



MALLARD ALERT

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Hurricane Relief

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"Experience is a hard teacher because she gives the test first, the lesson afterwards." – Unknown

I wrote to Mallard's clients late in the day of September 11, 2001, and opened with those words. While Hurricane Katrina is a far different event than the terrorism of 9/11, they raise similar questions and introduce similar challenges. In short, they test us.

Any commentary on either event must begin from the heart. Each of our hearts goes to those who have been hurt by Hurricane Katrina. I can not imagine the devastation of losing one's home, of being stranded for days on end; I still have trouble contemplating the scope of New Orleans' devastation.

While we may wish to compartmentalize our investing, and not 'sink' to the level of reviewing the impact of Hurricane Katrina on our portfolios, the nature of investing is that your fortunes are impacted by local and world events. When the security of your retirement relies on your investment portfolio, it is irresponsible to **not** raise the question of how a catastrophe such as Hurricane Katrina is likely to impact your portfolio.

Let me first cover some broad concepts:

- Generally speaking, it is very difficult to make accurate forecasts, and it is no easier to *accurately and confidently* assess the economic impact of a specific event such as this in a way that can serve as a rational basis for a significant portfolio change. To justify such a change requires making an accurate assessment and doing so before other investors come to the same view. This is typically a loser's game and not where our edge lies.
- Though we are unlikely to be able to take action based on an economic assessment of Katrina's fallout, it is important that we think about the possible consequences so that we can determine whether client portfolios are adequately protected against *possible* risks, consistent with their risk thresholds.
- Rational investing requires assessing risk and making conclusions based on incomplete information. Because there is always uncertainty we rely on diversification to provide shorter-term portfolio protection against unforeseen events. This type of event is a good example of why we diversify.

Short Term Fallout—It will take more weeks and perhaps months for oil and natural gas production, and for refining capacity to recover to pre-Katrina levels. Fortunately, OPEC, Europe, the US (through the Strategic Petroleum Reserve), and other countries are pitching in to smooth out supply during this recovery process.

I believe that nearby ports will share the work that had been performed in New Orleans' port, until the port is back up. Again, this should help reduce destabilizing spikes.

The S&P 500 and the Dow Jones are both actually higher now (September 19th) than they were the Friday before Katrina struck. While the Gulf residents and businesses have suffered, airlines appear to be rushing towards bankruptcy, and as US citizens are suffering (at least those who fill their tanks), the market ‘feels’ that the rebuilding efforts will have more winners than losers.

Longer Term Implications—The US economy had begun to recover before Katrina struck. The economy at times behaves like an aircraft carrier, slow to turn/reverse, and at times a victim/beneficiary of its own momentum. While Katrina was incredibly destructive, and while the impact will put a drag on the US economy, we do not expect this drag to derail the current recovery, merely to slow it.

With a mild recovery, and with almost all parties working to avoid an energy crisis, I do not foresee spiraling inflation. Katrina has definitely boosted inflation in the past few weeks, however I am not convinced that it will measurably boost long-term inflation.

I feel that the two biggest longer-term questions deal with interest rates, and the US dollar. As I am writing this, the Federal Reserve Bank continued to gradually increase the fed funds rate, noting that while Katrina has ‘increased uncertainty about near-term economic performance’, it does ‘not pose a more persistent threat’. In the aftermath of 9/11, we saw the introduction of a new **permanent** drag on the economy, the cost of increased security. Katrina brings a **one-time drag** on the economy, the cost of rebuilding New Orleans and the Gulf Coast.

I expect that the Fed will stop raising rates fairly soon (by year end), and that by doing so, the housing market will begin to cool. This would be a good thing, for it increases the likelihood that we can escape this housing bubble (and it **is** a bubble) without too much pain. Should the US housing market bubble **burst**, it

would likely lead to losses for banks and bond holders, and to a notable decline in consumer spending. It is hard to contemplate a housing bubble burst that does not cause/coincide with a recession.

The second major issue with Katrina’s aftermath is the cost of reconstruction, and the method of payment. I worry about the already threatened US dollar, should the government put Katrina’s bill ‘on the credit card’. This approach, of boosting the budget deficit without cutting other services or increasing taxes to pay for it, has been used for the wars in Afghanistan and Iraq, and are very destabilizing for the US dollar. We have managed to avoid a credit crunch due to the short-term benefit of foreigners’ insatiable appetite to hold US government debt. This party **will** end, and the more that we follow this course, the sooner a more painful end will arrive.

Recommendations— One word— GLOBAL. At Mallard we have always recommended globally balanced investing. The devastation that Katrina brought only reinforces the benefits of global diversification, both in the short-term and the longer-term.

How will the bursting of the US housing bubble harm a Korean electronic manufacturer, or a British beverage firm? How will a 10% drop in the US dollar impact a German government bond? For that matter, how will a US clothing store, or a US farm equipment manufacturer be hurt when a European city is targeted by terrorists?

The world has been unsafe for decades. Danger can not be avoided. Its impact, however, can be reduced by carefully placing your eggs in more than one basket. At Mallard, we are strong proponents of proper global diversification, of both stocks and bonds. We feel that this approach is **the best precaution for future storms**.

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