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Monthly Letter to Our Clients and Friends The Trifecta – Okun’s Law and Unemployment Is the Law of Supply & Demand Obsolete?

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Complimentary Copy

The Trifecta

It has been a long and hard winter for most of us, even those of us who make their home in the Carolina’s. But we know without a doubt, that the beauty of spring is just around the corner. Our hometown celebrates the season with the annual the Come-See-Me Festival, first held in 1962 to encourage visitors, relatives and friends to see Rock Hill in all its glory. The Come-See-Me Festival is the largest, all-volunteer festival in South Carolina and attracts more than 100,000 participants every year. It has been ranked in the South’s Top 20 Spring Festivals numerous times and has been featured in *Southern Living* magazine twice. This years’ Festival begins on April 15th and runs through April 24th. I know that those of you who are local residents will take in some of the events. For all my friends who live around the world you are hereby officially invited to pack up a few clothes, find an extra dollar or two and come to Rock Hill. You will enjoy every minute!

I personally accelerated my own passage into spring with three of my favorite things.

Visiting family and friends combined with a short ride on my trusty Moto-Guzzi motorcycle. For motorcyclists, the official kick-off to riding season is held every year in Daytona, Florida. The Daytona Bike-Week began in 1937 and except for a couple of years during World-War II has been held yearly in late February or early March. In a normal year, Daytona officials estimate that an average of 500,000 motorcycle riders and their friends take over the city.

I’ve never been a fan of these types of motorcycle gatherings, but it gives me the chance to visit with a few of my friends from around the country. I began my own tradition many years ago of riding down to Daytona on the last day of bike week to meet up with these friends, eat a few slices of pizza, and then get back on the bike and ride home. This tradition awarded me with both the short ride (slightly more than five-hundred miles one way – anything less is just a stroll), and the visit with friends seen too little. When my daughter Andrea and her husband, along with our only grandchild, moved to Orlando I was given the best of reasons to spend an extra day in sunny Florida. I truly hit the “trifecta”.

Okun's Law and Unemployment

Believe it or not, but I do gather a great deal of information about the economy from an event such as the Daytona Bike Week. I have no scientific process exactly, just my own observation. Daytona officials estimate that an average year will bring 500,000 visitors to the event. This year, I believe that number was just a dream. For the first time ever I was able to ride the short distance from Ormond Beach at the I-95 intersection with US 1 into Daytona Beach as if it were a Sunday afternoon. Just a couple of years ago it was agonizing bike-to-bike for miles.

A motorcycle is a luxury item for most individuals, and in troubled times is one of the first things to go. A loss of employment, a reduction in hours worked, or just the fear that a job is in jeopardy can quickly impact the motorcycle industry. It's easy for us to see this relationship in the motorcycle industry. Today, the fear of job loss is affecting multiple industries and placing fear into the hearts of people, even those who six months ago thought their job was secure. **When the fear of job loss is universally accepted, the overall output everywhere slows to a standstill because people just quit buying.**

What will it take to see job creation? Most of us believe that it will simply take a growing economy to create new jobs. But this leads us to the question, *how much* growth will it take? And that is where economist Arthur Okun comes in. **In 1962 Okun used his powers of observation and common sense to create two simple mathematical equations to explain the relationship between the rates of unemployment to real output.** Observation and common sense are not the tools required to pass scientific scrutiny, yet his initial work, along with the additional study conducted over the years by others, have provided a pretty good relationship between output and employment that answers our question of "How much growth" can be calculated with some reliability.

In its current version, Okun's law relies on calculating the output gap. The output gap is the difference between the current level of GDP and what GDP would be if everyone that wanted to be was employed. Janet Yellen, the President and CEO of the Federal Reserve Bank of San Francisco used this approach in a speech given at the University of San Diego on February 22, 2010 where she gave us her answer to our question. Here is what she said:

"Let me sketch out how this should work. In my forecast, GDP growth exceeds the growth rate of potential GDP by 1 percentage point this year and 2 percentage points next year. According to Okun's law, the unemployment rate should fall by about one-half percentage point by the end of this year and a full percentage point during 2011."

If Dr. Yellen is correct, then the current rate of unemployment, 9.7% declines to 9.2% in 2010 and 8.2% by the end of 2011.

Is the Law of Supply & Demand Obsolete?

Our personal expectations on employment are similar to Dr. Yellen's. We believe that it will take a stable or declining unemployment rate to create consistent growth in our economy. We can make investment decisions based on our expectations, however if we fail to incorporate the current price of the securities chosen to implement these expectations, we could easily become new members of the buy high sell low club. **Being right about the future course of our economy or interest rates does not directly relate to investment returns.** If everyone's expectations are the same and the majority of investors have acted on their expectations by investing in the same or similar types of investments, then we can be somewhat assured that demand for those securities have exceeded supply and are overpriced. One of the major mistakes investors make is ignoring the economic principal of supply and demand.

For the past year, a dramatic change has occurred in investors' asset allocation, i.e., their amount invested in stocks, bonds and cash. This reallocation of assets has been driven initially by the fear created from falling common stock prices, and secondly, the persistent low level of interest rates. It is difficult to track these changes initially, but within a short period of time, the flow of money into and out of institutional investor portfolios and mutual funds is reported. On March 8, 2010 Pension & Investments reported net flows of institutional investors by asset class for 2009. These flows were the best estimate provided by eVestment Alliance data.

Institutional Investors net flows by asset class

Class	Net Flows in millions
U.S. fixed income	\$139,530
Global fixed income	\$60,190
Emerging markets equity	\$31,191
Emerging markets fixed income	\$6,885
U.S. hedge funds*	\$128
Global hedge funds*	\$22
U.S. Real Estate*	\$9
Emerging markets hedge funds*	-\$1
Emerging markets alternatives*	-\$23
Emerging markets balanced/multiasset*	-\$905

Global balanced/multiasset	-\$1,135
EAFE fixed income	-\$3,183
Global real estate*	-3,266
U.S. balanced/multiasset	-\$7,897
U.S. global alternatives	-\$7,913
EAFE equity	-\$43,657
Global equity	-\$43,886
U.S. equity	-\$111,056

*Flows calculated are for information purposes only and may not represent true asset flows in a given category due to limited coverage in the eInvestment Alliance

Individuals have followed the lead of our institutional investors. The figures below are through the end of 2009, but the trend has continued. According to EPFR Global investors have pulled \$15.3 billion out of U.S. stock funds so far in 2010. They have placed about \$2 billion into emerging-market stocks and \$20 billion into U.S. Bond funds.

U.S. Mutual fund flows as reported by TrimTabs.com for the year ending 12-31-2009

Class	Net Flow in millions
U.S. bond funds	\$370,000
U.S. bond ETFs	\$39,000
International stock ETFs	\$35,000
International stock funds	\$26,000
U.S. stock ETFs	-\$18,000
U.S. stock funds	-\$32,000

By reviewing these tables, it is easy to see that investors have been shunning U.S. stocks and buying bonds. What is amazing is that it has continued even though the U.S. stock market has produced some very positive returns, while short term interest rates are near zero percent. Am I wrong to think that bond prices are overpriced and U.S. stocks are under-priced? Am I wrong to think that the law of supply and demand has suddenly become obsolete? The bigger question is, if I am wrong, and bonds are bargains while stocks are overpriced as the cash flows reflect, what

will be the damage to our portfolios in buying stocks and selling bonds? My guess is very little. Stocks can still go down, even from these levels. It will take further interest rate declines to gain excess returns from bonds. As Charles Biderman, CEO of TrimTabs recently stated “the greatest risk to the economy is higher interest rates triggering a blow-up in the bond market”.

Some Final Notes

If there is one reason I have been able to stay in this business for over thirty years it is my belief in the economic principal of supply and demand. Thirty years ago the industry pundits told me to buy real-estate and oil and gas limited partnerships. After the 87 crash, the rage was enhanced government bond mutual funds. In the late nineties the emphasis was on small cap technology IPO’s. In the last decade Auction Rate Securities, mortgaged backed securities, and all types of investments described with initials were the preferred choice. And now we see that bonds and emerging market stock funds are the rage.

The majority of limited partnership investors lost on their investments. Enhanced government bond mutual funds have disappeared, the tech bubble burst, auction rate securities are still in limbo, while the economy and investors struggle to recover from the derivative bubble. **Maybe this time is different. But for me, I will continue to believe that the law of supply and demand is alive and well.** Our mission is to protect our clients against the possibility of substantial error by helping develop rational investment policies. Refusing to follow the crowd has allowed us to stay true to this mission.

Until next time,

Kendall J. Anderson, CFA

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