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... And much more!

November 2011 Economy Report

Monday, November 7th, 2010

As I discussed in detail in my October newsletter, the US economy is not headed into a double dip recession. We had a strong market rally, because the economic indicators were heading in the right direction, albeit slowly. Greece continues to be a moving target that causes the market to go up and down with huge volatility on a daily basis. When bond investors agreed to a 50% haircut to solve the Greek debt crisis the market had its biggest rally in the past few years. However, the Greek Prime Minister then called for a public referendum on austerity cuts and the markets had a violent sell off. It is very hard to predict the direction of this crisis, but here is the latest.

The Greek Situation – Then And Now

Greece political leaders sealed a pact to form a national unity government on Sunday November 6th after the Prime Minister announced his resignation under pressure from several European leaders. There will now be a coalition government with a new leader. Greece now has just one day to explain to the rest of the European

Union how it will form a unity government to enact a bailout agreement. Greece must show it is serious about taking steps that include austerity cuts to stave off bankruptcy. The Greek people generally reject the austerity measures and have expressed their dissatisfaction through angry street protests. This will have no further impact on the decision Greek politicians must make as France and Germany have made it public that both of their governments have reached the end of their patience with the beleaguered Greek economy. The big concern I see is that even if the Greek debt situation is settled traders may begin to attack Italy and Spanish bonds by shorting them, thereby causing interest rates in these countries to skyrocket. I am less concerned about Italy where over 90% of the bonds are owned by Italians and make it less vulnerable to “short” attacks by bond traders.

Here is a summary of how Greece got into their current predicament. Between 2000 and 2007 the Greek economy was one of the fastest growing in the Euro zone. During that period it grew at an annual rate of 4.2% as foreign capital flooded into the country. A strong economy and falling bond yields allowed the government of Greece to run large structural

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“Dow lost 12% in the quarter; its worst quarterly performance since the first quarter of 2009.”

deficits. These deficits financed public sector jobs, pensions and other social benefits. In the beginning of 2010 it was discovered that since 2001 Greece had paid Goldman Sachs and other banks hundreds of millions of dollars in fees for arranging transactions that hid the actual level of borrowing. The purpose of these deals made by several successive Greek governments was to enable them to continue spending while hiding the actual deficit from members of the Euro zone.

Greece represents only 2.5% of the Euro zone economy, however the danger is that a default by Greece will cause investors to lose faith in other Euro zone countries. This concern is focused on Portugal and Ireland, both of which have high debt and deficit issues. Italy also has a high debt, but its budget position is better than the European average and it is not considered among the countries most at risk. Spain has a comparably low debt among advanced economies at only 53% of GDP in 2010 and it does not face a risk of default. Spain and Italy are far larger and more central economies than Greece and both countries have most of their debt controlled internally, which puts them in a better fiscal situation than Greece and Portugal. Unless

the situation gets far more severe it is unlikely that Spain and Portugal will default.

If the European rescue plan falls through and Greece defaults on its debt, the effect would be global. Europe could fall into recession, hurting a major market for American goods and banks could severely restrict lending.

Fear Is Driving The Stock Market

Last month the market was driven by investor fear and that was the main reason for the huge sell off in the stock market. Stocks ended the quarter with the biggest quarterly drop for the S&P 500 and the Nasdaq since the fourth quarter of 2008. The Dow lost 12% in the quarter; its worst quarterly performance since the first quarter of 2009. However, this all changed with October, which saw the largest gain in the stock market in many years. This rally was the result of stronger economic indicators and investor sentiment that things were getting more stable in Greece. If the Greek debt situation is resolved I believe investors will be presented with a fantastic opportunity to pick up stocks cheaply in the range of ten times to twelve times earnings. The time of entry is now with a portion of your investment capital each month while closely



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monitoring the Greek debt crisis. If the Greek deal falls apart the markets will sell off again.

A Review Of The Economic Indicators

Currently the economic indicators are mixed, but overall I remain positive and believe it is a good time to add to your investments in the stock market. This is what I am watching.

1. Consumer Confidence And Sentiment:

Consumers drive two-thirds of the US economy and that's why this indicator is so important. In October consumer confidence unexpectedly dropped to its lowest level in two and a half years, which suggests the consumer is still struggling. Consumers are fretting about job and income prospects. With consumer spending accounting for about 70% of the economy, economists say the recovery will be hard pressed to make significant headway until confidence improves.

2. **Business Activity Index:** Business activity in the US expanded in October at about the same pace as it did in September, which is a sign that overseas demand and business investment will help keep the economy expanding.

3. **China's Economic Activity:** With the interconnectedness of the world economy we definitely have to pay attention to China, which is the world's second largest economy. China's economic growth has been powered by the success of its manufacturing and export sector. China's manufacturing activity edged up in September, but had an unexpected drop in October. This causes concern because that weaker demand for Chinese goods means a slowdown in the global economy. Fears of a slowdown in the US and Europe, which are two of the biggest markets for Chinese exports, have raised concerns about whether or not the Chinese export sector can sustain its growth. Slowing demand from the US and Europe is starting to affect that sector.

4. **Corporate Earnings:** Corporate earnings are on track for the third quarter to beat the second quarter's growth rate. However, guidance for the fourth quarter is being downgraded by many companies concerned about lower consumer demand, the Euro zone sovereign debt crisis and possible weaker manufacturing data from China. Although these areas are showing improvement they, in fact, remain a major concern for corporations around the world and the reason for lower earnings guidance by many companies for the fourth quarter.



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“The better news was that employment numbers for August and September were revised upward adding 102,000 jobs to the nation’s payrolls.”

Year over year the S&P 500 is showing 16.8% growth in earnings. Of the companies that have reported so far this quarter 70% beat expectations, 10% were in line and 20% were below expectations. At this time the Price Earnings multiples are very low and showing a great buying opportunity for investors.

5. **Oil Prices:** With oil prices in the mid ninety dollar range I see this as very bullish. If we were really seeing a global recession the demand for oil would be much weaker and I believe oil prices would be below \$60 a barrel. This is a key number to watch to monitor the direction of the economy. With oil over \$90 a barrel that is certainly not indicative of a recession. Investors who have followed my guidance of buying oil below \$70 a barrel and selling above \$90 a barrel have done very well.

6. **US Unemployment Still Lagging:** A healthy US economy is driven by a healthy consumer. Due to outsourcing and higher productivity of current employees I do not see unemployment levels dropping to pre-2008 financial crisis levels anytime in the next several years. The economy will need to grow under the weight of much higher unemployment levels than we’ve seen historically.

The good news is that American employers added more jobs last month and the unemployment rate eased slightly. According to last Friday’s Labor Department report, the economy added 80,000 jobs in October. The unemployment rate improved slightly - falling to 9.0% from the 9.1% reported the previous month. The better news was that employment numbers for August and September were revised upward adding 102,000 jobs to the nation’s payrolls. The bad news is that in the two-plus years since the recession officially ended the labor market is still struggling to gain back even a fraction of all the jobs lost. Only about a quarter of the 8.8 million jobs shed have been recovered. In October alone 13.9 million Americans remained unemployed; 42% of that number having been out of work for 27 weeks or longer. It is important to note that we need to add around 150 000 jobs a month just to keep up with population growth and we have been averaging 125,000 jobs a month over the last year. That’s a 25,000 job shortfall each month.

7. **Housing And Real Estate:** With the exception of a few micro markets, we can’t anticipate a recovery of the Real Estate market until 2015 or 2020. By recovery I mean a return to levels prior to the 2008 financial crisis. In fact, the erosion of housing prices is still going on.

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“With underwriting standards becoming stricter and a flood of foreclosures still pending the housing sector will continue to struggle far into the future”

Over the last 12 months housing prices in America's 20 largest cities dropped 3.8%. The housing sector has been a drag on the economy for the last three years as US households have lost trillions of dollars in equity. This loss impacts consumers, who feel they have created less wealth for themselves and are cautious about taking on any large spending projects. One of the big problems stalling any housing recovery is the fact that banks do not make very much money on mortgage loans. This is because the spread is too slim between what they pay for the money from the Federal Reserve and what they earn loaning that money out to consumers and businesses. The sad fact is that, in large part, bank mortgages would drive a housing recovery. The lack of funding from that source leaves a much smaller pool of money available to drive housing prices upward. Therefore, in most markets the trend for housing prices is downward. This tight lending environment creates another problem in that small business will not receive the funding they need to allow them to invest and expand. This is a challenging situation, as small businesses have traditionally provided the jobs needed during economic recoveries. The tight credit

conditions facing businesses today will negatively impact the recovery of the economy. With underwriting standards becoming stricter and a flood of foreclosures still pending the housing sector will continue to struggle far into the future. In addition, we can anticipate a rise in delinquent auto loans, credit cards and student loans.

8. Deleveraging Is Epidemic: The fear in the economy is causing deleveraging at all levels. Consumers are paying off debt instead of spending. Internationally Federal governments, municipalities and corporations are all deleveraging in this tighter financial environment.

The main effect of all this deleveraging on the economy is less money in the system. The negative impact of less money is less growth for the economy at all levels. The positive impact of this process is that it will lead to a global slowdown at a subdued pace rather than a full scale global recession.

What are possible effects of deleveraging on the average citizen? I see four right away.

1. Many governments will increase the retirement age. For example, in Greece

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“The day after Obama was elected I stated in my first newsletter that I believed he would not be re-elected.”

the government lifted the retirement age from 50 years to 68 years of age.

2. Governments will definitely be looking at ways to cut healthcare costs. Canadian subscribers should take note that healthcare in Ontario constitutes 48% of its budget. This will be a focus point of cuts.

3. In the U.S. Medicaid is definitely on the chopping block. It is attracting a lot of negative attention as we are now seeing a flood of fraud cases with many examples of Medicaid fraudsters taking \$90,000 a year in pension funds and playing golf full time.

4. In the USA there will be sizable cuts in military spending. The simple truth is that we will see cuts everywhere within all levels of governments and we will see the impacts trickle down into every level of the world's populations. The New Austerity – Living Within Our Means During this time of deleveraging governments and individuals will need to learn to live within their means. One of the possible adjustments I see coming will come as a shock to most Americans, but here it is. I believe the austerity cuts in the USA will include an elimination of the tax deduction for mortgages. I believe this will be phased

out over the next 10 years. Only America has this benefit and it has cost the US government over \$600 billion dollars in lost tax revenue over the last several years. I can hear the howls already, but to reduce our trillion-dollar deficit Americans may need to end this form of government subsidized home ownership.

Political Realities

It is true that President Obama inherited a difficult situation from President Bush, however, since his presidency began Obama has tacked an additional \$5 trillion in spending onto our national debt. Politically, the results for this spending tend to weigh more in favor of a negative presidency and hurt his changes for reelection. The day after Obama was elected I stated in my first newsletter that I believed he would not be re-elected. It is not now – nor was it then – because I was anti-Obama in any way. I was simply looking at the situation he was taking on. The crisis he entered was very deep. In some cases I felt he made the right decisions, but his leftist policies are not conducive to the American constitution and way of life.

As for the Republican debates the most intelligent candidate with knowledge

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*“The big news in
Canada is the
TransCanada
Pipeline.”*

of the issues, who conducts himself professionally, is Newt Gingrich.

Herman Cain seemed plausible as he was not a career politician and had no-nonsense straight forward answers, but I believe the allegations against him will be too much for him to overcome.

Governor Rick Perry of Texas is the biggest disappointment. It appears on television that his intellect is at best average and his grasp of issues is embarrassing. He cannot think on his feet and I believe the success of Texas had everything to do with the strength of the oil companies, which would have made any Governor look like a hero. I have nothing against the man except that my muscles get tense every time he speaks; he is such an inferior product and not a credible representative of the United States of America. According to the rating polls, most Americas agree with me. What a relief!

The Word On Gold

Ten years ago in my published archived writings I suggested that investors should hold as much as 20% of their portfolio in gold. This was written at a time when gold was not a popular investment, but I was concerned about the “fiat” currency we know as the US dollar. My idea might have been unpopular then, but for the past ten years in a row gold has increased in value.

Over the years I’ve changed my recommendations for gold investors, publishing my suggestions that they reduce their gold holdings to 15% and 10% of their portfolios. In early 2011, I began sharing several of my concerns about margin calls and a probable market sell off that could see gold hard hit as investors took profits on their easy to liquidate gold. Now, as we work our way through the fourth quarter, if investors don’t currently hold gold it still makes sense to have 2% to 3% of portfolio in gold as a hedge against uncertainty. That is because the outlook for the balance of 2011 is really just a guess. I hear well-argued cases for gold to go either way: Why gold could increase in value and why gold could decrease in value. If you have 2% to 3% of your portfolio in gold I recommend that you sit on the sidelines and if you have more than this amount you might consider taking the profits. That said, typically gold is bullish in the autumn as India and China buyers add to their holdings for weddings and holidays.

TransCanada Pipeline Issue Ignored by US Media

The big news in Canada is the TransCanada Pipeline. The oil pipeline will connect Canada’s Alberta oil



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“Due to the derivatives fiasco banks are no longer able to trade their own accounts”

sands with refineries on the Texas Gulf Coast. If the USA does not agree to proceed with the pipeline then over time Canada will find a new market. I believe this is a deal that has to get done. It is crucial to America's energy security. It is interesting to note that this is a huge story in Canada, yet barely makes the headlines in the USA. In fact, I would guess over 95% of Americans are not even aware of this as a story while in Canada it is almost a national debate. What we do hear in America is filtered through the Hollywood machine, which propagandizes that the TransCanada Pipeline is an environmental disaster waiting to happen.

The truth is that technology for the pipelines has never been better. Yet, environmental groups, some US politicians and numerous celebrities say the project will delay the shift to a green economy and increase the risk of oil spills in environmentally sensitive areas. This will be a real test for Obama, who hopefully will do the right thing. There are too many jobs at stake and hopefully Obama will not give into leftist lobby efforts. Obama will make a final decision on approving the pipeline based on economic and health criteria.

So what should investors do in this economy?

1. Hold cash for the rally. The best strategy at this time is to hold cash. The economic indicators studied in their entirety show that the US is not entering into another recession. Holding cash will allow investors to take advantage of a likely huge market rally once the Greek debt crisis stabilizes and more indicators continue to show the US economy is not headed into another recession. Holding cash is only a short term strategy, however, because investors are receiving no return on their money in the bank and inflation hovers at 3%.

2. Choose your dividends. Over the last 50 years in the stock market 97% of all profits have come from dividend yielding stocks. These gains are a combination of gains in stock value and dividends. This is the most conservative means to build a portfolio and generate cash flow. With the stock market trading at very low price earnings multiples this is a prudent time to enter the market and slowly buying dividend yielding stocks.

3. Avoid USA bank stocks. Legislation now makes it difficult for banks to make money. The spreads between borrowing and lending costs do not allow banks to make enough profit lending on mortgages. Due to the derivatives fiasco banks are no longer able to trade their own accounts. Essentially, too many profit

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“I am very focused on the Las Vegas Real Estate market with a very successful cash flow project that issues positive cash flow checks every 90 days.”

centers have been taken away from banks for them to be profitable. As a result, banks are trying new ways to increase their take such as raising debit card processing fees. However, when Bank of America tried it, the backlash was so severe all the other banks backed off and Bank of America is now doing the same. The bottom line is that the revenue stream for banks will not be growing anytime soon and it is growing revenue that should attract investors.

4. Know how to trade or shop for the long term. At this point, the markets remain a “traders” market presenting relatively quick buy and sell opportunities. It is not a market to buy for the long term until we definitively see in which direction the economy is heading.

For those wanting to buy stocks as a “gain” strategy, be sure to watch the “insider” buying occurring within many large corporations

5. Short the Euro. Shorting the Euro is a good strategy for the next several months, because even if the Greek crisis is solved there are still too many other nations in Europe with problems. That means investors who short the Euro have a much greater chance to make money than lose money.

6. Gold stocks make sense. I like gold stocks as they are not reflecting the value of gold. Gold stocks are trading well below the spot

price of gold. Prudent investors will buy gold-producing companies that are showing constant production and trading well below their future forecasts of production. Gold stocks are now a better investment than buying gold.

7. Invest in cash flow Real Estate. A large article published in Canada’s national paper (Financial Post) suggested that Canadians should be looking to invest in Las Vegas. The article stated, “...housing prices in the city are down almost 60% compared with their high point in August 2006, but rents remain relatively steady, which is a good scenario for investors.” The article goes on to say, “Las Vegas is one of the most attractive places in the US from a landlord or investor perspective.” As many of my subscribers are aware I am very focused on the Las Vegas Real Estate market with a very successful cash flow project that issues positive cash flow checks every 90 days. We have 50 condos and all 50 condos are rented with a waiting list of tenants. If you are interested to learn more and wish to get involved please send an email to education@allianceinvestor.com. In conclusion, investors must be ready with cash to take advantage of the buying opportunity of undervalued stocks. I am now bullish on the stock markets, because interest rates are low, there is a lot of investment money on

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*“Contact us for
more information
or to book a
Las Vegas Real
Estate Tour!”*

the sidelines, the earnings season was great, stocks are cheap and 2012 is a Presidential year, which is always good for the stock market. Yet after all that is said, despite my optimism, everything comes to a grinding halt if we see a recession in Europe caused by the debt crisis. There can be no doubt that we live in interesting times and investors want to remember that change brings opportunities.

Until next time,

Michael Lathigee

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