

Five Burning Questions

By David L. Blain, CFA

If you are a regular reader of financial publications or an avid watcher of business television media, you've probably read or seen one of the following five questions discussed. Unfortunately, most reports tend to be negative in nature, tilted toward the editorial bias of the particular medium or tell only one side of the story. Therefore, with my advisor hat placed squarely on my head, I will try to answer these burning questions honestly and without prejudice.

What is the relationship between the housing bubble and the meltdown in the credit markets?

Conventional wisdom holds that the Federal Reserve lowered rates too quickly from 2001 to 2003 in hopes of softening the effects of the technology sector bust then didn't raise them fast enough during 2004. This delay prompted a mania for home ownership especially among subprime borrowers.

The mania was encouraged by government policies, lenders and the media causing home prices to soar to unsustainable levels. When this so-called "bubble" burst, it led to recession in the residential real estate market and trouble in many peripheral industries, most notably the credit markets.

The recent distress in the credit markets has been caused in part by the collapse of certain derivative securities known as collateralized debt obliga-

tions or CDOs. While CDOs have been around for years, it was the use of subprime mortgage-backed CDOs that led to the current problems on Main Street and Wall Street. Here, in a nutshell, is what happened.

To raise capital, banks and brokerages issued bonds using subprime CDOs as collateral. The bonds were sold to other banks, brokerages and hedgefunds to fund mergers and acquisition activities or as alternative investment vehicles. These financial companies purchased the bonds on margin (putting down a small portion of their own money and borrowing the rest).

When the borrowers who held the underlying mortgages in the CDOs began to default, the bond issuers couldn't make interest payments, buyers couldn't pay their loan interest and margin calls were made.

This situation made pricing CDOs difficult if not impossible, and led to almost total illiquidity of the securities (a bigger problem than the actual defaults of CDOs). As a result, billions of dollars had to be written-off. Sadly, the extent to which CDOs were incorporated into Wall Street was not known by the public or the financial institutions themselves. In a Fortune magazine article last year, Robert Rubin, the chairman of Citigroup, admitted that prior to the company's woes he "had no familiarity at all with CDOs."

To be fair, the housing boom also led to unprecedented levels of homeownership, contributed to lower closing fees and spurred innovation in the creation of mortgage products. And, in fact, the vast majority of homeowners are not in danger of defaulting on their mortgages or losing their homes.

What is the impact of rising oil prices on inflation?

There are obvious reasons for the rise in oil prices including increased demand in China, India and other emerging economies, lack of production in Iraq, lower OPEC output, and lower inventories overall. There are, however, more subtle reasons such as market speculation, corroding infrastructure, political unrest, lag time in bringing new oilfields online and, to a lesser extent, the falling dollar.

First, let's take a look at the impact of a weaker dollar. Oil, for the time being, is priced in dollars. Therefore, strong demand combined with a weak dollar means it takes more dollars to buy oil thus driving up the cost. Also, the weakening dollar may induce investors to seek a safe haven in commodities such as oil or gold. While both of these points of view may have some validity, it's more likely that the rise in the price of oil is simply a question of supply and demand.

What about the price of oil and inflation? The rise in the price of oil certainly contributes to an inflationary environment, but it is not the primary cause of inflation. One of the primary indicators of inflation is the Consumer Price Index (CPI). The Bureau of Labor Statistics defines CPI as "monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services." But a more important indicator is Core CPI which *excludes* more volatile energy (including oil) and food prices. That's because energy and food can be subject to large price changes due to supply disruptions such as production cut-backs or drought. This volatility makes

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them less representative of relative price increases which are a more accurate measure of consumer inflation.

As a consumer, the effect of higher oil on the economy-especially at the gas pump-is all too noticeable (it's important to note that so-called "Big Oil" has nothing to do with setting the price of gasoline or any interest in gouging consumers). However, as an investor, fluctuations or volatility in one market present opportunities in others.

How does a weak dollar affect the U.S. trade deficit?

The US trade deficit is defined simply as the condition when the value of our imports exceeds the value of our exports. Intuitively, it seems that as the dollar falls, it will create more foreign purchasers for US goods thus lowering the trade deficit. But despite the drop in the dollar, the deficit has risen from \$38.6 billion in January of 2002, to \$58.2 billion in January of this year. However, the drop in value of the dollar against many of the world's major currencies has not been enough to have much effect on our trade deficit. This is partly because the dollar has not experienced the same decline against the currencies of two of our largest trading partners, Japan and China, as it has against the Euro.

The relationship between the value of the dollar and the trade deficit is fairly straight forward, but how is the dollar valued? The dollar is a commodity, and like any commodity, its value is based on its relationship to other like commodities, in this case other currencies. This relationship can be complex, but simply put, the value of the dollar is an expression of its purchasing power both internationally and domestically as compared to other currencies.

One reliable measure of the dollar's value is the U.S. Dollar Index (USDIX). The USDIX was created in 1973 as a way to measure the value of the dollar against a basket of other major currencies including the U.S. dollar, the Euro, Japanese yen, Canadian dollar, Pound Sterling, Swedish Krona, and Swiss

Franc. The original price of the index was \$100, but it recently traded at \$70, the lowest price since inception. Of course, the value of the dollar can also be tracked using daily foreign exchange rates listed in most major newspapers.

As the slowing US economy begins to affect Europe later in the year, it will likely force the European Central Bank to cut rates which should mark the beginning of a turnaround for the dollar. However, the trade deficit will continue to fluctuate without any major changes up or down.

Do presidential elections affect the economy?

During the 1992 presidential campaign between George H. W. Bush and Bill Clinton, James Carville famously said, "It's the economy, stupid." While incumbent president Bush focused on international affairs, Clinton focused on the economy. Clinton won. So, does the economy affect election results, or do election results affect the economy?

According to Ned Davis Research, since 1888, when either incumbent party wins, the S&P 500 has been up an average of 13.95% for the election year. When either incumbent party loses, the S&P has been up an average of only 3.39% for the election year. Election years when the Republican incumbent wins, the S&P 500 has been up an average of 17.47% vs. 8.91% for Democrats. Statistics from measuringworth.com show that when either incumbent party wins, real GDP grows by an average of 7.43% for the election year. When either incumbent party loses, real GDP grows by an average of 7.36%. For election years when the Republican incumbent wins, real GDP grows by an average of 7.42% vs. 7.43% for Democratic incumbents. For election years when Republican incumbents lose, real GDP grows by an average of 7.26% vs. 7.46% for Democrats.

Given these results, it's likely that presidential elections have less effect on the economy than the economy-as a campaign issue-has on elections. After all, Election Day is in November, and by that time the final tally of GDP and the performance of the S&P for the

year are mostly known.

What is the economic impact of the wars in Iraq and Afghanistan, and terrorism?

The increase in government spending to fund the wars in Iraq and Afghanistan, and to fight the global war on terror certainly has an impact on the economy. But, is it really the major drain on the economy as the news media reports? Let's take a look at the terror issue first.

The immediate impact of another 911-style attack in the U.S. would most closely resemble a natural disaster such as Katrina with sudden losses followed by the stimulus of the rebuilding effort. In the short term, this kind of attack creates global uncertainty and can cause short term market declines, lower rates of return on certain investments, and the transfer of large amounts of capital borders as investors seek safer markets.

The ongoing economic impact of terrorism in the U.S. is similar to that of the annual urban crime rate (0.05 percent of GDP per year). Part of this may be caused by restricted monetary flow to stop asset transfers, money laundering, and freeze assets of sympathetic countries or groups to deprive terrorist groups of money. Also, tighter border controls can trigger trade disruptions and cause imbalances. Finally, tensions between allies and others over tactics to fight terrorism can cause economic disruption.

Since 2003, the cost of the wars in Iraq and Afghanistan as a percentage of GDP has been about 4%, compared to 21% for WWII, 14% for the Korean War and 9% for Vietnam. (According to the Congressional Budget Office, spending on Medicaid, Medicare and Social Security accounted for about 9% of GDP for fiscal year 2007, more than double military spending.)

Conclusion

While its true there may be storm clouds on the horizon, the sky isn't falling. So, if you're feeling pessimistic about all the negative economic news in the press, put down the paper, turn off the TV and read a good book.

Secular Bear Markets

By David L. Blain, CFA

We may be in the midst of what I refer to as a secular, or long-term, bear market. Secular bear markets are usually comprised of several cyclical, or short-term, bear and bull markets. During a typical secular bear market period, returns on stocks can lag behind returns on U. S. Treasury bills.

This does not mean, however, that we should not be invested in equities and other asset classes. It simply means that we are more considerate when making investment decisions about which asset classes and individual securities we include in our portfolios. After all, regardless of what the markets are doing, there are always opportunities for those who are patient and disci-

plined. Let's take a look.

First, in a typical portfolio, we own between 25 and 40 individual securities representing numerous asset classes, sectors (energy, consumer staples, tech, etc.) and several different market capitalizations (large-, mid-, and small-cap). Stocks from different sectors with different market capitalizations rarely move in the same direction at the same time. This diversification within the equity asset class helps protect our portfolios against sudden downturns in the market.

Secondly, while it's true we are currently experiencing a secular bear market in equities, it is equally true that

we are experiencing a secular *bull* market in commodities. That's because stocks and commodities are, for the most part, inversely correlated. This simply means that when stock prices go up, commodity prices go down, and vice versa. It's because of this inverse relationship that we maintain a commodities position in most of our portfolios to help limit downside risk.

Finally, it's important to remember that in a diversified portfolio, equities make up only a portion of the overall allocation. A proper balance between equities, bonds, commodities, cash and real estate is more likely to improve expected return, reduce overall risk and help you achieve your financial goals.

Who We Are, What We Do

By Jeb Collier

At D. L. Blain & Co., LLC, we are wealth managers, not just financial planners or investment advisors. We consider the families and individuals we advise as partners, not just clients. Therefore, we are involved in all aspects of their financial lives and we purposely maintain a lower number of partnerships to ensure that we can stay personally engaged.

Wealth means something different to every partner we advise, they do not pick and choose which services they *want* but rather, they receive counsel regarding all of the services that managing their wealth *requires*. We provide stewardship of our partners' total wealth and they in turn invest us with full discretion in making financial decisions. Simply put, we give our partners comprehensive advice on managing their wealth in all its dimensions.

We devote all our focus and energy to improving the quality of our partners' lives by better managing their wealth. We understand their financial, health and wellness, professional and family circumstances better than they do. All decisions regarding their wealth are made with a view towards seeing them through retirement and securing their legacy to future generations. And, all decisions are made within the context of a fiduciary relationship. Partners should judge our performance based on a measurable change in the overall quality of their lives. In other words, do they feel more secure, and are they better able to comfortably enjoy their wealth, how and when they desire.

People often ask us what we think interest rates, the stock market, bond yields, etc., are going to do in the fu-

ture. Instead of trying to predict the future, we simply try to achieve consonance with trends as they evolve then limit our downside as they wane. We help our partners remain diversified by reallocating assets away from investments that have done well and those that have underperformed, to investments in emerging trends.

We do not offer standardized or canned advice on topics related to wealth management. We are not an absentee wealth manager who is available only when he or she finds it necessary or convenient. We have a staff of very capable professionals who share the same level of respect and concern for the well being of our partners. In fact, since starting D. L. Blain & Co., LLC in 1999, we have not had a single partner leave of their own volition.



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Inside the Company & In the News

By Mary Ellen Crisp

D. L. Blain & Co., LLC in conjunction with Swift Creek Holdings, LLC recently announced the provision of \$2.6 million in debt and equity funding to purchase 450 acres for the development of Swift Creek Plantation, a new country estate community located near beautiful and historic New Bern, North Carolina. Swift Creek Plantation is a multiphase development offering spacious home sites and award-winning home designs in a pastoral setting. The Swift Creek Plantation development consists of 160 home sites – including lake- and high-bluff creek-front, and equestrian-approved sites – varying in size from one to nine acres arrayed across a diverse landscape of woods and water. It will also include 18 multifamily homes located immediately adjacent to the primary road front. Amenities include a 20-acre lake with beach and picnic area, dock and canoe/kayak landing, covered pavilion and fireplace for entertaining, walking paths, and nature trails. Homeowners will have an award winning collection of architectural designs to choose from measuring 2,000 to over 3,500 square feet. Plans feature three- or four-bedroom and two-and-a-half- to four-bathroom configurations. Available styles include Victorian, Casual Country, and Federal and Colonial revivals. The Preferred Builder Team at Swift Creek Plantation will employ modern construction methods and state-of-the-art materials for a higher level of satisfaction and a commitment to excellence. Due to the late nature of this project, we were unable to offer many clients the opportunity to participate. If you are interested in this type of investment, please let us know and we will keep you in mind for future projects.

D. L. Blain & Co., LLC is proud to welcome Stephen J. Sarver to the firm as Financial Advisor. In his capacity as a financial advisor, Stephen will provide comprehensive financial and estate planning, investment management, and business consulting services. Prior to joining D. L. Blain & Co., LLC, Mr. Sarver was Regional Manager and Vice President, at First Citizens Bank Private Wealth Advisory Services, in New Bern. During his 20 year career at First Citizens Bank, he served in various senior positions in the bank's wealth management unit. Mr. Sarver serves on the Board of Directors of the New Bern Breakfast Rotary Club and is a member of the New Bern Area Chamber of Commerce, the New Bern Military Alliance and St. Andrew's Lutheran Church in New Bern. He is a former member of the East Carolina Estate Planning Council. Stephen holds a B.A. in Business Administration from Edinboro University, in Edinboro, Pennsylvania, and is a graduate of the Mid-Atlantic School of Trust at Bucknell University. He and his wife, Kimberly, an assistant principal at Bangert Elementary in New Bern, live in Trent Woods with their two children, Britta and Christa.
