SUMMER 2011

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PLANNING WITH PURPOSE

The Economy Burns while Washington Fiddles

Economic Update by Brian T. Jones, CFP®

Alan Abelson quipped that in the July 11, 2011 issue of Barron's. While I love the line, I was loathe to turn on my TV or pick up a newspaper or magazine in late July as Congress and President duked it out in prime time for the entire nation (and the world) to see just how dysfunctional our government has become. The ability of Congress and the President to draw out the debt debate until the final possible moment served only to cause mass uncertainty in the markets here and abroad. Some commentators likened the U.S. to a petulant child asked to clean up his/her room, only to wail, kick, and scream that such a task was all but "impossible."

But against mighty odds(?) an agreement was reached and approved on August 2 - the deadline. The old saying that "something is better than nothing" might be true, but we are not sure that the agreement downtown will do much (if anything, long term) to curb our massive spending imbalances. Several economists quipped that the U.S. has less than 3 years time before our debt to GDP ratio exceeds 100%, which would put the U.S. on par with Greece, prior to their first round of austerity measures 3 years ago (CNBC.com August, 2, 2011). That is a frightening thought indeed.

The agreement between Democrats and Republicans did little to calm market uncertainty. Corporate profits appeared to have slowed down from previous quarterly earnings (but were for the most part fairly strong), and consumer spending cooled as the unemployment rate remained stubbornly high. The Fed, sitting on an already mammoth balance sheet packed full of U.S. treasury denominated securities and mortgage backed securities (MBS), is almost to a point of being out of ammunition and may be forced to watch the U.S. economy make due without government support for the first time in (gasp!) 3 years time.

Add to these issues the S&P downgrade of the U.S.'s credit rating one notch from AAA to AA+ on Friday August 5th and it was obvious that August was off to a dreadful start. While the rating downgrade merely confirmed what everyone was thinking all along, the psychological impact was swift and violent. Markets traded off when the markets reopened on Monday the 7th and volatility continues to remain heightened at this point. The good news here is this move will hopefully put pressure on politicians on both sides of Congress to act in our nation's best interests and fix the long term structural deficit problems facing our nation. Translation: this means having the political will to do the right thing, knowing that this may not get you re-elected.

There continues to be fallout from the Japanese tsunami that has rocked the manufacturing sector,

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"Quotables"

"In addition to an existing nearly $10 trillion of outstanding Treasury debt, the U.S. has a near unfathomable $66 trillion of future liabilities (Medicare & Social Security) at net present cost".
-Bill Gross, PIMCO Investment Outlook August 2, 2011

"Our true choice is not between tax reduction, on the one hand, and the avoidance of large federal deficits on the other," this Democratic President said. "It is increasingly clear that...an economy hampered by restrictive tax rates will never produce enough revenues to balance our budget just as it will never produce enough jobs or enough profits."

He went on. "In short," he said, "it is a paradoxical truth that tax rates are too high today and tax revenues are too low and the soundest way to raise the revenues in the long run is to cut the rates now." And that's exactly what John F. Kennedy did. The 35th president of the United States, who delivered those remarks at a Dec. 14, 1962, speech to the Economic Club of New York, made good on his pledge. As a result, federal tax revenues went from $94 billion in 1961 to $153 billion in 1968 as Kennedy slashed the capital gains tax and cut the top marginal tax rate.
-John Carney, CNBC.com July 15, 2011

Here's Warren Buffett in his 2008 shareholder's letter, regarding his decision to offer reinsurance to a small portion of the then-$822 billion of tax-exempt bonds insured by the three largest bond insurers:

"Local governments are going to face far tougher fiscal problems in the future than they have to date. The pension liabilities I talked about in last year's report will be a huge contributor to these woes. Many cities and states were surely horrified when they inspected the status of their funding at yearend 2008. The gap between assets and a realistic actuarial valuation of present liabilities is simply staggering. When faced with large revenue shortfalls, communities that have all of their bonds insured will be more prone to develop "solutions" less favorable to bondholders than those communities that have uninsured bonds held by local banks and residents. Losses in the tax-exempt arena, when they come, are also likely to be highly correlated among issuers. If a few communities stiff their creditors and get away with it, the chance that others will follow in their footsteps will grow. What mayor or city council is going to choose pain to local citizens in the form of major tax increases over pain to a far-away bond insurer?"

Moral of the story: Reelection trumps repayment.

"We have learned a harsh lesson about the dire consequences a financial crisis has for ordinary Americans in the form of lost jobs, lost homes, lost wealth, and lost businesses, and those of us charged with overseeing the financial system should always keep this human cost in mind."
– Federal Reserve Bank of San Francisco, President Janet Yellen, July 15, 2010, before the U.S. Senate

Occasional turbulence in financial markets is inevitable. There will always be short-term "shocks" that spark new awareness about previously unknown risks, just as the housing market decline that started in 2006 made clear that some financial institutions had taken on greater risk than many investors realized.

Shocks, however, do not easily or frequently lead to large-scale panics like the global financial crisis of 2007 and 2008. Many complicated factors led to that outcome. Among the most important factors was a long history of government interventions that led market participants to expect certain firms to be rescued in the event of distress. That "safety net" may make market participants less inclined to protect themselves from risk, making instability and financial panic a more common and severe occurrence. Part of the government's financial safety net is explicit, such as

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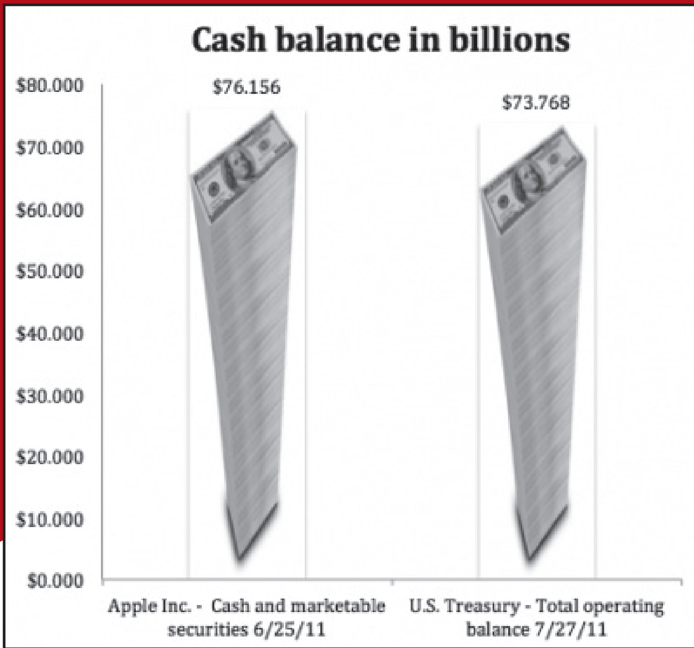
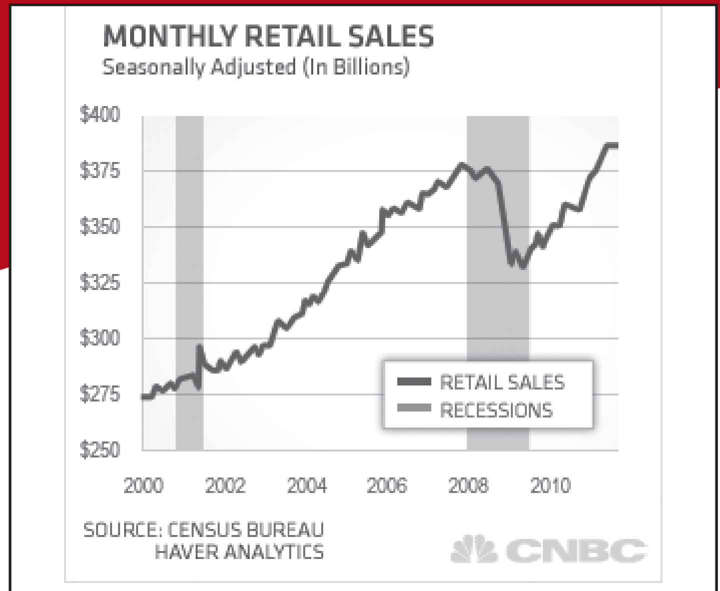
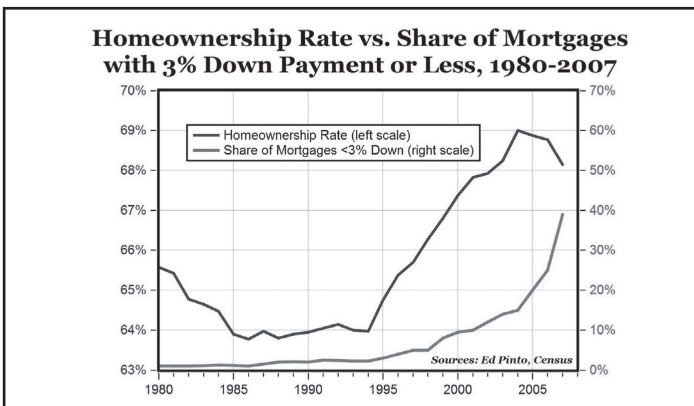


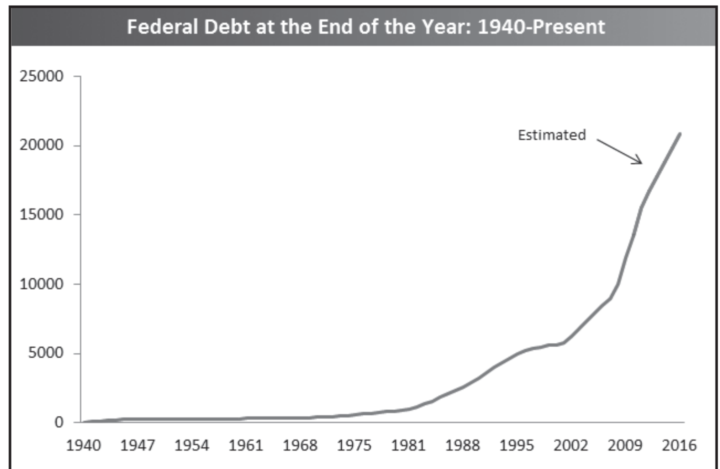
It turns out Apple has more cash than Uncle Sam
Source: CnnMoney.com



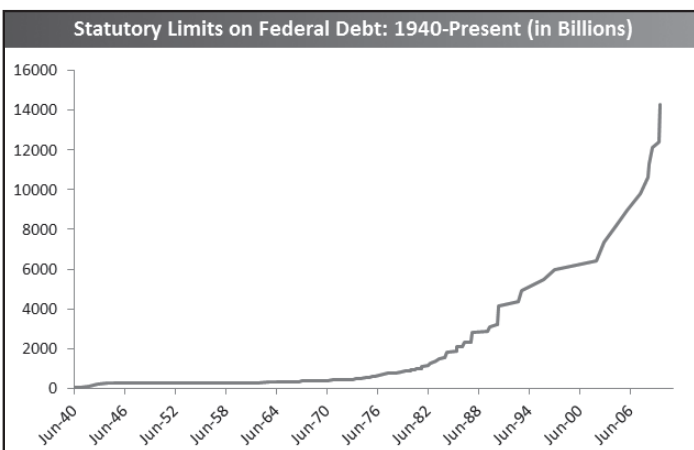
Good news: the consumer continues to spend
Source: CNBC.com



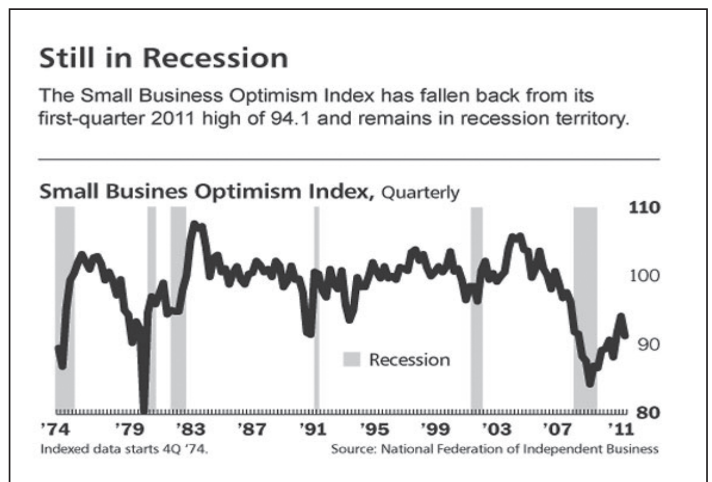
A chart showing how the mortgage crisis happened due to low down payments on homes
Source: seekingalpha.com



Bad news: the Federal debt is unsustainable based on current levels
Source: Bespoke Investment Group



Statutory Limits on federal debt chart
Source: Bespoke Investment Group



Bad news: small business, one of the largest employment creators in the U.S. remains on the sidelines when it comes to hiring
Source: National Federation of Independent Business

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deposit insurance that protects relatively small investors like households and small businesses. Commercial banks are charged fees for that service and are supervised, which limits their incentive to take risk.

A large portion of the safety net is ambiguous and implicit, however, meaning that it is not spelled out in advance. For decades the federal government has proven its willingness to intervene with emergency loans when institutions seen as "too big to fail" (TBTF) are on the brink of collapse. Market participants conduct their business making educated guesses about which institutions may be supported in times of distress.

While the extent of the TBTF problem has not been conclusively determined, the Richmond Fed believes that it is significant. This intuition is based on past experience. The history of government interventions — from the bailout of Continental Illinois National Bank and Trust Company in 1984, to the public concerns raised during the Long Term Capital Management crisis in 1998 — shaped market participants' expectations of official support leading up to the events of 2007-08.

Source: Federal Reserve Bank of Richmond
"Too Big to Fail" April 29, 2011

"Start with Greece, the epicenter of the crisis, or perhaps more properly, the farce. One must remember that the Greeks won membership in the euro zone after lying about the size of their existing national debt, by hiding more than $3 billion of it through a series of swaps arranged by Goldman Sachs. Likewise the nation's national administrations, whatever their political stripe, have become famous for fudging their budget numbers to keep deficits under the euro zone standard of 3% of GDP. Meanwhile, the populace was kept content with easy work rules, lush early retirement benefits and no show jobs afforded by a bloated payroll state".
- Jonathan R. Laing, Barron's , May 30, 2011

"The public wants what it wants, when it wants it, and it doesn't want to pay for it. America today is a democracy with the feature that the founding fathers most feared. Citizens can vote for benefits, secure in the knowledge that someone else will pay the taxes".
-Thomas G. Donlan, Barron's, May 30, 2011

In 2010 154,000 stay at home dads took care of 287,000 children under the age of 15, compared with 49,000 stay-at-home dads in 1996, according to the U.S. Census Bureau.
- Wall Street Journal Friday June 10, 2011

"Baby boomers are being replaced by groups of young workers who have regrettably scored rather poorly in international educational match-ups over the last two decades. The average income of U.S. households headed by 25-year-olds and younger has been declining relative to the average income of the baby boomer population. This is a reasonably good indication that the productivity of the younger part of our workforce is declining relative to the level of productivity achieved by the retiring baby boomers. This raises some major concerns about the productive skills of our future U.S. labor force."
– Alan Greenspan, Interview in The Globalist

"We humans have the brains and means to reach real planetary sustainability. The problem is with us and our focus on short-term growth and profits, which is likely to cause suffering on a vast scale. With foresight and thoughtful planning, this suffering is completely avoidable. Although we will have energy problems with peak oil, this is probably an area where human ingenuity will indeed eventually triumph and in 50 years we will have muddled through well enough, despite price problems along the way. Shortages of metals and fresh water will each cause severe problems, but in the end we will adjust our behavior enough to be merely irritated rather than threatened, although in the case of metals, the pressure from shortages and higher prices will slowly increase forever".
– Jeremy Grantham, GMO Quarterly Letter, July 2011

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the continued high unemployment rate, the ongoing horror that is the U.S. housing market, high fuel prices (which should be coming down based on the retreat in oil prices due to the market selloffs), high food prices, a consumer that appears to be pulling back on spending, a manufacturing sector (once the shining beacon in our economy) that appears to be slowing down, uncertainty over European sovereign debt, etc. etc.

Inquiring minds want to know: where do we go from here?

We believe that we continue to watch the U.S. slowly (read: S-L-O-W-L-Y) recover from a very deep, painful and wide reaching financial recession. This recovery goes through periods of "exuberance" and periods that Ben Bernanke would describe as "transitory" or short lived. This slow and protracted recovery we find ourselves in will likely last for the next couple of years. The revision of Q1 GDP growth to 0.4% indicates that the economy is indeed slowing down. While this is not at a growth level that everyone would like it to be ("normal" non-financial recessions have seen growth in the 4-5% range), it continues to be growth none the less.

We believe that corporate earnings, which have been pretty good for the last couple of quarters, may slow down a bit, and layoffs from large corporations may increase in the near term. The labor market will continue to struggle to add new jobs on a monthly basis, and the consumer may take a break on spending for the remainder of the summer as summer vacations and back to school take priority. And Congress will continue to debate anything and everything debt related for the foreseeable future.

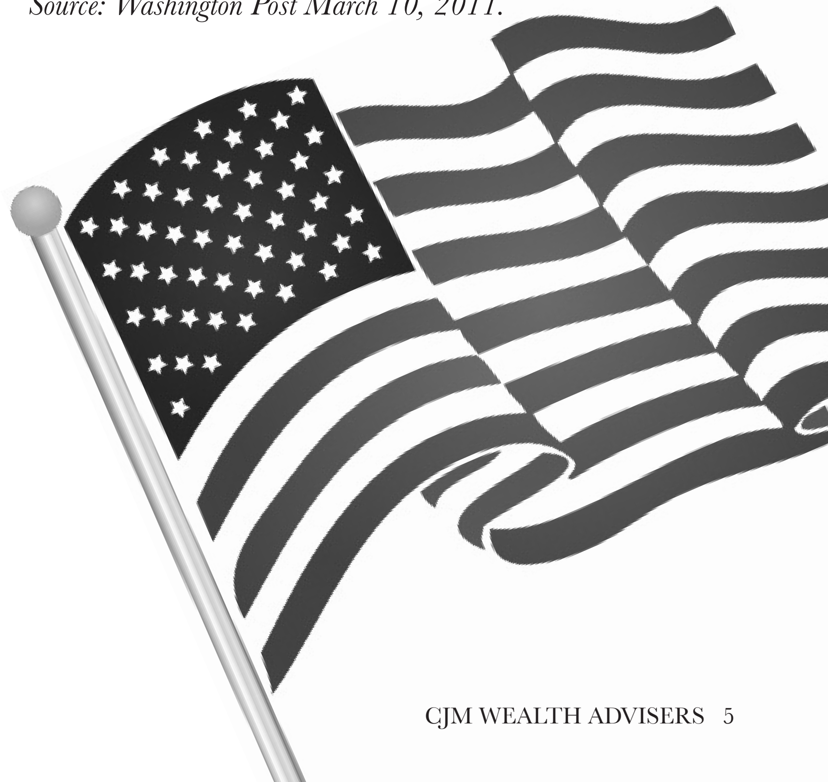
Thank You, Mr. Buckles

We are indebted to our veterans and active duty military personnel for their sacrifices on behalf of our country. We wanted to honor our nation's last surviving veteran of the First World War, Mr. Frank Buckles who passed away earlier this year

Frank W. Buckles was born February 1, 1901 and died February 28, 2011. He was America's last surviving veteran of World War I. At the age of 16 he was accepted into the U.S. Army and determined the fastest way to get to France was to enlist in the Ambulance Service. After two years in Europe he returned home in 1920. But this was not the last time Mr. Buckles would see war in his lifetime. In 1941 while working in Manila, Philippines he was taken prisoner by the Japanese and spent three and a half years in a prison camps. After returning home in 1945 he eventually settled down where his family originally settled back in the late 18th century in West Virginia. He worked on his farm until the age of 106.

Mr. Buckles was a testament to the generation(s) who have come before us and have done great things to advance this nation. Mr. Buckles was buried with Full Military Honors at Arlington National Cemetery on March 15, 2011.

Source: Washington Post March 10, 2011.

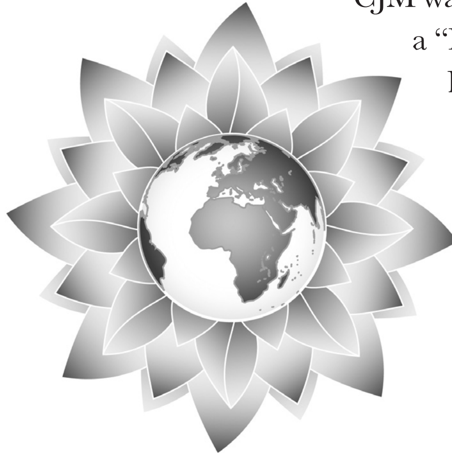


CJM News

CJM Newsletter is Going Green!

Starting in February 2012 the CJM quarterly newsletter will be delivered electronically to all clients.

In the interim, we will continue to send a hard copy to clients as well as an electronic copy. This is just another way CJM is working to reduce our carbon footprint and be more environmentally friendly to our community.



CJM named by Washington Business Journal

CJM was recently recognized by NABCAP as a "Premier Advisor" in the Washington Business Journal.

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What is your purpose? Is it to…

…create a retirement income stream to last a lifetime?
…minimize investment risk and maximize return?
…prudently plan a legacy for your heirs?
…carefully position a business for a future sale?

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