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Deficits, Debts, Downgrades, and Downturns—What's Next?
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Well, they finally did it. As it had threatened earlier, the Standard and Poors rating agency lowered the US credit rating on long-term Treasury bonds one notch from AAA to AA+. Fannie Mae and Freddie Mac—two US-backed mortgage purchasers, were also downgraded today. (Short-term US Treasuries were not downgraded.) The various stock market indexes have responded with panicked drops of 5.5-6.9% on top of last week's declines. Ouch!

The S&P is just one of four rating agencies. Moody's and Fitch have not yet lowered their estimation of US creditworthiness. But the biggest, most powerful, and most meaningful rating "agency" of all—the global bond market—voted the *other* way. Unlike the predictions of most pundits, US Treasury prices have soared and interest rates have dropped. Money is flowing into US Treasuries as a safe haven. The US dollar is still the world's reserve currency.

The downgrade may be irrelevant because, unlike Greece, the US has the ability to simply print more dollars to meet its debt obligations. While this may be inflationary, it is far from a default. More than anything it is a blow to our national psyche. While we believe that the stock market is oversold, this event poured salt into festering economic wounds that simply are not healing as quickly as they should. Mix in memories of 2008 and a good pinch of panic and we have the makings for a huge market sell-off.

So now what?

If we knew what was going to happen in the next few days or months, we would give you explicit advice about what you should do. But we don't. And neither does any other intellectually honest professional. There are just too many positive and negative facts that have yet to play themselves out in a highly-charged political environment. That is why we employ broadly diversified portfolios that have winners and losers on almost any given day. But we do have some guidelines and observations.

Observations and Suggestions

- ***Remember that you are not investing in employees or government reports***. Rather, you are investing in some of the most profitable, best run, and financially strongest entities on the planet: global stocks. Ask yourself how many fewer Band-aids Johnson & Johnson sold because of the downgrade. Or how many fewer bottles of Coca Cola will be consumed world-wide after the next Commerce Department report?

- ***The proverbial horse is already out of the proverbial barn***. With the stock market down nearly 2,000 points in the last three months, selling now locks in losses and makes it difficult to take advantage of quick major upswings.

- ***Unlike the similar decline in the fall of 2008, the fundamentals of most companies represented by the S&P 500 Index are much better.*** These companies used this intervening period to clean up their balance sheets and increase their productivity and profitability. That is why we believe the market is currently oversold and why it won't go "all the way to zero" as people feared it would do in 2008.

- ***Although this market drop seems highly unusual, corrections of this size have happened every two-three years, although not as quickly as this one did.*** According to Capital Research and Management, since 1900 corrections in the Dow Jones Index of -15% or more occur about once every two years. Corrections of -20% or more happen about every 3.5 years.

What Should You Do?

We've said it before, but we'll say it again. Stay calm! (Maybe all of you are, as we have received practically no phone calls or emails this past week***!***) ***If you feel a need to do something, give us a call.*** We're here for you. Perhaps you've discovered you are not as risk tolerant as you previously thought. We can help you apply your situation to the current environment. And if you just want to think things through for yourself, consider the following points.

1. Ask yourself why you feel the need to make a decision or change something.
Is it fear? A change in circumstances? A newscast? Following the crowd? The result of careful consideration and planning?

2. Prioritize your goals.
What is most important to you now? And more importantly, <u>why</u>? Goals are often mutually exclusive. Avoiding investment risk at all times can conflict with your goal to retire comfortably and keep up with inflation. Portfolio income today is a tradeoff with more retirement income later. Taking care of yourself and your spouse can conflict with leaving an inheritance for your children. Retiring early can conflict with your goal of not outliving your money. These may be hard choices, but *not* setting priorities can leave you at the mercy of external forces. And it gives you no direction when it comes to controlling what you can control. We can help you sort through these conflicts, set priorities, and assign "price tags" to each goal.

3. Put things into context. In the big picture, we're not in Somalia, and we've been in worse economic situations than this, and lived to tell about it. By many market and economic measures, we're better off than we were two and three years ago. And maybe the bright side of this downgrade and market correction is that it will force our elected leaders to do the right thing and be civil about it.

On a personal level, if you are retired, that's a much different situation than being 10 years away from retirement with a secure job and/or a practice with good cash flow. If you or your spouse have a secure pension, that's a much better situation than being mostly dependent upon your portfolio for income. If your child is a high school freshman that is different than if she is a college sophomore. Consider your age and life expectancy. ***And most importantly, what is your time horizon for each of your portfolios?***

4. Consider alternatives.
Sometimes anxiety is a roadblock to clear thinking. Maybe you don't need to make a drastic change, but rather some tinkering around the edges or employing other strategies. This is where we can help.

5. How will this affect your long-term goals?
This is closely related to #3, putting things into context. A course of action that makes you feel comfortable now could make you very uncomfortable years later. For example, moving to cash and staying there for too long may turn out to have been an expensive decision down the road.

6. Define your criteria for a good decision.
What has to be true when you have achieved your goal? Answering this question with measurable points will actually help you prioritize and reinforce your goals. Qualitative goals are hard to quantify. But try anyway.

A Framework for Making Decisions
In an Uncertain Environment