THE WEALTH STRATEGIES GROUP
Independent Unbiased Financial Advice

The Seven Signs of a Changing Economy™

"What to look for, where to find it and what to do when you see trends changing!"
As of September 2010

Summary:
When the content of this month's update is viewed as an entire body of information the overall observation is neutral. It would be fair to suggest that the economy has stabilized. It would also be reasonable to report, as National Bureau of Economic Research (NBER) did on September 20, 2010, that the recession that began in December 2007 ended in June 2009.

A recession simply means two or more quarters of a contracting economy as measured by Gross Domestic Product (GDP). This was the longest recession since the end of WWII, lasting 18 months. The recession of 1973 - 1975 and 1981 - 1982 were both 16 months in duration.

Since June 2009 the economy, as measured by GDP has grown at +5% in 4Q09, +3.7% in 1Q10 and +1.7% in 2Q10. The fact that most of this growth was stimulus induced and increased the country's deficit and debt level to the highest in history is not calculated in to GDP. The national debt level was increased 1.88 trillion, or 17% this fiscal year ending 9/30/10. In the data benchmarked for The Seven Signs of a Changing Economy™ update it would be fair to suggest 3Q10 GDP should be in the -1% range, but due to data collection methods and adjustments used by the Bureau of Economic Analysis (BEA), it is likely to be reported more in the +1% range.

These GDP numbers suggest a decelerating economy, but at this time the economy is not contracting.

Under Sign #1 Personal Consumption Expenditures (PCE) the consumer spending is flat. The Consumer Metrics Institute data, which tracks internet based discretionary consumption expenditures, which exclude food, gasoline and other items that we must purchase to live, showed the largest contraction rate since they began tracking this data, at -6.05% year over year (YOY).

Sign #3 Leading Economic Indicators has stabilized, i.e. stopped going down, but suggests no upturn in the economy until 2/1/11.

Sign #4 Employment Rate remains at 9.70% and is not expected to drop by a significant amount any time soon.

Durable Goods are those long shelf items we don't really need to spend money on right away. They are purchases that can be put off until we "have the money". As you will see in Sign #6 Durable Goods new orders are down, back orders are down, and

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inventories are up, i.e. people are not buying as much and inventories are suitably restocked from the recession sell off.

This data doesn't suggest a big growth spurt or an immediate downturn in the economy, more of a flattening. Is this due to the pending election on 11/2/10 or perhaps the reality that the Bush tax cuts really will roll back to 2001 levels?

In an effort to get a "second opinion" on the economy it may make sense to look at a key driver of the economy, real estate.

Existing Home Sales: Rose 7.6% last month, but remain down 19% YOY (Source: zillow.com) (Foreclosures were 24% of the total sales)

New Home Sales: All-time record low at 288,000 (Source: Reuters)

House Prices: Lowest in 6 years down 3.2% YOY (Source: Federal Housing Finance Agency)

Mortgage Applications: Down 38% YOY (Source: Federal Housing Finance Agency)

Refinance Applications (to get lower mortgage %): Up 51% YOY; FYI, there is little to no economic benefit to a "refi" (Source: Federal Housing Finance Agency)

Single Family Housing Starts: Up 4.3% for month, but -9.1% YOY (Source: National Association of House Builders)

Building Permits: +1.8% (Source: National Association of House Builders) (If housing permits are lower than housing starts, then housing is not growing)

Housing Market Index: -31.6% YOY (Source: National Association of House Building)

Number of Mortgages Delinquent or in Default: 12.90% or roughly 6.97 million of the 54 million first liens outstanding (An estimated 90% of these have not become available for short sales or sales from the lien holder) (Source: Marketwatch)

Real Estate is a key to the economic turnaround and with sales up slightly but down year over year (YOY), sale prices down, mortgage applications down, building permits down and literally millions of homes yet to hit the market from foreclosures (more supply) it is difficult to conclude anything except this economic key is not likely to become a meaningful growth contributor for another two to three years!

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In addition, it is likely the Bush tax cuts will roll back to 2001 levels on 1/1/11. (Emphasis on "likely"…I personally believe there could be a surprise reversal here.) If these tax cuts do happen, the impact on the average person's lifestyle (which they have grown accustom to) and the economy will be, in my opinion, devastating!

Those of you who know me also know I am not an alarmist. That said, ask any of your friends if they start to understand the impact of these tax increases when you show them the following numbers.

A married couple filing taxes jointly with adjusted gross income of $129,000 would be entitled to deductions of $12,500 and personal exemptions of $7,300 to arrive at their taxable income of $109,200. Their total Federal Income Tax in 2010 would be $19,663.

The tax rollback takes away the 10%, 25%, 33% and 35% tax brackets. Since the U.S. tax code is based on a "progressive" tax, some of your income in 2010 is taxed at 10%, some at 15%, some at 28%, etc. as you increase your taxable income level.

When the two lower tax levels are "sunset" the same couple's Federal Income Tax in 2011 would be $32,331.

Taxable Income is $109,200
2010 Federal Income Tax is $19,663
2011 Federal Income Tax is $32,331
A Federal Income Tax increase of $12,668

If not rolled back this tax increase will most certainly affect Consumer Expenditures as the average person/couple will very simply have less money to spend after taxes! As we all know Consumer Expenditures represent 70% of the U.S. Gross Domestic Product. It seems reasonable to suggest the already decelerating GDP, noted on page one, could edge lower by this time next year. Again, this may not happen. However, it is on the "list of things that have a negative impact on investments".

So, the question really comes down to this. If the economy is at best stabilized, but not yet growing, why is the stock market going up?

In my opinion four key reasons:

1. Very low trading volume - see Sign #2 below. In the last week of September 2010 only 5 billion shares traded (low).

2. High frequency trades - These are trades that use computer activated algorithms to buy and sell trends. In low trading volume environment like we have the price movements can be greatly exaggerated.

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1. Short covering - These are institutions, hedge funds and individuals who reverse the order of the investment process. They sell before they buy with the belief that the investment will go down (versus up) to create the profit once the transaction is completed. When the markets go up, or against them creating a loss, they get scared and buy the position back - which creates more buying that pushes stock prices higher.

2. The Federal Reserve is expected to effect a second stimulus package where the Federal Reserve will print dollars to buy bonds in the open market in an effort to keep interest rates low and add additional money supply to the system. The estimate of this quantitative easing program is approximately $1 trillion.

The fact is Corporate America is still, overall, not selling more stuff. The top line sales revenue remains flat and the profits that are driving up values remain a result of cost cutting. The stock market is often viewed as a leading indicator of the economy in and of itself. However, at some point the earnings growth must come from selling more stuff.

The current thinking at the Federal Reserve appears to be that if we print more dollars the dollar's value will drop, making our products cheaper overseas. Thus, we will sell more stuff overseas (exports) to make the sales of Corporate America increase. That should work for some companies in Corporate America, but the U.S. only exports 9% of our GDP. Japan, who has an even older population, and one that spends less on consumption, exports 30% of their GDP and its economy continues to implode as this is written.

The conclusion for now is there may be a short term (6 month) window to buy growth companies, but once the reality of a weak dollar, the probability of higher taxes, and a consumer who is not consuming at growth levels sinks in, it is likely that the value of shares in Corporate America will be dropping.

As always, your thoughts, comments and discussion are welcome. Please call me at 303-933-2107 or e-mail me at Jlunney@wealthstratgroup.com.

Respectfully,
James O. Lunney, CFP®, CEP
CERTIFIED FINANCIAL PLANNER Professional
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The Wealth Strategies Group was founded by James O. Lunney under the guiding principle that comprehensive wealth counseling combined with independent investment advice will provide high net worth clients with complete trust in our competence, execution and integrity.

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P.S. Please join me for our monthly conference call on The Seven Signs of a Changing Economy. You have the option of calling in or listening live for free from your computer. To call in, simply dial our new number, **347-826-7481**. There is no access code needed. To listen live from your computer, go to our website, www.wealthstratgroup.com, and click on the **"LISTEN LIVE"** button on the home page. You will be sent directly to our page on the Blog Talk Radio website and you can click on the link there. Instead of having a live Q & A session at the end of the call, you can now e-mail your question to me prior to the call at JLunney@wealthstratgroup.com and I will address them after my commentary on The Seven Signs of Economic Change.

The call is always on the first Thursday of each month at 1:00 p.m. MDT/3:00 p.m. EST. Please mark your calendar to join me for the next call on Thursday, November 4, 2010.

You're welcome to invite people from your family, work and social circle to join in the call. Just forward my e-mail notification to your e-mail list. It is very timely information and in the volatile investment environment a second opinion may be greatly appreciated in these uncertain times.

1. Indicator: Personal Consumption Expenditure (PCE)
Where to find it: www.bea.gov
What to look for: Consumer spending drops for three consecutive months
(Neutral)

The data representing Personal Consumption Expenditure (PCE) is mixed, filled with crosscurrents and a bit difficult to decipher. On the surface it is difficult to suggest the **reported** data is negative. Specifically, April +0%, May +2%, June +0%, July +4%, August +4%. These represent PCE growth over the prior month. Then we observe those **pesky details** like August's increase being nearly all driven by food, gasoline and back-to-school clothing. Not exactly consumer discretionary spending and certainly not the leveraged spending that has historically driven the economy and markets higher over long periods of time. Lastly, there is **real time data** versus the reported data posted above. The real time data from Consumer Metrics leads the Bureau of Economic Analysis (BEA) data by about four months. This real time data stabilized and started to show early signs of trending up until the last two weeks of September 2010. The CM Daily Growth Index is now the lowest (-6.05%) they have ever recorded. Meaning the consumer contraction is now worse than the "Great Recession" low of August 29 - 30, 2008.

During the lows of August 2008 the unemployment rate was approximately 6% versus today's 9.7%. With fewer people employed, housing continuing to struggle, banks are reluctant to loan, businesses are reluctant to hire and tax rates are likely increasing in 90 days, it seems reasonable to conclude the Consumer

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Metrics data is correct. As the current PCE is "stable" and the forward looking data is flashing "warning", we will continue to note the warning but remain neutral for this most important sign of all of The Seven Signs of a Changing Economy.

2. Indicator: Institutional Money Flow
Where to find it: www.wordenbrothers.com or www.barrons.com/convictionoftraders
What to look for: Decreasing prices on high volume of large block trades
(Neutral)

As we enter October 2010 the S&P 500 closed out 3Q10 at the 1136 level versus 1116 on the first day of the year. It has been a year of angst and hand wringing without much change. This, of course, masks the volatility that caused the angst and hand wringing. What can be seen in the volume is a lack of confidence in the current price level. In the last week of September the DJIA traded less than 5 billion shares. There have been fewer companies posting new highs and overall shares advancing versus declining has been below average.

For this to turn into a healthy bull market trend we need to see expanding volume, broad based new highs for the year and a more consistent upward trend in prices.

For the year the markets are about even, but September was a powerful upward month in pricing. Much of this is related to "short covering". We can, of course, relate it to whatever we want but the most bullish thing the market can do is go up. Thus, Sign #2 is raised from negative to neutral.

3. Indicator: Leading Economic Indicators (LEI)
Where to find it: www.businesscycle.com or www.newyorkfed.org/research/global-economy/globalindicators.html
What to look for: Trends down for three to four months
(Neutral)

The weekly Leading Economic Indicators (LEI) has predicted economic activity approximately seven months in the future with a high level of accuracy. The weekly LEI started to contract in the 10/9/09 report and continued to contract until 7/30/10 at which point it stabilized for six weeks until 9/10/10, when it started to trend up. This would suggest the economy would weaken 7 months after 10/9/09 or about 5/9/10. That's interesting as the S&P 500 peaked on 4/26/10 at 1220 before dropping to the low for the year on 6/30/10 at 1030 for a pretty healthy 15.51% reduction! The weekly LEI data would also suggest that the earliest we might see the beginning of a turn in the economy is 2/1/10. However, the weekly is still a -7.8% as of 9/24/10. When you consider this with the Consumer Metrics "real time" data, detailed above under Sign #1, you start to see the complexities in using just one or two data streams in predicting a possible trend. Of course, that is why we look at seven.

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Per the Conference Board LEI report dated 9/23/10 "the U.S. remains on a general upward trend, although its growth has slowed substantially in recent months. Its six-month growth rate is at its slowest pace since the middle of 2009, with the weakness among its components having become more wide spread than strengths over the past six months."

The LEI report goes on to note "The six-month change in the index has slowed to an annual rate of +4.1% annual rate…versus +9.7 % for the previous six months."

The weekly LEI, Consumer Metrics and monthly LEI all suggest a deceleration in economic growth. However, at present, we do not have actual economic contraction for the normal three to four quarters noted above under "What to look for", therefore, Sign #3 remains neutral.

4. Indicator: Employment rate and after-tax personal income
Where to find it: www.bls.gov
What to look for: A flattening, then downward trend in non-farm employment with a flattening to decreasing after-tax income
(Negative)

U.S. Government statistics state the consumer represents over 70% of the Gross Domestic Product (GDP), see Sign #1 above. That said, it is difficult to be a decent consumer without a job. Unemployment remains at 9.7% with the four week average of initial claims at 464,750. This is now the longest, 18 months, and the most people unemployed after the high water mark for claims set 18 months ago. It exceeds the prior longest period of 13 months, which occurred back in 1982.

Since I talk with many people each day my observation from the "front" is businesses are still cutting back employees and until sales pick up will not be hiring or making other significant investments. The Business Round Table recently reported that their survey of CEOs indicated hiring plans are on hold, suspended or in a state of "freeze". For those over age 55 unemployment is the highest on record and the length of time unemployed is the longest on record. (Source: Bureau of Labor Statistics)

The smiley face on the data was that if not for 114,000 temporary census workers "completing their work" the number of newly unemployed would have been much less. No matter how the numbers spin we still need 200,000 new jobs a month to start reducing the overall unemployment rate down from 9.7%. This is not yet happening and Sign #4 remains negative.

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5. Indicator: Durable goods spending
Where to find it: www.census.gov/indicator/www/m3
What to look for: A decreasing trend, especially a downward trend of four to five months out of six
(Negative)

These long shelf-life items like non-perishable, non-fashion items are usually the first to show signs of a slowing economy. Remember, these are items we can do without, if need be. New orders decreased $2.5 billion or 1.3%. Five of the last six months have shown negative growth. As noted above under "**What to look for: A decreasing trend, especially a downward trend of four to five months out of six**". Shipments decreased $3.1 billion or 1.5%. Inventories increased $1.3 billion or .4% for the eighth consecutive month. Unfilled orders are not always posted under Sign #5, but it is interesting to note they have dropped for the past few months.

Just for fun, let's connect the data points backward…order backlogs are down, fewer new orders are coming in, less product to ship out and inventories have been expanding for eight months equals…this better be one heck of a holiday shopping season or unemployment will be going up again! Clearly, this detail suggests a contraction is at hand which is reflected in the Institute for Supply Management (ISM) Manufacturing Index, which dropped from 56.3% to 54.4%. A reading "around" 50 indicates no growth. Thus, slight but contracting growth in ISM combined with the detail in new orders, etc. equals a negative Sign #5.

6. Indicator: S&P 500 earnings per-share growth
Where to find it: www.standardandpoors.com
What to look for: Two down quarters of S&P 500 earnings per-share growth
(Neutral)

The cost cutting to grow earnings theme is getting a bit old but is certainly alive and well. This month FedEx reported a 100% increase in profit as "the global economy strengthened and trade expanded after last year's recession."

Sounds pretty good, right? Apparently not, as they also stated weaker profit margins in key business segments and a "soft" next quarter. CEO Fred Smith stated "we expect a phase of somewhat slower economic growth." FedEx also intends to reduce the company's workforce by "roughly" 1,700 and close "about" 100 facilities.

Perhaps you really can cut to the bone more than once?!

Perhaps most importantly, stock buy backs, mergers (before capital gains tax increases in 90 days), acquisitions and creative dividend payouts are helping to support overall price levels in Corporate America.

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Standard and Poor's is estimating $94.41 per share for 2011. 2009 was $56.87 and 2010 is now estimated to be $83.14/share.

The only reason Sign #6 remains neutral versus positive is the lack of overall revenue increases. Corporate America is not growing revenue they are proactively cutting people, infrastructures, processes and strategy to create earnings. Thus, neutral appears more prudent for the outlook.

7. Indicator: Inflation/deflation numbers
Where to find it: www.bls.gov/ppi/ or www.bls.gov/cpi/
What to look for: An interruption to the consistent but modest increase in the cost we all pay for goods and services
(Neutral)

The Producer Price Index (PPI) increased .4%. Last month we saw a .2% increase and the first increase in four months.

The Consumer price Index (CPI), the inflation rate you and I expect to see at our household level was up .3% in August and represents a 1.1% inflation rate year over year. As a reminder, owners equivalent rent (OER) is approximately 40% of the CPI calculation. As housing prices appear to have stabilized for now this calculation has edged up. As more delinquent mortgages move into the default level, as discussed in the summary above, the new supply of property would normally put downward pressure on home prices. In turn, this would normally reduce CPI, i.e. inflation.

That said, the Fed has suggested inflation rates are below the 2% annual target level. The Fed has also suggested they are likely to implement another round of stimulus, estimated at $1 trillion, after the November election. This could give the stock market a short term bump up as well as short term bump up in the inflation number.

The 3Q10 GDP will be reported 10/29/10, four days before mid-term elections. It should be negative but will most likely be reported at +1.00% to +1.50% with downward revisions after the election on 11/23/10 and 12/22/10.

As outlined above under Sign #6 2010 EPS are now estimated at $83.14 and 2011 EPS are estimated at $94.41.

Thus, the Rule of 20* is: 20 - assumed real inflation rate of 5% x S&P 500 estimated earnings per share = Fair Market Value

Therefore: (2010) 20 - 5 = 15 x $83.14 = 1247.10 S&P 500 Fair Market Value
(2011) 20 - 5 = 15 x $94.41 = 1416.15 S&P 500 Fair Market Value

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As of 9/30/10 the S&P 500 = 1141.20

*The Rule of 20 is in this calculation implying, and using, a price/earnings ratio of 15. Thus, 15x the expected Earnings per Share. I am suggesting both EPS and the multiple of 15 could drop. The earnings could be reduced due to the consumers spending less. The multiplier of 15 could drop to, say 8 for example, if investors were to get scared and become risk adverse. All of a sudden 8 x $75 turns the 1,125 2010 FMV into 600 and even worse if earnings were to drop from $75.00/share to less than $75.00/share! This is the multiplier risk and earnings risk I personally worry about. It may never occur, but what an unfortunate event it would be if it did and we had not prepared for it as a possibility. Thus, I am glad we have!

My opinions voiced in this material are for general information only and are not intended to provide specific advice for every client.

All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

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