



Investment Insights

Kevin Kennedy

Tropical Storm BIC—Time to Board Up The Windows? Nov. 4, 2005

Many economic forces that have been at work throughout this year are finally converging to cause uneasiness and concern among all investors. In reverence to this amazing year of large storms, I'll call this one "Tropical Storm BIC".

The "B" in BIC is for Bubble, as in housing bubble, one of the hottest topics and potentially most damaging developments of 2005. "I" stands for Interest rates, perpetually in the headlines in 2005 following 12 straight Fed rate hikes. "C" is for you and me, the Consumer, the driver of economic growth the past three years, whose savings rate is now negative and available credit is running low. Will Tropical Storm BIC turn into a hurricane, and wreak havoc on the financial markets? Or will this storm, like others before it, spin over the horizon and be forgotten?

I'd give this storm a 20% or less chance of becoming a meaningful hurricane. BIC would be a devastating storm if there was a dramatic and sudden crash in the housing market combined with a sharp drop in consumer spending. In this situation, we would likely have a recession, the stock market would drop, and it would feel like 2001 all over again.

There's probably also a 20% chance the storm misses us entirely (i.e. all of these issues miraculously resolve themselves). Although the challenges this economy faces are significant, they are not entirely "new", and issues like high debt levels, negative savings rates, etc. can persist for long periods without negative ramifications. To miss the storm entirely would take some fancy footwork, however, and although we can hope for the best, it's not the most likely scenario.

The odds-on forecast is a 60% chance we see some damage from BIC, with isolated areas of medium to heavy damage. Most at risk are the leveraged families who have borrowed to spend money on consumable items (cars, trips, etc) and now face a double-whammy: rising debt-service costs (the Prime Lending Rate has risen from 4.75% to 7% in the past 12 months) and a potential decline in the value of their loan collateral (i.e. home). Also at risk are those who have used creative financing to make purchases they will find it hard to extricate themselves from (i.e. interest-only or negative amortization loans to afford otherwise unaffordable home purchases). Debt and leverage, much like living on the beach in Biloxi, can be wonderful at times (when interest rates stay low and real estate does well). However, we've all seen what can happen when a storm hits.

Whether the negative fallout of these situations unwinding themselves has a minor or major impact on the overall economy may be influenced by other visible economic stresses on the system. Particularly, if gas and heating oil prices remain high, the tightness this causes in many people's wallets, combined with negative headlines and growing stories of personal bankruptcies and foreclosures, may cause consumers to hunker down for a while, further slowing the economy.

These different scenarios, and the "odds" I've placed on them happening, has differing impacts on different people. For example, tough economic times are great for investors in bonds, but not as good for investors in stocks. Slowing consumer spending hurts some companies, and their stocks and bonds, more than others. How your portfolio would fare under any of these scenarios is a great question to ask your advisor today.

That said, in my 20 years of experience, only 10-20% of the time are market events the cause for wholesale portfolio reallocations. I've found that 80-90% of portfolio changes are driven by a change in your financial plans and risk tolerance. Thus, your most important concern is not the accuracy of these forecasts for the future, but your accounting for the information relevant to your situation today (i.e. personal and family goals) in the design of your investment strategies.

Kevin Kennedy is president of Kevin Kennedy, LLC, a registered investment advisor firm in Alameda. Reach him at 510-748-1898 or Kevin@KevinKennedyLLC.com. Stocks, bonds, and mutual funds involve risk, including loss of principal. Past performance is no guarantee of future results.