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Written by: Philip C Benedict, CFP®

the BENEDICT *REPORT*

6000 Lake Forrest Drive NW, Suite 550, Atlanta, GA 30328-5901 • 770 671 8228 • 770 671 0232 *fax* • 800 678 8227

The Benedict Report

December 5, 2007

We don't usually send out a *Report* during the holiday season, but we have had a number of questions the last few weeks regarding the economy, real estate, the weak dollar, the sub-prime mess, etc. Thus, we decided to offer some comments and opinions in hopes of providing some insight to the information that is bombarding you daily.

We will start off describing a scenario that currently seems to be playing out in our economy. We believe that, if you understand this, a lot of what you hear from the media over the next several months will make more sense to you. But, that doesn't mean the news won't still be somewhat disturbing.

(As with most of our Reports, the words are written by Phil Benedict, but with thoughts and ideas and opinions that have been provided by everyone in the office.)

IT WILL BE UGLY…it is already starting!

In the late 1990's, the stock market was roaring, caused by huge increases in the money supply after the Russian debt crisis in 1998 and even more increases to avert the feared Y2K crisis at the century's end. To make up for the "easy" money times, shortly after the beginning of 2000, the Federal Reserve started raising interest rates and rather dramatically reduced the money supply and the market reversed course.

By 2001 the stock market was falling like a rock. American businesses reacted quickly and literally stopped hiring, stopped buying and went into survivor mode. In many cases, they did whatever they could to reduce their debt and certainly declined to take on new debt. Many individuals who had a significant amount of their wealth tied to the stock market did the same thing. However, since this group tends to be a wealthier segment of the population, we didn't hear much about it. The Federal Reserve responded by slashing interest rates and adding massive amounts of money to the economy in an attempt to prevent a nasty overall recession.

The real estate market, which had been appreciating quite rapidly, seemed to gather more steam apparently as money that previously had gone into the stock market was finding itself going into real estate investments/ speculations.

As the investor class was cutting back, another part of the population salivated at the very, very low interest rates created by the Federal Reserve. The low rates made borrowing literally painless. This group responded by borrowing to buy homes, beach houses and rental properties, new cars, new kitchens, new everything…they had found the way to riches!

By 2005, the stock market had healed and the investor class was feeling frisky. They were again buying new autos, new homes and the like and this added to the price appreciation of real estate.

Now it is late 2007 and we are watching much of the leverage (borrowings) unravel. We are not just talking sub-prime here; we are talking about many of the people who used a lot of leverage (borrowed money) to purchase properties that now cannot be sold or, if they can be sold, it would be for far less than they owe. These people have to walk away from the loans resulting in defaults on the mortgages.

Businesses and the investors had their recession early in this decade. The over-borrowers are just starting their recession. Overall, this is a much larger and less affluent group than the part of society that had their recession in 2001-02 and this group will get the attention of the media and Congress. As it progresses, it would not surprise us to see demands grow for immediate fixes and that may develop into demands for some sort of revenge. It is not a normal human trait to enjoy feeling severe pain, but it is a human trait to blame the source of the pain on somebody or something else. (It is not that this group of people is bad or even did anything wrong, they were aggressive borrowers and got caught in a major financial climate change, and it will be painful for all involved.)

We believe the pain will have implications for society and politics, but whether it has a significant impact on the stock market overall we are less certain. Many of today's large corporations are making money around the world and a large portion of the U.S. population that did not get over-leveraged with loans and mortgages. However, IF the stock market is doing well while the leveraged population is suffering, we would anticipate much societal tension. We doubt there is anything that we can do to ease this tension, but being aware of the causes may aid in its understanding. The media loves human stories that are full of pathos, blame and presumed economic injustice, so be prepared.

THE NON-ROSY WORLD OF REAL ESTATE

I must admit I have never been overly sensitive to the real estate marketplace and prices of homes. I always considered a home as a place to live…period. I never considered it an investment. My thinking was, "so what if the price goes up? If I sell and buy a new home that one will have gone up also. Besides, I can't eat shingles during my old age."

I have only bought two homes in my life and, if I hadn't made a big move in the mid-70's, I suppose the number would have stayed at one. I also did not refinance a mortgage to take out the "equity" as was so popular over the last few years. I am a believer in a paid for home as early in life as is practical.

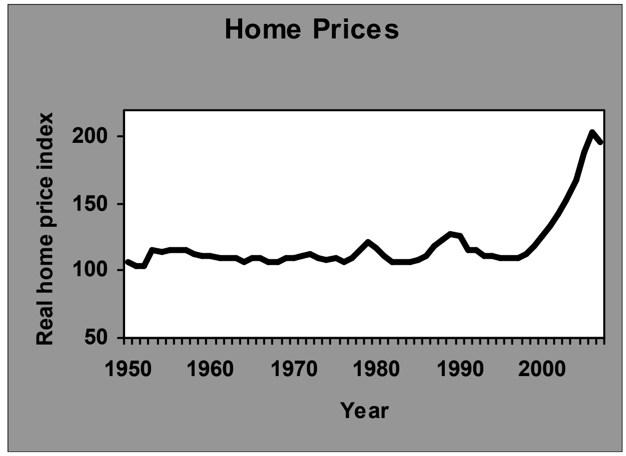
I say all this not to sound like I am above the masses but to emphasize that I am not an expert on residential real estate and the feelings and emotions that it evolves, so keep that in mind as you read the next few paragraphs.

It is quite evident that most Americans feel their home is a critical investment and their most important investment. It is an investment that is very much tied to our emotions and our self-esteem. It is also one in which we have very little control over the price or the speed in which it can be sold.

But, I haven't had one question on generic investment issues regarding the home as an asset. What we are being asked is, "how long do you think before things get back to normal?"

This is difficult to answer with a quick phrase because it assumes that the last few years in the residential real estate market were normal. I would argue that there was nothing "normal" about the metropolitan Atlanta real estate market in 2005 and 2006. Florida beach property and many other hot-spots were even more abnormal.

Let's look at the following chart. This index, The Real Home Price Index, by Robert Shiller, tries to represent the average price of homes in this country AFTER inflation. Thus, when you see a trend that is somewhat flat, it is representing that home prices were rising about the same rate as inflation. But, look at the last few years. Does this look "normal" to you?



Residential home prices and activity vary a great deal from one locality to another. I would guess that growing areas with limited land availability will recover much faster than areas with ample building lot availability. But, home prices in some areas went to such extremes that it will probably be years and years before the buyers will ever have a chance to sell at their purchase price. I would guess that many beachside condos would fall into this category, especially the ones that are primarily rental units and not in areas popular to foreign buyers.

What would I do now? Accept the fact that real estate cycles are generally multi-year cycles. Assuming I have to sell, I would sell. I wouldn't try to rent the property in hopes that I will recapture the *lost* appreciation. It certainly appears things may get far worse before they start getting better. If I wanted to sell merely to upgrade, then I would follow through on my plan because I assume the upgraded new home has probably declined in value similar to my current home. But, I wouldn't buy the new home until I had the current one sold. In a slow real estate market, that would be a much bigger gamble than usual.

Look at the chart again and maybe you will have to agree with me that this "bubble" will take quite a few years to heal. Be prepared, be prudent and be patient.

MORE ON THE CREDIT CRISIS!

Have you ever wondered why in smaller communities the politically connected seem to frequently start a bank? Let's see how it works; I deposit $10,000 and the bank agrees to pay me $400 per year in interest. The bank uses that as *lending reserves* and is allowed to make loans of $60,000 (or some other amount depending on current regulations). Let's say they can charge 7.5% on the loans, their earnings are $4,500. Hey, you say, that's a pretty good thing. It is, but you can see how it could get out of hand and how the bank has some incentive to make somewhat riskier loans to get even a higher rate of return.

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It is now the twenty-first century and things are far more open. Big money wasn't going to go to the local bank; let them earn huge profits on their loans and pay the big money boys a pittance. The boys on Wall Street smelled a deal, the hedge-fund managers smelled opportunity and money from all over the world was looking for decent returns in a low-interest rate environment. Thus, a *shadow banking* system was created, one that was not regulated by the Federal Reserve System, one that was pure capitalism…maybe, at first, capitalism at its best and later at its worse.

The Wall Street brokers, the matchmakers, took money from the big hedge funds and other big investors and provided money to independent mortgage brokers to make loans on residential homes. How simple, how pure, how relatively safe. Everyone was happy, except the bankers who were experiencing rather severe competition.

But, competition and the easing of interest rates by the Federal Reserve pushed mortgage loan rates to very low levels. Wall Street can't make big fees marrying up a high-fee hedge fund to invest in 3% mortgages, unless…unless they can borrow the money at 1% and loan it at 3%. Eureka, a money machine is off and running again. But, that is only a 2% spread, not enough for the testosterone driven Wall Street brokers and hedge fund managers. How to spice it up? Be more like a bank. Invest $10 million to use as *lending reserves,* actually collateral is a better word here and borrow $100 million at 1% to invest at 3%. Two percent profit on $100 million works out to be, excuse the delay…I had to go to my calculator for this, $2 million or twenty percent of the original $10 million investment.

You know, or are at least watching, the *rest of the story.*

DINOSAUR MATING RITUAL…

I hesitate to write this, but I have to. I grew up in Southeastern Michigan, which is/was the heart of the auto industry, the domestic auto industry that is. Most of my parent's friends were either farmers or workers in the auto industry. Many communities were economically dependent on a single manufacturing plant that supplied the auto industry.

A couple of months ago, I looked at the headlines of a Detroit paper as GM (General Motors) and the UAW (United Auto Workers) announced their new contract…one that would "save" the auto industry [GM 52 wk high/low $43.20; $24.50; 12-05-07 $28.10]. I tried to think of words that would capture what I was thinking and came up with words like, Byzantine, archaic, deceptive, and oblivious; however, nothing seemed to jump into my mind like the image of two dinosaurs making love! There was no future for these animals and I don't believe there is a future for this giant corporation without drastic change.

I just don't think General Motors has the financial ability to honor the contract. I look at their balance sheet and see that in 2002 they were paying $7 billion dollars of interest on long-term debt and in 2006 it was almost $17 billion. Does that not look like a company that is borrowing against the future to pay current expenses?

Then, I see the headlines of the November 12, 2007 issue of the *Detroit News* proclaiming that…"GM offers absentees a carrot and a stick."

I read on and learn that the auto plants have a big problem with workers not showing up for work. The article mentioned how at times up to twenty percent of the workers were not available to work. That figure did include regular vacation time, but if you need five people to get a job done and only four are there, you have a problem. That's like playing a football game with nine players…what chance do you have to win?

Let me get this right. You have a company that is struggling to avoid bankruptcy; you have a workforce that is struggling to keep their jobs, salaries, benefits and that's not enough motivation to just *show up*? I know a lot of people who are/were employed by this industry and I'm quite certain that eighty percent or so of the employees are diligent hard-working employees. I imagine the problem is with the other twenty percent, BUT it is still a big problem. This is not the big, fat auto industry of 1967. It is now a fiercely competitive, highly technical, global industry and the opponents are among the toughest competitors of any industry in the world. You can't win this game with only nine players. Wake up GM management, wake up UAW leaders. Quit telling the workers things they want to hear, tell them truths!

Okay, I've outlined what I perceive to be the problem, what is my suggested solution?

I think General Motors' management needs to come clean with themselves and their workers and the world. They are in a struggle for survival and they are not winning. And, the union leaders need to also tell their members how survival is at stake. Don't get me wrong, it appears the union did make significant concessions, but that is not the real problem or the real solution. Today's players, on all levels, are paying for a lot of bad decisions in the past, but life, unlike pickup trucks, doesn't come with a reverse.

Next, I think the UAW can be the solution. But, the solution is not the UAW of Walter Ruther where the company and the union were adversaries. That's yesterday's structure. The UAW needs to become something of an out-sourced human resources/production department for GM.

The leaders of the new UAW need to create a motivated, trained workforce that they bring to the table…or plant. If a worker is not up to the HIGH standards that the new UAW requires, then he is replaced. The management of GM has their hands full trying to design cars that people want to buy - and selling those cars. They shouldn't be worrying about those low-end workers who can't get out of bed to show up to work on the day before a holiday.

The new UAW needs to train the troops, whip the troops into action, provide motivation to the troops, provide discipline

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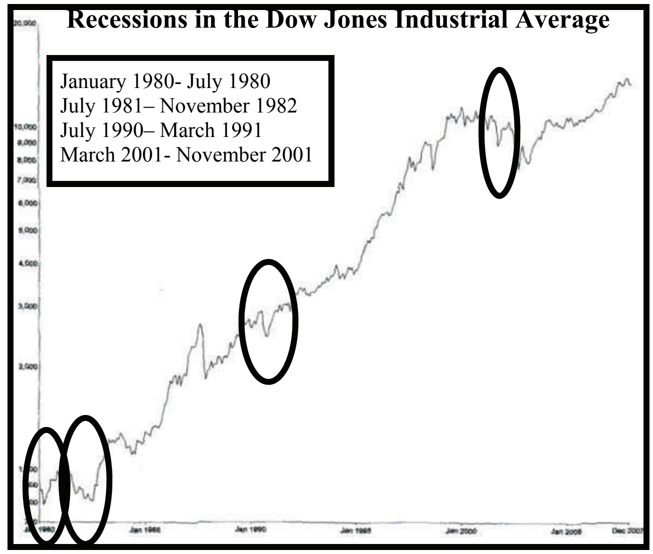
when necessary and make available a motivated, skilled team to build automobiles for **their** company much like the Marines do for the Commander in Chief.

Let the UAW sign a contract with the automaker to be paid a certain amount per completed automobile and then they, the new UAW, can decide on wages and benefits for their members. Pay the workers for successful results, not merely for showing up…or worse for not showing up. It is time for the UAW to provide incentives and protect the disciplined, motivated and skilled high-end worker and weed out the rest. Catering to the low-end, un-motivated, un-disciplined employee is putting the motivated, skilled employee at great risk. If this doesn't happen, future generations will read about the domestic auto industry like today's children read about giant reptiles.



"ARE WE GOING INTO A RECESSION"?

The one question we have probably heard the most the last few weeks is, are we going into a recession?

This seems to be especially scary to the younger crowd, probably because they have never experienced "a recession" or at least were not aware of it. Of course, I have no idea if the economy as a whole will go into an *official* recession or not. Actually, it doesn't matter. If you were making your income from the real estate industry, you are already in a recession. If you live in the Great Lakes states in areas economically dependent on the domestic auto industry, you have been in a recession for several months. If you are a marina operator at Lake Lanier or a landscape service in metro Atlanta, you are probably suffering your recession as this is being written.

If you are a farmer, in areas not suffering a drought, times are probably pretty good. Likewise, if you are in the export business or the transportation of exports, your business is probably booming. The energy industry is thriving, auto repair businesses seem to have more business than they can handle and the healthcare industry seems to be running at full speed.

I wouldn't pay too much attention to the *official* recession talk you hear on television. We may or may not have to endure an *official* recession, but either way you will hear a lot about it. You see, the media loves the "R" word, recession, because fear is a great ratings boost. Just like weather media loves the "H" word, hurricane and entertainment media apparently loves the "J" word, jail.

Question: If we go into a recession, won't the stock market drop?
Response: Maybe. The following chart shows the Dow Jones Industrial Average since 1980. [Dow Jones Industrial Average is a non-managed index that cannot be directly invested into.] We have tried to draw a circle showing the times we were in an *official* recession during this last twenty-seven years. I don't see any pattern from this simple exercise.

Question: If we go into a recession, won't a lot of people lose their jobs?
Response: In real estate, auto manufacturing, etc., a lot of people have already lost their jobs. During the sixties and seventies our economy was very dependent of heavy manufacturing, thus, when those very cyclical industries went into a downturn, our entire economy seemed to be impacted. Those very cyclical industries no longer are a big part of our economy. Our recessions now seem to flow from one industry to another and from one geographic area to another.

Question: If we have a *recession,* will I be all right?
Response: Economic slowdowns are quite natural. In fact, one of today's big risks is that the Federal Reserve has been too active in trying to prevent recessions when sometimes we have to let nature take its course.

I guess your question is, will you survive financially? First of all, if you are worried about the stock market, you must realize it is only part of one's financial status. And, it would not be unheard of for the stock market to tumble if the economy slows, in fact, it would be a natural event. ,But it would also be quite natural for the stock market to recover in a few months and probably go on to new highs. History would actually show the stock market declining **before** the official recession and healing during the economic slowdown, when the news is very bad. This should not negatively impact most long-term Investors; however, if your investments are heavily dependent on the stock market and you are withdrawing a fairly large percentage of your account on a monthly or annual basis, any meaningful down market will have an adverse impact on your financial security both short term and long term.

Question: What do you see for the future? Should I be apprehensive or excited?
Response: You are asking this of someone who tends to see the positive side of almost everything, so take that into account as you read my response. For a few minutes, forget the daily headlines and look backwards. From an economic viewpoint, is our standard of living higher now than it was ten years ago? Twenty years ago? Thirty years ago?

In the last ten years, we suffered what is considered the biggest stock market decline since the 1930's, but we were looking at some mutual funds the other day that we had purchased in 1997 and the gains were substantial. It may take many years, but, eventually, today's housing slow-down will be old history.

Today's oil prices are causing some economic pain, but they are also pushing us to create new alternatives that will improve our standard of living for generations. The renewed focus on natural resources and the environment will create a lot of governmental inefficiencies, but it should also push us into new ways to provide much more with much less.

The economic problems I see on the horizon seem to be the standard ones of cycles and supply and demand imbalances. Also, if the United States tries to fight this wave of globalization instead of taking advantage of it, that would be a big, big negative.

A more near-term problem was addressed in previous articles, the de-leveraging of consumers and financial companies. People, who borrowed money to buy things, now have to pay that money back and can't be buying new things. This part of society is in for real pain and it will impact the economy as a whole. But, that group that had their recession in 2002 is most likely not in debt and are feeling rather affluent now. I don't know if the spending of the affluent can off-set the dramatic slowdown in spending by the leveraged group, we shall see. Quite frankly, I would gladly accept an economic recession to stop this massive debt train we have been riding, it will make the future even brighter.

Most people need to concentrate on their own internal affairs and how to maximize them and not on the world affairs over which they have no control.

Just my thoughts! Thanks for reading.

OUR OFFICE:

Philip C Benedict, CFP®
Travis M James
Mark A Beaver
Christopher P Hall, CFP®
Ashley A Thompson
Jean B Wilson
Kristen D McElwaney

The primary author of The Benedict Report is Philip C. Benedict, CFP®, an Investment Advisor Representative and Registered Principal with **LINSCO/PRIVATE LEDGER**, a registered investment advisory firm and member of the NASD/SIPC. Travis James, Mark Beaver, Chris Hall, CFP® and Ashley Thompson provide technical assistance. Jean Wilson handles the layout and editing of the newsletter and Kristen McElwaney assists with the mailing.

BENEDICT
FINANCIAL ADVISORS, INC

6000 Lake Forrest Drive, Suite 550
Atlanta, GA 30328-5901
770.671.8228

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