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An International View Of The Economic Crisis

The world economy is making a comeback from the depths of 2008, but the results will vary from country to country and rising inflation could rain on the party. The biggest winners emerging from the global recession will be national governments.

Those are insights from a recent interview with Stephane Garelli, director of the World Competitiveness Center at IMD, a Swiss business school that ranks nations according to their competitive strength.

Garelli's outlook matches that of the International Monetary Fund, which expects the global economy to expand 2.5% in 2010, a full 0.6% faster than it had forecast in early 2009. The IMF predicts that in the United States, economic growth will edge up to 0.8% in 2010, following a 2.6% plunge in 2009. That, too, is an improvement from early 2009, when the IMF predicted the U.S. economy would remain flat in 2010. The 2009 IMD World Competitiveness Yearbook ranks the United States No. 1 among 57 nations in terms of international competitiveness.

First in, first out. Because the United States was among the first nations to enter the global recession, it should be among the first to lead the way out, Garelli said. While some smaller exporting nations—and possibly China—are expected to see the earliest real growth next year, recovery in the United States will provide the clearest message that the world economy is on the upswing, he said. Among the last to recover will likely be Japan, Germany, and Switzerland, because of their lack of economic flexibility.

Depression avoided. The risk of a worldwide economic depression has passed, Garelli said (a depression is defined as a 10% drop in gross domestic product or a recession lasting three years). "However, Iceland and the Baltic States may be exceptions," he added. Deflation is also not likely to hit many countries, although Britain, Japan, and Spain could suffer its effects, along with the automobile industry and a few industrial sectors.

Stimulating results. Garelli said the stimulus packages from national governments will work best in emerging economies, because people there need consumer goods and are likely to spend the money. In developed countries, "people will save the money they receive," Garelli said. "They can delay a purchase without a perceptible decline in their standard of living."

Jobless threat. Rising unemployment will remain a major barrier to economic recovery, because it has a devastating impact on public finances, Garelli said. As jobless rates surge, more government funds will be allocated to support the unemployed rather than create new jobs.

Tax havens hit. A side effect of stimulus legislation will be new attacks on tax havens, Garelli pointed out. In order to pay for stimulus spending, many countries plan to raise taxes on the wealthy. One way to do that would be to close tax loopholes.

Inflation looms. Global economic recovery will almost certainly bring a

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Keeping Guard Against Inflation

If you don't think inflation could rear its ugly head again, you could be fooling yourself. Currently, the Obama administration is most worried about price deflation. But recent events could change that outlook.

For starters, the federal government is spending money at an unprecedented clip. It has approved a $787 billion stimulus program, a budget of $4 trillion (up from $3 trillion the prior year), and hundreds of billions more in rescue packages. Also, short-term interest rates, guided by the Federal Reserve, have hit rock-bottom, and rates are quite low in other countries, too.

All of this is kindling waiting for a spark. Once ignited, growth and inflation could come roaring back to life.

For that reason, it's smart to allocate a portion of your fixed-income investments to Treasury inflation-protected securities (TIPS). These bonds are backed by the U.S. government, and have built-in protection that boosts their value when inflation rises. Since inflation might not return for a few years, and TIPs currently have extremely low nominal yields, averaging into these investments over time could be a better strategy than investing a large sum all at once.

Another inflation-hedging strategy is to invest in commodities. When growth resumes, demand for oil, copper, and other commodities will rise, increasing their prices. But given the volatility of commodities, it's generally recommended that you keep no more than 5% to 10% of your portfolio in this asset class.

Ron Dickinson

A Welcome Spike In Personal Savings

Are you looking for something good that may have come out of the recession? As a result of the economic downturn, Americans have generally been spending less and saving more. The savings rate in U.S. households in 2009 reached a high point of 6.9% of after-tax personal income in May. Even though the savings rate has slipped slightly since then, the watershed mark was the highest rate since 1992, when savings peaked at 7.7%.

While it's not an exact measure of fiscal health, the savings rate is the percentage of household disposable income that is put into savings rather than consumed. Mortgage payments are not considered savings, but retirement plan allocations (not capital gains) are. Although a sub-7% savings rate isn't much to brag about in most parts of the world—the annual percentage in other countries routinely hits double digits—it marks a dramatic shift in our personal financial habits. During recent years, the percentage of savings actually dipped below 1%, bottoming out at 0.4% in both 2006 and 2007. In 2008, the saving rate was still only 1.8%.

What's behind the trend towards more savings? During the preceding two decades, rising stock market values and home prices had enticed consumers into thinking they had money to burn, and they became less and less inclined to save for retirement and other needs. Even retirees were encouraged to spend like there was no tomorrow.

But the recent precipitous decline in household wealth ended the wild spending spree. Real estate values around the country have dropped by an estimated 35%, and during the past two years, U.S. household wealth has been reduced by a whopping 140% of annual disposable income. That's a total of $14 trillion.

Faced with daunting economic news, people have been forced to rein in spending, while increasing their efforts to prepare for a secure retirement. For instance, instead of buying goods with their checks from the economic stimulus package or taking advantage of other tax incentives, many people have chosen to hold on to the money. And it doesn't look as if things will change radically anytime soon.

How long will the latest trend last? Most economists predict a slow, steady climb back to better times rather than a quick return to another financial boom. But cutbacks in domestic consumption will also slow down the economic recovery. In the meantime, the savings rate is expected to rise gradually until it hits the 10% mark at some point during the next 10 years. Other financial experts believe the recovery period could last even longer.

Of course, an increased savings rate is to be applauded, especially after it had plummeted dangerously close to zero. Americans will have to adjust to a lower standard of living compared with the heyday of 2007. But if forgoing a few luxuries is the price you have to pay for protecting your financial future, that's probably a trade-off you'd be willing to make. ●

Financial Tips For Those Out Of Work

The numbers are scary. From December 2007 through October 2009, unemployment in the U.S. doubled from 7.6 million to 15.1 million. But the statistic that matters most is your own, and if you've been laid off or your company has gone under, you're competing with an army of others for the few available jobs. Still, manage your financial affairs carefully and you'll certainly survive the economic crisis. You might even emerge in better shape than you were before. These eight suggestions could help.

1. Don't panic. It's normal to be nervous if you've suddenly been sent packing after years of gainful employment. But now's the time to take stock of your situation as calmly as possible. Keeping your emotions under control will make it easier to find the way forward.

2. Reduce spending. Food and shelter are necessities, but other purchases are discretionary. Consider ways to trim your cable TV bill and think twice about dining out. Finding things you can do without may also help you overcome the feeling of powerlessness that often comes with unemployment.

3. Eliminate unnecessary debt. Cut up your credit cards? Maybe not, but charge only what you can afford to repay each month. Otherwise, a small debt could quickly spiral out of control.

4. Take advantage of benefits. These days, you can likely avoid those dispiriting visits to the unemployment office and apply for jobless benefits by mail or online. And if you need to continue your health insurance coverage under COBRA, a provision of the American Recovery and Reinvestment Act of 2009 will subsidize 65% of the cost for nine months.

5. Network, network, network. Applying for posted jobs pits you against a host of other applicants. You may do better reaching out to friends, family, and business associates. Be

Best Times Often Followed Worst Times

These have been tough times for strategic long term investors. While it may seem logical to stay the course through the market's inevitable ups and downs—taking advantage of stocks' tendency to deliver strong returns over very long periods—that logic was little comfort during the bear market, when some portfolios lost more than half their value. Wouldn't it have been better to bail out in, say, late 2007, replacing stocks with cash or with bonds, which have outperformed equities during most of this decade?

Of course it would have been better, but myriad problems stand in the way of executing a successful market timing strategy, which calls for getting out of investments before they swoon and getting back in when they're ready to rise. To investigate market timing's feasibility, Donald Bennyhoff and Yan Zilbering at the Vanguard Group recently examined the performance of the Standard & Poor's 500 stock index from 1928 through 2008 and reported their results in a research note, "Market-Timing: A Two-Sided Coin." Looking only at prices—they left aside dividends because of a lack of data on daily total returns before 1980—Bennyhoff and Zilbering found that the index had returned an average of 5% a year during that 81-year stretch. A clairvoyant investor who had managed to be out of the market on just the 20 worst trading days—avoiding an average loss on those dark days of 9.2%—would have gained 7.5% annually. Anyone who had missed the 20 best days, on the other hand, would have gained only 2.6% a year. That amounts to a 50% swing, up or down, in portfolio performance.

No one could ever hope to forecast all of the market's best and worst days. But given that infinitesimally small changes—being out of the market on just 20 of 20,340 trading days during the 81 years the researchers considered—can have a profound impact, it may seem worthwhile to try to identify some of them. What if, for example, you got out of the market after it had a particularly bad day, or got in after a really good one? Wouldn't more of the same be likely to follow?

Often that's not the case, according to Bennyhoff and Zilbering. Frequently the best and worst days happen within shouting distance of one another, and some of the best days have been particularly likely to follow hard on the heels of some of the worst. In dramatic turnarounds, eight of the 20 best days occurred within 10 trading days of one of the worst 20 days. On October 29, 1929, the S&P sank by 16.1%; the next day, it soared 12.5%. In 2008, a 7.6% loss on October 9 was followed by an 11.6% gain on October 13.

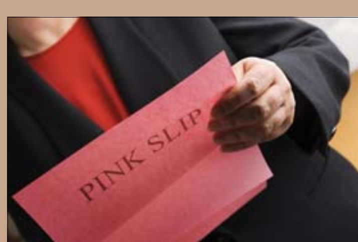
Post-plunge rebounds often last more than a day, with the market frequently recouping, during the next few weeks, a significant fraction of what it has lost. For example, the worst sell-off in the Vanguard study—on October 19, 1987, when the S&P 500 lost 20.5% of its value—was quickly followed by a lot of buying. Within 20 trading days of Black Monday, the market had rebounded by 9.6%. A similar thing happened during the 1929 crash; after that 16.1% free fall on October 29, the S&P stabilized temporarily, regaining 2.5% during the 20 trading days that followed. And in 2008? Twenty days after December 1, when the market fell 8.9%, it had regained 9.1%. Looking at the S&P's performance following all 20 of the worst days, the market regained an average of 2% during the next 20 trading days.

For would-be market timers, those tendencies make a difficult job virtually impossible. While it may be feasible to anticipate broad market shifts and to make tactical adjustments to a portfolio based on certain metrics like price-to-earnings ratios, any attempt to time a wholesale market entrance or exit will probably fail. Few people expected the stock market to surge when it did in the spring of 2009, or to advance as much as it did during the next several months. Investors who had cashed out their portfolios during the market rout almost certainly missed some (if not all) of the rally.

The recent volatility of the S&P 500—from day to day, week to week, and month to month—only reinforces how unlikely it would be for anyone to get in or out at just the right time. Rather than try to time the market, which almost always backfires, most investors would do better to stick with a well-diversified portfolio with regular asset allocation rebalancing to keep volatility in check and increase potential long-term gains. ●

Performance data quoted represents past performance and does not guarantee future results. Indices are unmanaged and do not reflect thepayment of fees and other expenses associated with an investment. Investors cannot directly invest in an index.

casual—you don't want to seem desperate—but be sure they know you're job hunting.



6. Consider a career change. If your industry or profession seems unlikely to rebound, you might broaden your search to include related fields—from print media, say, to work on a website, in public relations, or in another job requiring writing and editing.

7. Start a new business. If you've always dreamed of turning a hobby or other passion into a profitable business, this might give you the push you need to go for it. If you can fill a niche with high-quality services or products while keeping startup costs low, you'll stand a good chance of success.

8. Stay positive. An extended job search may sap the energy you had when you were first laid off. But perseverance will pay off. And remember: If you're middle-aged or near retirement, your wealth of experience is an asset, not a liability.

Finally, in a pinch, you may need to tap your retirement plans. But money you pull out now will be difficult to recoup later on, so consider this option only for emergency purposes. ●

Do You Really Need That Inheritance?

Sometimes it pays just to say "no thanks" to a generous bequest—even from your own spouse. There may be estate planning benefits to having the assets go directly to contingent beneficiaries named by the decedent. If those beneficiaries are your children, this strategy could help them keep more of the bequest.

Officially declining an inheritance involves executing a legal document known as a "qualified disclaimer." This refusal, which can apply to all or part of a bequest, must be executed within nine months of the donor's death and before you've received any income from the inheritance. While this is generally a reactive measure, similar results can be obtained setting up a disclaimer trust as part of your estate plan.

One factor in deciding whether to refuse an inheritance is the uncertain future of the federal estate tax. Repealed for 2010, it will be revived in 2011 under unfavorable conditions.

The amount of an estate that's exempt from federal tax, which was gradually increased to $3.5 million for those who died in 2009, will drop back to $1 million for 2011, unless Congress enacts new legislation.

Also, after gradually being reduced to 45%, the top estate tax rate will return to 55%. The Obama administration and Congress will likely adjust the rules or change the timetable, but most experts expect the estate tax to continue to exist in some form. A qualified disclaimer or a disclaimer trust could help you prepare for whatever comes.

Suppose that under your current will, all of your assets are to go to your spouse if you die first, and vice versa. Then, at the death of the surviving spouse, the remaining assets will be divided among your children. With this arrangement, there's no estate tax due after the first death—because a spouse can inherit an unlimited amount tax free—and the surviving spouse's estate can be reduced, for tax purposes, by whatever individual exemption is in effect at the time.

But this wastes the exemption of the first spouse to die. Instead, the surviving spouse could disclaim an amount equal to the estate tax exemption, passing it directly to contingent beneficiaries. The first spouse's exemption relieves the heirs of any current estate tax liability, and later the surviving spouse's own exemption can be used.

Before disclaiming any assets, one's current and future potential need for the disclaimed assets needs to be carefully analyzed by a financial planner, since this is an irrevocable decision. We can work with you and your attorney to consider whether turning down an inheritance might make sense for you, and help you follow the rules that govern the process.

Also, if your net worth nears or exceeds federal estate tax exemption limits, we can discuss how setting up a disclaimer trust now can benefit your heirs. ●

View Of The Economic Crisis

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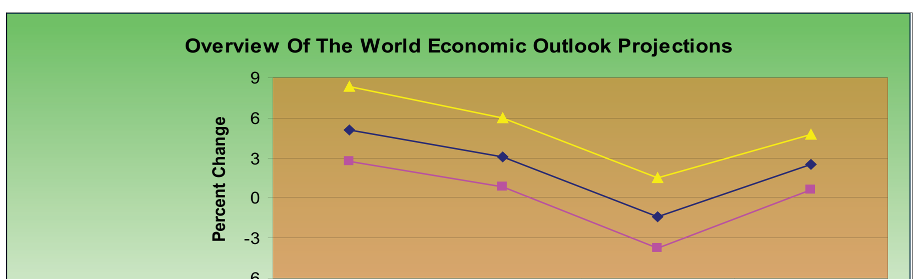
new round of global inflation. "It will be triggered by both an excess of money supply (especially dollars) and a rapid rise in commodity prices (fueled by the demand of emerging nations)," said Garelli. "Central banks will not react immediately to rising inflation so as not to impede recovery—and because inflation is an effective way to reduce the value of debt."

Spending spree. Recovery also will trigger a rush by companies to spend billions in cash that has been set aside during the recession, Garelli predicted. The world's largest 100 companies have cash reserves estimated at a total of $600 billion. "This money will be used to buy back shares," Garelli said. "Acquiring industrial assets and companies will also be a priority."

Winners take all. In the end, national governments will emerge as clear winners. "They have the ultimate power: printing money, making laws, and setting taxes," Garelli said. "The multilateral world is on the decline, and it is again a brutal power game among big nations. But beware: In the words of Thomas Jefferson, 'A government big enough to give you everything you want, is also strong enough to take everything you have.'" ●



	2007	2008	2009	2010
World output	5.1	3.1	-1.4	2.5
Advanced economies	2.7	0.8	-3.8	0.6
Emerging economies	8.3	6.0	1.5	4.7