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Your Bottom Line

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Recession but Not Depression

Warren Mackensen

Well, it is now official. The National Bureau of Economic Research, the private think-tank responsible for officially determining the peaks and troughs of the business cycle, declared that our economy entered a recession a year ago, in December 2007, ending a 73-month growth phase that began back in November 2001. Still to be settled are the questions of how deep and how long the current recession will be. At its ripe old age of 12 months, the present downturn already shows more longevity than the previous two recessions in 2001 and 1990-1991, each of which lasted only 8 months.

Without a doubt, we are experiencing an economic decline that will be highlighted in economics textbooks for years to come. However, despite the inevitable comparisons in the media, it is doubtful that today's economic malaise will resemble anything like the Great Depression. Here are a few reasons for this optimism:

- **Inflation is falling rapidly across the world.** After a dizzying run-up, the similarly paced decline in oil and other commodity prices has put a damper on inflation, freeing up the Federal Reserve to aggressively confront the problems in the credit markets. The government's latest inflation indication showed a 1% decline in consumer prices for the month of October, following two months of little change in August and September. On a year-over-year basis, prices have risen a historically reasonable 3.7%. According to some analysts, if sustained, the plunge in gasoline prices alone – from over $4.00 per gallon this summer to less than $2.00 per gallon today – will represent the functional equivalent of a $225 billion tax cut for consumers. Also noteworthy from the inflation report is that the cost of medical care, which had been rising at a much higher rate than average, has slowed substantially, increasing only 2.8% over the last 12 months. By leaving more money in consumers' wallets for other spending, this moderation in price increases will have a positive impact on the economy in the coming months.
- **Three policy mistakes in the Great Depression.** The Great Depression started out with a bursting asset bubble after a period of easy credit and irrational exuberance in the late 1920s that led to a recession. What turned that recession into a depression, with the US unemployment rate rising to 25%, were largely three major policy mistakes:
  - First, the Federal Reserve (and other central banks) stood by watching as one bank after another collapsed, and allowed a major contraction of the money supply.
  - Second, fiscal policy was passive as governments tried to adhere to the balanced budget doctrine. Falling tax receipts thus led to cuts in government spending, aggravating the downturn in private sector demand. This only ended when Franklin D. Roosevelt took office as President in 1933 and created the New Deal.
  - Third, starting with the Smoot-Hawley Tariff Act in 1930, a trade war began between the U.S. and Europe, with governments raising import tariffs that choked off world trade.

Thanks to the lessons drawn from the Great Depression, today's policymakers are acting very differently. Following the collapse of Lehman Brothers, the regulators have made it clear that no systematically important banks will be allowed to fail. Central banks have resorted to major monetary easing, consisting of a combination of much lower official rates and massive cash infusions into the financial system. Governments around the world are busy developing and enacting large fiscal stimulus packages. In addition, it appears unlikely that the world will see another trade war. Today's policymakers understand what went wrong back then and are eager not to repeat the mistakes of their predecessors. ❖

Time to Re-Visit your Financial Plan

David A. Batchelder

Economic uncertainty has permeated the markets. We have seen the U. S. stock market shed 1,000 points in a week's time, and then recover half of the loss in one day. Most days, words of optimism do not help in this kind of a market. Indeed, investors are selling things for the sake of selling with little or no regard for their fundamentals or overall investment strategy.

With markets this volatile, it is certainly tempting for investors to succumb to the emotional pain of market losses by either moving all of their holdings to cash or taking on excessive amounts of risk in order to recover lost ground. Research on investor behavior and market cycles tells us that giving into these emotional forces significantly diminishes overall portfolio return. In its 2008 study of investor behavior, private research firm Dalbar shows that, during the 20 year period from 1988 – 2008, the average equity mutual fund investor significantly underperformed the S & P 500's 12% average annual return. By trying to pick short-term winners and quickly moving into and out of different asset classes, the average investor's return was closer to 5% annually, less than half that of the S & P 500. Emotional investors tend to sell and buy assets at the least opportune times. Updating our financial plans during market declines has a much larger potential payoff in the end than efforts to pick winners or time the market.

Clearly there is little precedent for the extreme volatility we have seen in the markets these past months. Still, market history teaches us that a great deal of lost ground can be recovered over a very short period of time. Now more than ever, we need to be patient, focus on our long-term financial plans, and have the courage to weather the storm. ❖

2009 Retirement Contributions

Retirement Plan Contribution Limit	Under Age 50	Age 50 or Over
IRA & Roth IRA	$5,000	$6,000
401(k), 403(b), 457	$16,500	$22,000
Roth 401(k) & Roth 403(b)	$16,500	$22,000
SIMPLE IRA	$11,500	$14,000
SIMPLE 401(k)	$11,500	$14,000
SEP, Profit Sharing, Keogh	$49,000	$49,000

Estate Tax Changes in 2009

David Mayes

The new Obama administration and Congress will most likely take action to make changes to the estate tax in 2009. Under current law, estates will receive a $3.5 million exemption in 2009 and be subject to a maximum tax rate of 45%. In addition, assets passing at death receive a so-called "step up" in basis under the existing rules. This means that beneficiaries receiving estate property do not pay capital gains taxes on the increase in value of the assets while the decedent held them. Only the post-death increase in value is taxed to the beneficiary when the assets are sold.

Both of these provisions disappear in 2010 when the estate tax is temporarily repealed. In 2010, the estate tax exemption is effectively unlimited (no tax) but beneficiaries must determine their capital gain on subsequent asset sales using the decedent's tax basis (original cost). This change in the basis rules undoubtedly will cause some serious tax headaches, particularly in cases where the decedent had held assets for long periods. Records dating back to the original purchase may be difficult to find. The rules change again in 2011 when the exemption amount and maximum rate revert back to their 2003 levels of $1.0 million and 55%, respectively.

Given the need for maintaining revenue in the face of large deficits, it is expected that Congress will take action to address the 2010 estate tax repeal early in its 2009 session. Stay tuned… ❖

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MACKENSEN & COMPANY, INC.
FEE-ONLY FINANCIAL PLANNERS

6 Merrill Drive
Hampton, NH 03842-1970
603-926-1775
800-927-7365
fax: 603-926-1249
web address: www.mackensen.com
email: info@mackensen.com