



INVESTMENT COMMENTARY

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Stephen Molyneux

UNCERTAINTY HANGS OVER THE ECONOMY

NATURAL DISASTERS, POSSIBLE NUCLEAR CRISIS, GEOPOLITICAL UNREST, AND SOVEREIGN DEBT CAST A SHADOW OVER GLOBAL ECONOMY

A devastating earthquake and a monster tsunami followed by severely crippled nuclear power plants in Japan, plus a growing wave of bloody violence in the Middle East and North Africa, and a new round in the protracted European debt crisis have all added a great deal of uncertainty to the prospect of future growth for the global economy. The global sovereign debt problem, especially in the euro zone, seems to drag on and on without resolution. Unrest in the Middle East appears to be spreading and intensifying with each passing week. And the massive natural disaster and nuclear crisis in Japan has damaged the world's third largest economy to a degree that is still unknown. This trifecta of problems has added new hurdles to the tenuous global recovery and has the potential to blunt future growth.

High sovereign debt levels continue to plague local, state, and federal governments in much of the developed world. The recent protests in Madison, Wisconsin highlighted the predicament many state governments are facing. Variations of the Wisconsin labor battle have been unfolding in miniature across the nation as state governments try to reconcile anemic revenues with mounting obligations. Economists, while agreeing debt levels must be addressed, worry that deep spending cuts by local and state governments will further weaken the U.S. economic recovery. Across the pond, European governments cannot agree on how to address their growing debt crisis. The Prime Minister of Portugal resigned this past week as the country's Parliament rejected a new austerity plan. Like Greece and Ireland before it, Portugal will likely require a bailout from the IMF and the EU. The recent political crisis in Portugal will only add to its financial woes. Prior to the Prime Minister's resignation, investors were already demanding interest rates above 7% for 10 year bonds, a rate that most analysts see as unsustainable even in the medium term. While Portugal is a small nation, it is seen as yet another domino of heavily debt-laden European governments that will require sizeable bailouts to survive. The events in Portugal have triggered a new bout of nerves about other EU nations that have much bigger economies but similar debt problems, such as Italy, Spain, and Belgium. Most analysts see Spain as the next possible trouble spot in the EU. The Spanish banking sector was recently downgraded by Moody's, citing their exposure to falling real estate values, and their exposure to losses in Portugal. Spanish banks hold \$109 billion in Portuguese sovereign debt. A growing number of economists see no possible escape for many of these highly indebted nations except through default.

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IRA Contribution Reminder

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As one economist quipped, “they are trying to remove a mountain of debt with a teaspoon that has a hole in it.” And in the face of this long-drawn-out debt crisis, the most recent meeting of euro-zone finance ministers could not reach any agreement on how its 17 members will share the burden of enlarging bailout funds to rescue Europe’s most indebted members. Kicking the can down the road, the finance ministers said they will re-examine the issue at their next scheduled meeting.



JAPAN WILL PROBABLY SEE A CONTRACTION IN ITS ECONOMY FOR THE NEXT TWO QUARTERS

The full impact of the horrific earthquake/tsunami and ongoing nuclear crisis at the Fukushima Daiichi power plant is still unknown. Supply chains for a variety of products will suffer. We have already seen certain companies, such as GM and Boeing, forced to reduce production due to a lack of necessary Japanese components, and technology analysts say there is a looming shortage of flash chips which will impact many final products such as the iPhone and iPad. Japanese companies, located far from the disaster center are facing possible reduced production from scheduled rolling blackouts. Supply logistics have become a nightmare for some companies. Certain critical devices for the production of a variety of products were produced in Sendai, the Japanese city heavily damaged by the tsunami. Manufacturing many of these critical components requires a highly skilled workforce which makes it impossible to replace them quickly with workers in other southeast nations. How much bearing the Japanese disaster will have on other Asian economies is difficult to gauge, but many of Asia’s booming economies are deeply reliant on Japanese trade and investment. Beyond the disruption the Japanese crisis will present to various corporations and sectors of the global economy, many economists worry over the added debt Japan will incur in its rebuilding efforts. Even before the quake, Japan had the highest government debt level of any industrialized nation, a stunning 200% of GDP. In fact, just weeks prior to the quake, Moody’s cut Japan’s credit rating to “negative” citing concern over their enormous debt levels. While the Japanese are some of the most resilient people in the world, they face a monumental task rebuilding their nation with the added burden of an aging population and an enormous level of sovereign debt. Even in the best case scenario, Japan will probably see a contraction in their economy for at least the next two quarters.

Many Of Asia’s Economies Are Deeply Reliant On Japanese Trade And Investment

As if there weren’t enough problems facing the global economy, the protests and riots which began in Tunisia and have since spread and intensified in other areas of the Middle East and North Africa have resulted in considerably higher oil prices. A recent survey of economists reported they are most fearful of one major headwind: oil prices. Crude oil prices have risen nearly 11% just since January. Economists fret the sharp increase in energy costs will prompt consumers to slow spending, thereby paring economic growth. It is no coincidence that the recent surge in gasoline prices at the gas pump was followed by a sharp drop in the consumer sentiment survey to its lowest level since November 2009. High gasoline prices impact spending habits and the sentiment of consumers.

Many corporations can absorb higher energy costs temporarily, but if energy costs remain high or move higher, corporations will be forced to raise prices. The airline industry, highly sensitive to fluctuations in fuel prices, is already instituting fuel surcharges on ticket prices to offset higher costs, and many airlines are lowering their future growth projections. High energy costs have the potential to affect earnings everywhere in the supply chain. Also, high energy costs can cause an atmosphere not conducive to companies wanting to hire new employees or make new investments.

We can only hope that the Fed Chairman, Ben Bernanke is right when he said he expects the effects of higher oil prices to be transitory.

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U.S. Economic Data Despite stubbornly high unemployment and falling home values, household wealth in the U.S. climbed by \$2.1 trillion in the fourth quarter as households continued to rebuild their finances. Also, it was the 11th consecutive quarter households cut their debt. Consumer spending rose at a 4.1 percent annual pace in the last quarter of 2010, the most in four years. The latest economic data regarding U.S. corporate earnings reported profits hit an all-time high in the fourth quarter of 2010. At an annualized rate, this would translate into \$1.68 trillion in profits. The Fed statement reports corporations had \$1.9 trillion in cash and liquid assets at the end of the fourth quarter, a new record. On the whole, corporations have significantly improved their balance sheets since the financial crisis.



U.S. CORPORATE PROFITS HIT AN ALL TIME HIGH IN THE FOURTH QUARTER OF 2010

Even though profits are at record levels, many corporations seem cautious about spending. Durable goods orders have dropped for two straight months and some analysts see this consecutive drop in capital spending as a red flag for future growth. There are also a growing number of economists and analysts that have trimmed their GDP predictions for the first half of 2011. Many now foresee the GDP in the 2% - 2.7% compared to their previous outlook of 3% - 3.5%.

Housing Sector Someday, the U.S. housing sector will recover. Unfortunately, at the current time, the housing market remains severely depressed. Sales, building permits, and prices continue to fall. Sales of new homes in February reported the largest monthly drop ever recorded, falling 28% year-over-year. Sales of existing homes decreased 9.6% compared to a year earlier, with sales falling in all regions of the country, led by a 12% drop in the Midwest and a 10% drop in the South. The number of permits issued in February for future housing construction fell to a new low not seen since the government started tracking the figures in 1959. Housing starts, the number of new homes being built, fell 22.5% compared to the previous month. The S&P / Case-Shiller index of property values in 20 U.S. cities fell 2.4% in December from a year earlier with 18 of 20 cities showing a year-over-year decline. The National Bureau of Economic Research reports the value of real estate held by households slid by \$244 billion in the last quarter following the prior quarter's \$629 billion drop.

THE HOUSING SECTOR REMAINS DEPRESSED - SALES, BUILDING PERMITS, AND PRICES CONTINUE TO FALL

A recent report by the Census Bureau demonstrates the severity of the housing crisis in certain regions of the nation. The data reveals that a staggering 18% of homes in Florida are sitting vacant, with a vacancy rate of 16% in Arizona and 14% in Nevada. Some counties within these hard hit states have vacancy rates above 30%. Housing market analysts predict it will take nearly a decade before vacancy rates in these hard hit states return to the single digits. Short sales, distressed sales, and all cash purchases are taking up higher percentages of total sales in many areas of

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the country, a possible sign that investors see a growing opportunity to buy up properties at bargain prices. Cash sales now account for 32% of all sales. In hard hit cities such as Phoenix and Las Vegas, cash sales topped 50% of all deals. With continued high unemployment, falling home prices, tougher lending standards, and a looming retreat of government involvement through Fannie Mae and Freddie Mac it is very difficult to predict when the housing sector will return to normal.



SUMMARY



- **Economic recovery slowed by earthquake in Japan, long-term impact should be muted**
- **Political unrest in Mideast presents greatest threat to investors as oil production may be interrupted**
 - **Debt issues in Europe threaten investor confidence and suppress demand**
 - **U.S. stocks still attractive over five year timeframe, returns of 7%-9% annually**
 - **Non-U.S. stocks attractive as global economy expands**
 - **U.S. bonds vulnerable to sharp increase in interest rates over next 12 to 36 Months**
- **Stocks, commodities, and commercial real estate benefit from reflationary policies of Federal Reserve**
 - **Prefer corporate bonds, especially high yield, over treasury and agency bonds**
 - **Rising commodity prices, should they continue, pose threat to economic recovery**
 - **Short-term, a modest correction in commodity prices is expected**
 - **Over long-term, agricultural, energy, and base metal commodities very attractive**
 - **U.S. dollar to erode relative to currencies of emerging economies**
 - **U.S. dollar to appreciate relative to euro**
 - **State and municipal debt will contribute to elevated unemployment rate**
 - **Unemployment rate to stay elevated due to myriad of structural problems**

HANOVER ADVISORS

115 PERIMETER CENTER PLACE, SUITE 825

ATLANTA, GA 30346

(800) 874-5238 OR (770) 392-3998

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