

HARBOR VIEWS

HARBOR ADVISORY QUARTERLY NEWSLETTER

Summer 2008



THOUGHTS ON THE ECONOMY

Three months ago we termed the headwinds facing the U.S. economy a perfect storm. Those winds have since grown stronger.

GDP growth has yet to turn negative allowing economists to codify the current economic environment a recession but we believe most Americans would consider it so. Energy prices have increased further with crude oil trading above \$145/bbl. and natural gas over \$13/Mcf in early July. The effect of these high energy prices on heating, transportation and electricity costs has yet to fully hit the economy. We believe high energy costs as well as the worsening credit crisis will push us into recession by late this year. The economy has lost over 400,000 non-farm jobs since the beginning of the year and the LEI (Index of Leading Economic Indicators) points to further slowing over the next six months. Growth will remain slow until late 2009 before beginning a slow recovery.

The credit crisis has now engulfed Fannie Mae and Freddie Mac, the GSE's (Government Sponsored Entities) who provide liquidity to the secondary mortgage market. We predicted last quarter that the Treasury would need to make its implicit guarantee of the GSE's **explicit**, and that happened on Sunday night, July 13th. Secretary Paulson announced an extension of the Treasury credit line to both GSE's with unlimited borrowing capability as well as authority for the government to invest in the equity of the GSE's. Congress appears ready to endorse such legislation during the week of July 21st.

It is unfortunate the \$168 byn spent on the stimulus package was not directed toward the epicenter of the problem in the mortgage market. That amount of capital could have refinanced about 5 million mortgages at an assumed default rate of 15%.

The problems with the bond insurers now appear to be reaching a crescendo. These organizations will need to be restructured with some sort of regulatory or government assistance soon. Should this not happen, the CDS's (Credit Default Swaps) they have written will not be worth the paper they are written on and will cause enormous losses at commercial and investment banks. The investment and commercial banks continue to take large write-offs which will grow larger with a recession.

A LOOK INSIDE HARBOR VIEWS

- *Thoughts on the Economy* – Slow growth predicted until 2009 ...
- *Our View of the Financial Markets* – Harbor Advisory defensive position protects our clients in a tumultuous market...
- *Feeling the Heat* – We've fielded numerous client questions surrounding the economic benefits of geothermal heat pump installation for the home ...

LATEST NEWS FROM HARBOR ADVISORY

- We have recently updated our website! The new features include a shorter URL! You can now visit us at www.harboradvisory.com. Take a look and let us know your feedback.
- Jack De Gan continues to make news with his regular guest appearances on CNBC's top rated financial shows "Squawk Box" and "Closing Bell." If you missed him nationally you can catch clips of the rising star on our updated website.



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We provide a safe harbor for individuals and families in New England ...

Most of Harbor Advisory's new clients come through referrals from our existing clients or from industry professionals who know us and how we work.

All of us at Harbor Advisory value these referrals as the greatest compliment our small, independent firm could receive.

If you know an individual or family who is seeking counsel and might appreciate sound, personalized investment advice and financial services we would welcome the opportunity to meet with them.

The Federal Reserve and the Treasury Department have been more engaged, creative and aggressive in supporting the financial markets than at any time since the Depression.

This all sounds rather dismal but in reality it is quite normal in a dynamic, free market economy. Expansions create excesses, and recessions, or economic slowdowns, purge those excesses and set the stage for the next advance. The excess this time was in real estate prices and in leverage (debt). Asset prices increased above levels fundamentals would suggest are appropriate because of increased leverage which is now being worked down. This is true from Wall Street to Main Street with investment banks deleveraging and families reducing their debt level.

OUR VIEW OF THE FINANCIAL MARKETS

The stock and risk credit markets around the globe have deteriorated dramatically since I last wrote to you. The S&P 500 recently broke below the level considered by many to define a bear market which is a loss of 20% from the highs reached in October 2007. The credit markets have fallen back near the lows reached in mid March...the last time the Federal Reserve had to save the world.

Harbor continues to hold very high levels of cash as the result of selling stocks last year and early in 2008. Our high cash positions and defensive stock holdings have allowed Harbor clients to outperform the broad indices over the last twelve months.

As I mentioned last quarter, we will need to begin putting some cash back to work as we feel the worst has passed for the financial markets. I now believe the bottom we saw in mid-July, with the S&P 500 down almost 23% from its high in 2007, is close enough that we should begin to tiptoe back into the market. Stocks could certainly fall another 5-10% which would just be further opportunity to increase our equity exposure in anticipation of the inevitable recovery which follows each decline.

These are the times that require us to recommit to our long-term strategy for investing in equities and look to the recovery that lies ahead. In the year following dramatic economic slowing equity markets usually perform well above the historical average and we want to be positioned to take advantage of that move. 2003 was such a year with the S&P 500 gaining over 25%.

FEELING THE HEAT

There is little in the physical world of consumer goods or amenities the price of which is not affected by the cost of fossil fuels. The price of transportation may be the most visible. Going for a day without seeing a gasoline price posting at \$4 plus per gallon is nearly impossible.

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Nod to the ubiquitous disclaimer:

While we're not infrequently, and always quite accurately, accused of being of strong opinion – we want to let the reader know we've been wrong before, we will be again but please don't hold it against us. The forward looking parts of the letter are the best efforts of fallible humans working at Harbor Advisory.

Another big ticket ongoing consumer expense is home heating and cooling and electricity. In recent times we have fielded numerous client questions surrounding the economic benefits of geothermal heat pump installation for the home or photovoltaic panels for electricity.

The subject is broad, deep and far too individualized a decision to cover in the newsletter even if we were engineers...**which we are most certainly not**. However, a few observations can and should be made. These will be restricted to geothermal for this issue. Solar will be discussed in a later issue.

Geothermal often evokes the image of tapping the heat from the earth's magma core. Unless you're living near Yellowstone or Iceland you can eliminate that warm thought. Geothermal heat pumps are old technology (improved by modern science) that allows taking calories from the thermal mass and groundwater below your house to heat your home's interior. Think of it as a refrigerator working in reverse.

Heating oil and natural gas having doubled over the last couple of years, changes the equation of what makes economic sense in a capital equipment expense decision of this magnitude.

In one recent example an estimated \$35,000 geothermal heat pump system would pay for itself over the course of 8 or 9 years (assumes oil prices do not decline). With current potential state tax incentives and the possibility of Federal tax credits after the elections this calculation could potentially cut that breakeven period to 4 or 5 years.

Of course, the first economic rule of thumb when considering an investment is to do the easy stuff first. In all cases the low cost options should be undertaken with the first dollars spent. As is often true, **conservation** is the best and most economically efficient investment you can make. These options usually include additional or more efficient insulation, window replacements, weather-stripping or generally "tightening" of air leakage in the home.

At Harbor we don't want to hold ourselves out as heating and ventilation experts or engineers. But when large capital expense projects can potentially save family money...we're delighted to help weigh the options if asked.