She graduated with distinction from the financial planning program at UC Berkeley and passed the CFP exam this January. Please join us in welcoming her to our firm.

For Clients and Friends of Financial Connections

January and February continued the downward trend of investment markets, but March offered a reprieve. Stocks saw their best one-month gain in six years. The quarter still ended with double-digit losses.

S&P 500 *Large U.S. companies*	–11%
Wilshire 5000 *All U.S. stocks*	–10%
International stocks *MSCI EAFE*	–14%
Bonds *Barclay Capital Aggregate taxable bonds*	1%

We think the stock market increased in March because the economy performed less badly than anticipated, not because it performed well.

<u>Recap of the current economic situation</u>

The fundamental problem is that over the last few economic cycles, U.S. households and financial service businesses took on additional debt in order to fund consumption and investments. This trend was self-reinforcing, as purchases with borrowed money drove up asset prices (such as homes and stocks) and profits, which then supported more borrowing.

Ultimately this trend became unsustainable. The unwinding has created the reverse problem: an adverse feedback loop of falling asset prices and lower spending and profits. As the economy continues its decline, contributing factors (e.g., rising unemployment, mortgage defaults, loan write-offs, reduced lending, and overall fear) all fuel one another.

<u>The consumer and lender of last resort</u>

The government, most experts agree, must stop or mitigate the effects of this adverse

feedback. The government is the only entity that can take on more leverage and spend more to plug the gap created as the consumer and private sector reduce their debt.
To date, Congress, the Federal Reserve, and Treasury have

- loaned money to troubled institutions,
- reduced interest rates,
- bought long-term government debt, and
- passed a stimulus package.

Many economists believe the stimulus package is too small or that an additional stimulus package will be enacted.

No one knows which of these programs the government is promoting will succeed. Note also that the United States is not alone in taking on additional debt to fund consumption and investment. It is a global problem. (See related article.)

<u>Positive Trends</u>

As the credit markets improve, so will the economy. Here are indications that improvement has already begun.

- Borrowing costs have fallen from record levels set in October 2008.
- Increasing number of companies have sold debt.
- Mergers and acquisitions are trending upward (a leading economic indicator).

There is unprecedented cash still sitting on the sidelines. Once confidence starts to return, a large amount of money may be getting back into the markets.

<u>Reports and Disclosures</u>

Included with your quarterly reports, we have enclosed our annual disclosure statement (ADV) and Privacy Statement.

If you'd like to come in to review your portfolio, discuss retirement strategies or just talk in general, please let us know. We'd be happy to get together.

WHAT'S THE SITUATION IN EUROPE?

Eastern Europe borrowed an estimated $1.7 trillion primarily from Western European banks. A large portion is denominated in Swiss francs. Because of the global recession, it is anticipated that the European problem will be as big as or bigger than our subprime problem.

For example, in Poland, 60% of the mortgages are in Swiss francs. Switzerland offers low-interest mortgages. When currencies are stable, all works well. A borrower can have a low-interest loan in francs or euros.

As a result of the global recession, the Polish currency, the zloty, lost half its value. That means if you are a mortgage holder, your house payment doubled because of the exchange rate of the zloty to the Swiss franc.

Austrian banks lent $289 billion (230 billion euros) to Eastern Europe. This equals almost 70% of Austria's gross domestic product (GDP). Much of it is denominated in Swiss francs borrowed from Swiss banks. According to Joseph Proll, Austria's finance minister, even a 10% impairment (a highly optimistic estimate) would bankrupt the Austrian financial system.

John Mauldin, a financial journalist and investment analyst we respect, writes the problem in Europe is that there are many banks that *"are simply too big to save. The size of the banks in terms of the GDP of the country in which they are domiciled is all out of proportion."*

According to the International Monetary Fund (IMF), Western European banks are 50% more leveraged than U.S. banks!

Many economists believe the U.S. economy will revive before Europe's. I think we can begin to see why.

It is true that the dollar is stronger than the euro. While many European nations have the euro as their currency, they have multiple governments and each country has its own politics with its own problems.

Because we have one currency and one government, we have an advantage in this environment. It keeps the dollar strong—at least for the moment.

CHANGES IN MARK-TO-MARKET

During our conference call on March 2, we discussed how this accounting rule forced banks and other companies to write down "damaged assets" by requiring them to value the assets—subprime mortgages, for example—at their value in today's market. This rule is blamed for exacerbating the financial crisis.

We used Jill's mortgage and Warren Buffet's Berkshire Hathaway as examples during our call.

The Financial Accounting Standards Board (FASB) voted April 2 to give institutions more flexibility on using mark-to-market. They said the objective of mark-to-market accounting is to value what would be received in an "orderly" transaction. The FASB says that does not mean it must be priced to include forced liquidation or distressed sale.

It is anticipated that the FASB's vote will improve the financial profitability of firms since many of these assets will be held to maturity—not sold today.

ON THE LIGHTER SIDE

In this time of constantly negative headlines and news reports, it is sometimes hard to be upbeat or optimistic.

The weekend of April 11 held a surprise that can't help but generate smiles. The British have a talent show that, like its U.S. counterparts, searches for talent but does not always find it.

A 47-year-old unemployed British woman shocked and delighted the judges and audience with her singing. She has already been on *Good Morning America*. It is a reminder not to give up on your dreams. The video is only 7 minutes long. We think you will enjoy sharing this woman's triumph.

Go to: www.youtube.com — search on Susan Boyle. Enjoy!

We often say, "Why can't we hear or see a little good news?" Below are some Web sites that are dedicated to a more positive point of view.

Positive News Network: www.positivenews.net
Ode Magazine: www.odemagazine.com
Happy News: www.happynews.com
Optimist World: www.optimistworld.com
Good News Network: www.goodnewsnetwork.org
Good News Served Daily: www.gimundo.com

TD Ameritrade has a new option. You can now receive your trade confirmations quarterly instead of at the time of the trade. If you're interested, please let us know and we'll start the process.

As your mutual funds shares reinvest, you are buying new shares at a lower cost. When the market rises, you will have more shares available to grow.