



## THE RISE AFTER THE STORM by Greg Herman, CFP™

After a nearly continuous upward climb from March 2009 through April 2010, stocks experienced a significant downturn in May and June and finished the quarter well into the red. A variety of events – from Eurozone debt fears to the “Flash Crash” in early May to disappointing economic data at home – stoked investor anxiety and led all of the major stock indexes to declines in excess of 10%.

Predictably, the media is locked onto the causes of the market decline, but the reality is that market declines are an unavoidable part of the investment landscape. Economic history is a story of crisis and resolution. Of booms, bubbles and busts. There is always something to which a decline can be attributed, but for long-term investors that “something” is not really the point. The point is that the market, in the aggregate, moves inexorably upward over the long term despite the crises that must be negotiated along the way.

If crises were easy to see coming, then everyone would be a successful investor. Everyone would ride the upward part of the curve and step adroitly to the side just before the next crisis began. The fact that very few investors are successful tells us that it is just the opposite – that crises and, more importantly, the market's reaction to them, are inherently unpredictable. On the other hand, many investors' reactions are predictable. They move their money to whatever has been the best (or least bad) most recently. In short, most investors zig when they should zag forgetting the fact that most often things head off in a direction no one saw coming or could have predicted. Investors are always fighting the last war.

It is important to keep this in mind when we are confronted daily with all of the doom-and-gloom predictions in the media and around the water cooler. When a malaise mentality grips the populace, things often seem beyond repair. Failure seems inevitable. But there is nothing that is inevitable. In the short term, the pendulum that is the economic cycle swings hard and unexpectedly in both directions, leaving those who try to outguess it in the dust.

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This year marks the 65th anniversary of two of the most important dates in American history: VE Day (May 8, 1945) and VJ Day (September 2, 1945) – the days on which the surrender of Germany and Japan, respectively, became official and brought World War II to a close.

No doubt those were great days for America, and for the Allied powers we were aligned with. But, from an economic perspective, it might be more instructive to examine the experiences of the two losing countries in that conflict following the end of the war, because it tells us something about the resiliency of the human spirit and, by extension, economic recovery in a free-market economy.

When World War II drew to a close, Germany was in shambles, having literally been cut in half by Russia and the West. When Russian forces blockaded Berlin, food became so scarce that the American military had to organize an airlift of unimaginable proportions to keep millions from starving to death. The German currency had collapsed, inflation raged, thousands were homeless, and there was no government to speak of, only occupying forces.

As bad as things looked for West Germany, however, things were arguably worse in Japan. Two major Japanese cities had been wiped out by atomic blasts. More than a half-million Japanese had died in the last months of the war. The imperial Japanese government – the only ruling authority all living Japanese citizens had ever known – was gone. More than 40% of Japan's infrastructure and industry was gone as well, having been destroyed in the war. And with almost no natural resources to make use of, Japan was completely dependent on the generosity of foreign powers to survive.

Who among us would have strolled into such horrific conditions in post-war West Germany and Japan and pronounced those countries on the verge of an economic boom that would last the better part of three decades? What investor would have surveyed the wretched economic landscape in those countries and thought to themselves, “These are all problems that will be overcome in short order. Now is the time to invest for the coming wave of economic growth!”

None that we can think of, and yet that is precisely what happened. Freed of their totalitarian constraints, West Germany and Japan experienced an economic boom that defied all expectations in the 1950s, '60s and '70s. Germany experienced GDP growth of 15% - 25% for a full decade after the war. Meanwhile, Japan's GDP grew from \$90 billion in the mid 1960s to more than \$1 trillion by 1980. Today, Japan is the world's second largest economy, despite more than a decade of economic stagflation. Further, Germany is the world's fourth largest economy despite having been forced to absorb the economic burdens of its dysfunctional sister, East Germany, some 20 years ago. In the wake of the recent volatility in European markets, Germany has been viewed as the Eurozone's safe haven.

The miraculous transition of Germany and Japan from destroyed enemies to thriving allies is an extreme testament to how quickly market forces can turn an economy around. And perhaps it is a good history lesson for us Americans today as we contemplate the sense of fatalism that has taken hold in the past few years about the current state of our economy and, by extension, our country's future.

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Yes, the United States has problems. We have a level of national debt that is unsustainable, entitlement programs whose obligations will soon exceed the tax payers' ability to meet them, and a government that seems unable to stop its frenzied spending no matter which party is at the helm. Clearly, something has to change if we are to turn our country's balance sheet back around.

Yet while I am not in denial about the considerable problems we face in the years ahead, I would also caution against buying into the malaise mentality that things are broken beyond repair. To embrace this notion requires the belief that there will be no more growth in this country's most successful multi-national corporations. It requires the belief that there are no more budding entrepreneurs in the wings, waiting to change the way we live, work and play.

In short, it requires the belief that the spirit and drive that has defined this country for the better part of two centuries is now, for some inexplicable reason, kaput.

Just consider a few examples of the kind of change that entrepreneurial spirit has wrought in only the past ten years:

- A decade ago, Google was a startup enterprise, the byproduct of an MBA thesis by two Stanford grad students. Last year Google generated revenues of \$25 billion – more than American Air Lines.
- A decade ago, Blockbuster owned the movie rental market and was poised to dominate for the foreseeable future with the shift from VHS to DVD. Today, Blockbuster has a share price of 15 cents and is on the brink of bankruptcy, while a firm that did not exist 10 years ago, Netflix, streams movies to people over cable modems and has a share price of \$123.
- A decade ago, Apple was an aging brand that sold PCs mostly to the graphic-design industry. It had a share price in the single digits. Today, Apple has transformed the digital entertainment industry and has sold 3 million iPads in just the last three months. It now has a share price approaching \$300.

These are just the tip of the iceberg, and this is from the most challenging economic decade our country has faced in a century. Crisis, scandal and the fickle winds of politics may all be headwinds to the forces of economic growth in a free-market economy, but they do not destroy it.

Today, almost everyone in the world can connect to the Internet and can access all the information the world has to offer in milliseconds. Do you believe that won't have profound implications on bringing that same entrepreneurial spirit we possess in this country to others around the globe? Do you believe that in another decade we will all be using the same phones and watching the same TVs and driving the same cars we are using today?

Maybe in Cuba. Maybe in North Korea. But not in the free-market economies in the rest of the world. The simple fact is that, when markets are free to function properly, economies prosper. Where governmental mismanagement impedes that growth – as it has done in Greece recently – markets will eventually find a way to work through and around the problem.

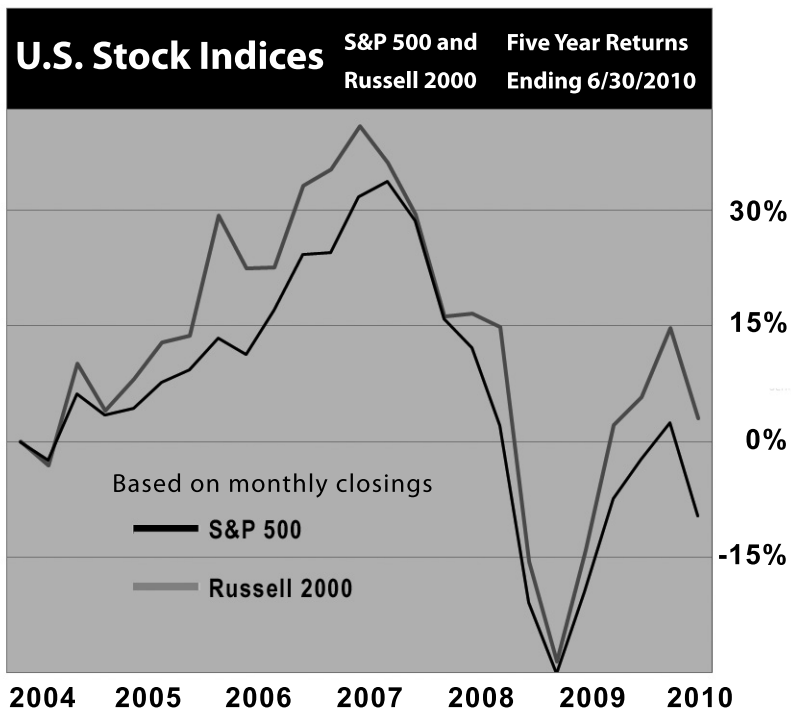
That resolution isn't always painless, but it is inevitable. It is what has kept economies growing for the past 200 years despite wars, depressions, recessions and defaults. And it is what will keep them growing in the future.

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We appreciate our relationship with you and look forward to speaking with you soon.



Greg Herman



### The Markets In Review

<b>EQUITY MARKETS</b>	<b>6-30-10</b>	<b>12-31-09</b>	<b>Change</b>
Dow Jones Industrials	9774.02	10428.05	- 6.3 %
Dow Jones Wilshire (5000)	10750.00	11497.40	- 6.5 %
NASDAQ Composite Index	2109.24	2269.15	- 7.0 %
S&P 500 Index	1030.71	1115.10	- 7.6 %
Russell 2000 Index	609.49	625.39	- 2.5 %
DJ World (Ex. U.S.)	178.06	201.09	- 11.5 %
MSCI – EAFE Index(1)	1348.11	1580.77	- 14.7 %
FTSE NAREIT Composite(2)	112.58	109.26	3.0 %

### OTHER INDICATORS

Crude Oil	75.63	79.36	- 4.7 %
Gold (per troy oz.)	1245.50	1095.20	13.7 %

### INTEREST

<b>&amp; BOND MARKETS</b>	<b>6-30-10</b>	<b>12-31-09</b>	<b>Change</b>
Fed Funds Target Rate	0.25	0.25	0.00
Prime Rate	3.25	3.25	0.00
Money Market	0.77	0.92	(0.15)
Libor, 3 Month	0.53	0.25	0.28
5 Year CD	2.54	2.61	(0.07)
10 Year Treasury Note	2.96	3.83	0.88
Dow Jones Corporates	3.99	4.48	(0.49)
30 Year Mortgage (Fixed)	4.75	5.48	(0.73)

Notes: (1) EAFE value stated in U.S. dollar terms. (2) Percent change reflects total return listed by FTSE Group and National Association of Real Estate Investment Trusts (NAREIT).

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