



Napa Wealth Management's The Sensible Investor



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Countering What You Are Hearing in the News

By Tim Ayles, Chief Investment Officer



Just wanted to pipe in with another update on what we are seeing in the economy and also regarding the reasoning behind our recent investment decisions. As far as what we are seeing in the economy, we still think the economic numbers will continue to improve for a few more quarters. In the end though, we also feel things will be tough through 2012.

Using our automobile production indicator, April production ran at a 5.04 million annual pace, higher than in March when it ran at 4.93 million - so production has started to tick up towards the 7.0 million in demand as we've previously predicted. Once again, businesses have overreacted and cut their output below demand levels in anticipation of a steeper than anticipated drop in business.

Yes, business has fallen off a cliff, but not as quickly as companies had expected. Over time, we think business will continue to fall. In the short term though, the uptick in business production will find its way through many different areas of the economy, thus altering the mood of the financial news and shaping investor, consumer, and business sentiment. This 'feel good' atmosphere will be around for 2-3 quarters until the reality of demand destruction starts to set in again.

We are seeing this now being played out in China. China put forth a \$600 billion stimulus package during the depths of the crisis that is still being felt there in both their stock market and economy. Money has been re-allocated and spent to buy goods and services to

build the economy. I sit back and wonder though how sustainable this might be. If the United States is China's largest customer, and our demand for their goods is down about 18%, then I would think that there are a lot of idle factories and workers in China. And now they are spending billions to build up an export based economy even more, to produce more and more products even though worldwide demand has fallen. Point being - don't buy into the full recovery of China that you are hearing in the news just yet.

Another point that I would like to address is inflation. The saying goes, as the government prints their way out of this mess, inflation is right around the corner. Stories of American consumers having to come up with a \$100 bill in order to buy bread have started to surface. While we believe that inflation will be massive in the future, we don't feel that it will happen in the next few quarters. The reason? Velocity of Money.

Velocity of Money is basically the rate of the movement of money available to purchase limited amounts of goods. It's what drives inflation. If I have the last gallon of water in the world and someone else has the world's last chicken to eat, we can both become a bit wealthier and live a bit longer if we split the goods down the middle and share with each other. If we happen to come across a well of water we didn't know about, the value of my water goes down drastically as the supply of the water has increased. Conversely, the value of my friend's chicken has gone way up - unless of course we then run into a chicken farm. He no longer needs my water as badly as I need his chicken.

In the same way, if I hold real assets that have value, (oil, water, toll roads, etc) and the government prints more money, then the value of a dollar becomes worth much less compared to the real asset.

One part of the inflation story that gets left out though is the velocity of moving money. Banks are the gatekeepers of money flow. If the government prints trillions of dollars and that money hits the banks but never becomes loans, then all the money printing in the world will have zero effect on inflation. The money has to make its way to businesses and people through loans, where the funds are used to buy products and services. People who produce those products now have more money to invest in more production, and thus the cycle of wealth creation continues.

Right now, because banks are afraid of loan losses, the money the government is printing is not quite making it into the real economy. It is only making it to the financial system. As long as money stays at the banks, people and businesses will have less money to spend. As they spend less money, companies are not producing as many products, which means they need fewer workers, which means those workers don't have a paycheck to buy products, which means companies make less money..... Etc., etc., etc.

You see the downward spiral. This is what is occurring now. Consumers are clamping down and not borrowing money and are actually paying off debt. Banks are not lending. Deflation is staring us in the face in the short term. There is now a cycle of less and less

money chasing fewer and fewer products. Inflation will be here and it will be brutal, but I feel it's a few years away.

In the meantime we will continue to buy companies that sell the products that people have to buy, even though less and less money is available. These are essential products and services that people must have.

We will also pick spots to make trades and sell stocks that we've bought for short term profits. We are not against holding larger amounts of cash in your accounts for somewhat longer than normal periods of time. This cash is a strategic asset though, not a wasted investment. Even though cash generates little return right now, we like having it on hand in your accounts so that when we identify a favorable investment level or an attractive company, we have the wherewithal to pounce on the idea. If we can make 5-10% in a matter of weeks from a short term investment because cash was available for the purchase, then we just earned 10 years worth of interest without being exposed for long periods to a drop in the stock market.

These are tough times and we need to do things differently than we have in the past. Hopefully, however, you have heard our investment strategy enough to know what we are thinking. I trust this newsletter will offer further clarification and insight to our method. As always, if you ever have a specific question about an investment, feel free to give us a call. We are here for you and if you are not a Napa Wealth Management client, this is a great time to talk with us.

Tim

We would like to make available some resource booklets that may be of interest to you.

- **Six Best and Worst IRA Rollover Decisions**
- **Helping You Avoid IRA Distribution Mistakes**
- **Avoid Mistakes in Buying Long-Term Care Insurance**

If you would like complimentary copies for friends or family, please email Miguel@NapaWealth.com.