

Weekly Commentary

November 24, 2008

The Markets

“Hope springs eternal,” wrote Alexander Pope back in the 1700s and, after a rocky start, we ended last week on a hopeful note.

If you look at the numbers in the chart below, it was another disappointing week in the stock market. Last Wednesday and Thursday didn’t help matters as the Dow Jones Industrial Average posted back-to-back 400 point plus declines. That set the stage for another nail biter as markets opened on Friday morning. Fortunately, the markets opened steady and after see-sawing above and below the previous day’s close, the Dow soared more than 6% in the final hour as word leaked that President-elect Obama would nominate Timothy Geithner as Treasury Secretary, according to MSN Money.

Geithner is currently president of the Federal Reserve Bank of New York and has been deeply involved in all the recent machinations at the Fed and Treasury as they plotted to thwart a systemic failure of our financial system. While no one thinks Geithner will single-handedly solve all our problems, his potential appointment shed some clarity on this important position and offered a glimmer of hope, which helped Wall Street close the week on a positive note.

Being hopeful and optimistic are certainly desirable traits and studies show they are associated with good physical and mental health. Unfortunately, those studies don’t tell us anything about how to manage investments. Successful money management takes hard work and we’re doing all we can to try and help you reach your goals and objectives. And, while we remain hopeful and optimistic that we’ll be successful in the long term, we don’t simply rely on having a sunny outlook to get there.

Returns through 11/21/08	1-Week	Y-T-D	1-Year	3-Year	5-Year	10-Year
Dow Jones Industrial Average	-5.3	-39.3	-38.0	-9.4	-3.5	-1.5
NASDAQ Composite	-8.7	-47.8	-46.7	-14.8	-6.1	-3.5
Standard & Poor's 500	-8.4	-45.5	-44.5	-13.9	-5.0	-3.9

Sources: Yahoo! Finance, Barron’s. Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly. Three-, Five-, and 10-year returns are annualized. Assumes dividends are not reinvested.

JUST A FEW MONTHS AGO, inflation was a big concern. Back then, the price of a barrel of oil had skyrocketed to an all-time high of \$147, gas prices were over \$4 a gallon, and other basic commodities and foodstuffs were shooting higher, too. Today, the world economy is slowing down and few people are talking about short-term inflation; instead, we’re starting to hear talk about the dreaded “D” word – deflation.

Deflation is a persistent decline in the level of consumer prices that’s typically caused by a decline in demand or a restriction of credit, or both. On the surface, you might think it’s a good thing because we’d all like to pay less for something rather than more, right? That sounds good in theory, but, when spread throughout the economy, deflation is an insidious condition that could cause serious harm.

Here are three dangers of deflation as identified by Nouriel Roubini, Professor of Economics at New York University's Stern School of Business:

1. Falling prices may lead companies to cut production and employment levels because of reduced demand. With more people unemployed, it may exacerbate a vicious cycle of falling prices as fewer and fewer people have the money to buy goods and services.
2. Falling prices encourage consumers to hold off on purchases because they know they can buy the goods and services at a cheaper price in the future. This also feeds a vicious cycle of declining prices.
3. Falling prices increase the real rate of interest, which helps stunt future economic growth. For example, if consumer prices drop 2% in a year, the real interest rate is 2% even if the actual interest rate (nominal rate) is 0%.

Last week, the Labor Department said overall consumer prices in October declined at a seasonally adjusted rate of 1%, which was the largest amount since records began in 1947. This was the third month in a row that prices dropped. The core rate, which excludes food and energy, declined at a 0.1% rate – its first decline since 1982.

While the headline number looks a little scary, some of the decline occurred because of a huge drop in gas prices, according to MarketWatch. Of course, we can't count on gas prices dropping to zero, so we'd have to see other categories experience declines before we could say deflation has arrived.

The government does have some tools at its disposal to combat deflation should it occur. One of those tools is to spend massive amounts of money to re-inflate the economy. The government has started to do that and it may accelerate when the new administration takes office. The trick is to add enough liquidity to the system to keep it running well, but not too much that we end up with runaway inflation—a delicate balance to say the least.

Weekly Focus – Word of the Week

“Hypocorism.” It's a noun that means a pet name or the practice of using a pet name. For example, “Mike started calling Peggy by her hypocorism, “Bubbles,” when they were sweethearts in high school.” Just for fun, see if you can use “hypocorism” in a sentence this week.

Best regards,

Jim

P.S. Please feel free to forward this commentary to family, friends, or colleagues. If you would like us to add them to the list, please reply to this e-mail with their e-mail address and we will ask for their permission to be added.

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* The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.

* The Dow Jones Industrial Average is a price-weighted index of 30 actively traded blue-chip stocks.

* The NASDAQ Composite Index is an unmanaged, market-weighted index of all over-the-counter common stocks traded on the National Association of Securities Dealers Automated Quotation System.

* Yahoo! Finance is the source for any reference to the performance of an index between two specific periods.

* Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.

* Consult your financial professional before making any investment decision.

* You cannot invest directly in an index.

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