Quarter Notes

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October 2009 | Fourth Quarter 2009 | Volume 17 No 3

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Stocks Bounce Back
Stocks have continued their recovery, climbing more than 56% from the low of 676.5 for the S&P 500 on March 9th. Investors who had the fortitude to stick with their investment policy and overall strategies have recovered much of the loss sustained last fall. Major stock indices rose 15% for the third quarter alone.

Congratulations to:
Our associate, Anthony E. Poppe, who just successfully completed his final CFA (Chartered Financial Analyst) examination. We look forward to Anthony receiving his CFA Charter in the coming months.

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Recession Appears to Have Ended; Now What?

When third quarter 2009 numbers are published, we should see the US rebounding from the longest recession since 1933. We expect to record GDP growth in both the third and fourth quarters, but we should restrain our optimism. This recovery is likely to be modest. Let's look at what the economists are seeing.

The inventory of unsold homes remains high, but housing is showing signs of stabilization. The government's first-time home buyer subsidy has encouraged demand, and the Fed's purchase of mortgage-backed securities is keeping mortgage rates low. Both programs, however, expire soon.

Household net worth has begun to recover with the rise in the stock prices. Personal savings has increased from levels approaching zero in the last few years to a recent peak of 6%. Consumers are paying off debt (de-leveraging). Demand, while sluggish, has not dried up altogether. "Cash-for-clunkers" was a huge success, contributing nearly half a percent to GDP. Now that the program has ended, the downside could be that it just accelerated sales that would have taken place in the months to come.

Inflation, which was expected to be caused by government spending or the Federal Reserve's immense infusion of cash into the system, hasn't materialized yet. It is unlikely to be a problem anytime soon because high unemployment results in little wage pressure. The government spending has not been competing with private demand; it has in some measure replaced it.

A year ago the financial system was in cardiac arrest. It is no longer on life support and though not fully recovered, it is functioning better. Some banks have already repaid their TARP Funds, so the 2009 Federal Budget Deficit will likely be lower than projected. Still, huge deficits lie ahead.

Overseas, there are signs of a global recovery, not only in emerging markets, but also in developed economies such as Germany. As foreign consumer demand recovers, US exports benefit and trade imbalances are reduced.

Even if the recession is technically over, we anticipate a slow and somewhat weak recovery. The wide "U" may replace the more familiar "V" shaped recovery. On a recent call, Pimco's Bill Gross and Mohamed El-Erian discussed their view of the future. They coined the phrase the "New Normal."

Index	Close on 9/30/2009	YTD % Change
Dow Ind.	9712.28	10.70%
S&P 500 Index	1057.08	17.00%
Nasdaq Comp.	2122.42	34.60%
Russell 2000	604.28	21.00%
MSCI EAFE	1552.84	25.50%
10Year Treasury	3.30%	

They described the "Old Normal" as a multi-decade period of declining interest rates, relatively low inflation, increasing use of borrowing (leverage) and financial innovation in a climate of decreasing regulation. This created a period of 6-7% annual economic growth. The "New Normal" will likely exhibit slower growth, perhaps 3-4% resulting from de-leveraging, re-regulation and de-globalization.

De-leveraging will continue. Consumer behavior has changed because of the collapse of housing, the high rate of unemployment, and the destruction of net worth. Consumers are saving more and spending less. Businesses, both foreign and domestic, will be slow to gear up production until demand is greater. Worldwide governments' stimuli have stabilized the global economy. We might see a surge of temporary inventory rebuilding, but private demand is not sufficient to reignite growth to pre-recession levels.

Economist and fund manager John Hussman argues that expansions are historically debt-financed. With consumers licking their wounds and banks recapitalizing, neither is eager to borrow or lend. Credit will continue to be tight for all borrowers. A robust recovery, where the economy returns to the old normal, is unlikely in the near future.

The expectation of a muted recovery does not mean it is time to pull money out of the markets. Stock and bond prices incorporate information well in advance of published enconomic data. Keeping a well-diversified portfolio with aggressive rebalancing is our best advice in these uncertain times.

Other Notes

Consumer Data: Consumers' spending accounted for more than 70% of US GDP in the "heady" days of the housing boom. With the crash in housing prices and declining sense of wealth, consumers are expected to account for only 66-68% of GDP.

China: Since 2005 China has moved from the world's 7th largest economy to number 3 after the US and Japan. *Source: The Economist*

Oil Consumption Is Down: Worldwide demand for oil was 86.2 million barrels per day in 2008. For 2009 demand is expected to drop to 83.8 million per day. *Source: Facts Global Energy*

Roth IRA Conversion Opportunities

Next year high-income taxpayers will have the option to convert all or part of their traditional retirement accounts into a Roth IRAs. While conversion sounds appealing with tax-free distributions, some obstacles might make the conversion unattractive.

Roth contributions are made with after-tax dollars – meaning that you pay your full income taxes first, and then make the contribution into a Roth. The benefit of the Roth is that the growth is tax-free as are withdrawals at retirement. One caveat: money can not be withdrawn for five years.The idea is that you pay the taxes up-front and then never owe taxes on the account. Another advantage is that Roths do not require that a minimum distribution be taken beginning at age 70½.

Roths were first allowed under the Taxpayer Relief Act of 1997, and are named after its chief proponent Senator William Roth (Delaware). There are many differences between a traditional IRA and a Roth IRA. The basic concept is that a traditional IRA offers tax-deferred growth, while a Roth IRA offers tax-free growth. A traditional IRA is typically funded with pre-tax dollars (although after-tax contributions are also allowed) and allows for growth to accumulate on a tax-deferred basis until the withdrawals begin at retirement. At retirement, distributions from a traditional IRA are withdrawn as taxable income taxed at your marginal tax rate – whatever it may be in the future.

In 2010 income restrictions placed on converting from a traditionalIRA into a Roth will be lifted. Currently through 2009, individuals are only allowed to convert if their modified adjusted gross income (MAGI) is below $100,000. Assuming the new laws take effect in 2010, the income limitation will be removed, allowing anybody the ability to convert a traditional IRA, IRA rollover, or perhaps an employer-sponsored retirement plan into a Roth.

The first thing to consider is that extra taxes will likely be generated upon conversion. Any dollars leaving the traditional IRA for the Roth will be added to your taxable income. It is critical that you have enough money outside of your retirement accounts to pay the taxes. Withdrawing excess dollars from the traditional IRA to pay the taxes will put you too far behind to catch up. The government is accommodating people with options to either pay the taxes in full on the 2010 return, or spread your tax burden over two years, paying half in 2011 and the other half in 2012. This is a one-time opportunity to spread the incremental tax over two years and must be exercised in 2010.

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Converting might make sense if you believe that tax rates will increase, or if you expect to retire in the same or higher tax bracket. Other important factors include your age, rate and time of expected withdrawals, and depressed market values. Roth conversions make better sense for younger investors who have a long time until retirement. It also might work well for other investors. For example an older investor with a large retirement account and substantial required minimum distributions might want to do a partial conversion. If you are interested in discussing further, please contact us so we can evaluate your situation to see whether converting makes sense.

Time to Review Variable Life Policies

If you are covered by a variable life insurance policy, now is a good time to take a look at how your policy is performing. While we are neither insurance experts nor do we sell insurance as part of our overall service we frequently are asked to review clients' risk management and insurance coverage. Unlike whole life or universal life, the performance of a variable life policy is determined by the returns of the underlying investment accounts, which are subject to market fluctuations.

When policies are purchased, the premiums and illustrations are based on a rate of return expected over the life of the policy. Premiums paid are used to purchase investments and pay the annual mortality costs, which reflect the actual insurance cost (risk to the insurance company that you will die during the year). Since the risk that you will die increases each year as you age, so too does the annual insurance cost. Administrative and service charges are also deducted from premium payments.

The underlying investments are expected to grow to the point where there is sufficient value in the contract to pay the insurance costs forever. The problem we are observing is that because there has been effectively no growth in the equity markets over the last decade, many of these variable contracts are now underfunded and in danger of crashing (running out of money to pay the insurance costs.) In the low interest rate environment we are experiencing, even fixed-rate accounts might not be accumulating sufficient returns to support your policy.

All insurance policies should be reviewed on a regular basis to make sure you are adequately protected for the risks you want covered. If you have any policy designed to accumulate value, request an "In Force Ledger" from your insurance agent or directly from the insurance company. We would be happy to help you review the policies and discuss any concerns.