

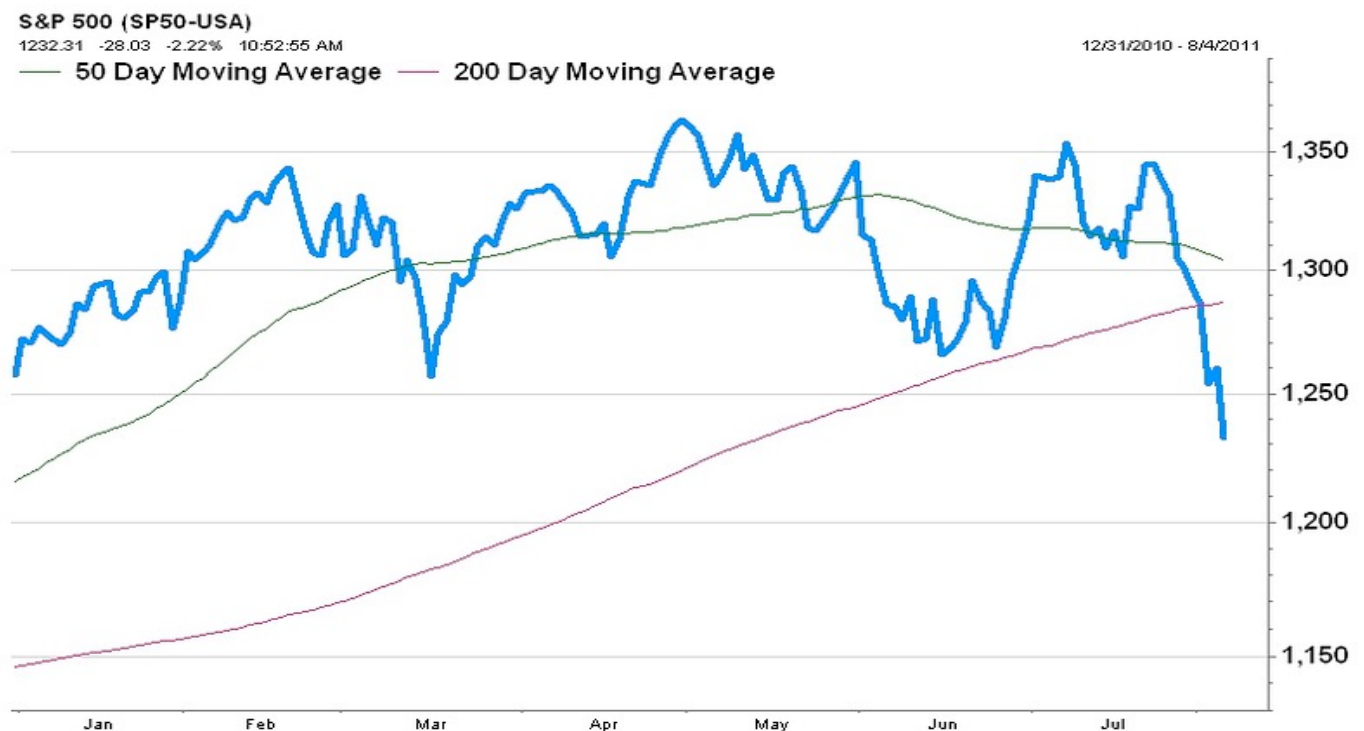
Life After The Debt Deal... U.S. Economy Haunted By Ghosts In The Machine

By Ronald A. Papa

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As we were assembling our *Second Quarter 2011 Economic Update*, I asked Karen and Sharyn to delay its publication until the then pending *Debt Ceiling* debate had ended. I never dreamed it would drag right into the last day, August 2. However, since it was a critical event, my intent was to slip in this additional update.

The markets have reacted very badly to the anemic political response to our debt issues. As I write this, the S&P 500 is negative for the year, way below its 50 and 200 moving averages, and officially now deemed a 10% "correction" from its April high of 1370.58. Stocks have tumbled in a broad selloff, as worries over a slowing economy depressed sentiment and weekly jobless-claims data showed little change to the weak U.S. labor market.



Thankfully, you are invested for the long term; and, like most of my clients, you are well diversified to avoid wild swings in market performance and the amount of sleep you get. I have been watching the Debt Ceiling debate with great interest and want to share not only my observations, but, those of Bill Gross, managing director of the giant investment management firm PIMCO. He is among those expressing initial relief at the government's recent actions, but with serious reservations.

Gross, whose company manages more than \$1 trillion in assets, said the deal -- which he characterized as a display of "dysfunctional government" -- scarcely touches the current year's \$1.5 trillion deficit.

Worse yet, he said that even if the scheme to have 12 members of a "super committee" (six House and Senate Republicans and six House and Senate Democrats) does manage to come up with another \$1.5 trillion worth of budget cuts over the next decade, **it would only reduce future deficits "at most by 0.5%"**

The cuts made in the debt deal are predicted by the Congressional Office of Management and Budget to bring down the country's "official" **total debt/GDP ratio from a current level of 100% to around 90%**. That drop in the debt/GDP ratio, Gross warns, is premised on an assumption that the U.S. economy will grow in 2012 and 2013 at a rate in excess of 3% per year. But, as Gross said, "Recent trends give pause to these estimates, as does PIMCO's New Normal, which believes **2%**, not 3%, is closer to reality."

The bad news: If growth is closer to 2% per year instead of 3%, "deficits move right back up to near double-digit percentages of GDP."

And there's another catch. This rosier scenario for the debt/GDP ratio **also assumes interest rates hold at current 2% levels**. If rates were to rise, either because of inflation or to defend a falling dollar, for example, Gross said every 100 basis point (1%) increase "raises the deficit by 1% and erases any hoped for gains."

The government's action on the deficit this week pales almost to insignificance, Gross warns, when one looks at the net present cost of future liabilities in the Medicare, Social Security and Medicaid programs, which he puts at a staggering **\$66 trillion**.

These enormous future debts can be addressed, he said, but not without taking steps to improve the efficiency of our healthcare system, reduce benefits, raise retirement ages, and, yes, increase tax rates, "or a combination of all of the above." Gross said the government also has the option of depreciating the currency and/or maintaining artificially low or even negative real interest rates. Not a pretty picture to be sure.

Gross's advice to advisors & investors:

- Favor countries with higher real interest rates like Canada, Mexico, Brazil and Germany.
- Diversify equity and fixed income investments out of the dollar and into developing nations "with stronger growth prospects.
- He also advocates investors buy commodity-based real assets "before reserve surplus nations do," and "above all,
- Don't be lulled to sleep by congressional law makers that promise a change in Washington."

Ron's advice to clients:

- The next few years will be challenging as we iron out this debt issue, contend with recessionary pressures of stagnant GDP growth, high unemployment, inflation, and low returns on investment.
- Re-assess your tolerance for risk and adjust your portfolio accordingly.
- If you rely on income producing assets that continue to be unpredictable, consider alternative income strategies.
- Tax rates in the near future will have nowhere to go but up. Seek tax-advantaged, especially tax-free, strategies wherever suitable.
- Call me to discuss your concerns with any of the above. Our success is measured only by your trust in our advice; and we have pledged to continue to earn it.
- Don't worry...Be Happy.





At first glance, the market results of the second quarter didn't appear to be too bad. Despite the significant volatility and stock market fluctuations, the Dow still finished the quarter up 0.8% (up 7.7% YTD)—its 4th quarterly gain in a row, making it 8 out of the past 9. Unfortunately, the larger indexes didn't do as well. For example, the Standard & Poor's 500 Index increased by 0.1% (up 6.0% YTD) and the NASDAQ Composite decreased by .3% (up 4.6% YTD) during the second quarter.

“Risk on, risk off” is a common saying on Wall Street and describes how the stock market is rising and falling as investors become alternately optimistic and then despondent about global economic growth, such as Europe's debt woes and the impact of Japan's earthquake and tsunami.

There have been a number of negative events that have occurred throughout the quarter. For example, while personal income increased slightly during the second quarter, many consumers didn't spend it. That meant that the National Savings Rate inched up from about 4.9% in April to 5% in May—good for individuals, but not good for an economy where consumer spending represents 70% of GDP. (Source: Bob LeClair's Newsletter, July 2, 2011)

There are a number of reasons why consumers are not spending, including:

- Low consumer confidence
- High gasoline prices
- Falling stock prices
- Falling house prices
- Continued high unemployment

This quarter, the credit rating firm Standard and Poor's had to deal with a number of countries with debt problems. It reduced Portugal's credit rating to “junk” status. Greece was a significant subject throughout the quarter, as fears of European contagion reached critical levels. In addition, Standard and Poor's has warned the U.S. that they may decide to reduce our credit rating if we do not handle our deficit problems and get our financial affairs in order.

Even with such a grim experience of worries, many investors largely expected (and continue to expect) the

economy to ride out the troubles, paving the way for stock gains, even though it might be a long and winding road to get there. “In the past, some of these events would have been a detour for the markets; now they are just a speed bump,” said Mathew Lloyd, chief investment strategist at Advisors Asset Management. (Source: WSJ, July 1, 2011)

Despite the downbeat economic news, the major indicators were up every day as we ended the second quarter and headed into the holiday-shortened week. This is another great example of the difficulty in trying to time the market. Many investors were very concerned with the market dropping about 7% in May and decided to sit on the sidelines. Then the stock market bounced right back at the end of June and many of these investors did not participate in the rise. We suggest making sure that we revisit your Asset Allocation and keep invested, at least to the degree that you should be based on a long-term plan. (Source: Bob LeClair's Newsletter, July 2, 2011)

Quantitative Easing

The Fed's controversial \$600 billion bond-buying program known as Quantitative Easing, or QE2, ended on June 30th with mixed opinions about its success. Quantitative Easing pumped money into the banking system through the purchase of approximately \$1 trillion in Treasury securities, which in turn gave banks abundant funds to lend out to businesses and consumers. The Fed officials hoped it would prevent very low inflation from giving way to a Japan-style bout of deflation—this occurs when the overall consumer price level decreases, dragging the economy down with it. The Fed also sought to stir the economy by holding down long-term interest rates, which in turn would hopefully boost prices for stocks, corporate bonds and other financial assets. In addition, they believed more job growth would follow.

Although the Fed succeeded in putting deflation worries to rest, economic growth is slower now than what it was when the program was enacted last year. Stock prices are higher and corporate bond yields lower, prices for oil, grains, and other commodities have surged, pinching many consumers. The question still remains, who will replace the Fed as a new buyer now that QE2 is over? (Source: WSJ)

April 25, 2011) If the demand for government Treasuries is not enough to replace the Fed, it is very likely that interest rates will go up, which in turn could cause even more problems for the real estate market and additional costs for everyone involved.

Unemployment

Many have expressed shock at the recent employment data. About 14 million Americans are unemployed—9.2%. That figure does not include those who have simply given up on trying to find jobs, or those who are underemployed. Taking that into account, the underemployment rate stands at a stunning 19.1%, according to Gallup Organization. It doesn't help that we currently export many of our jobs to lower-wage nations like India and China.

Many big public companies are likely to report strong second quarter profits, but that isn't the story on Main Street, where many small business are grappling with jittery customers, rising costs and tight credit. The owners of many small businesses say economic uncertainty and inflationary pressures have led them to delay hiring and capital expenditures. 70% have no plans to expand their staffs over the next 12 months, according to a recent U.S. Bankcorp survey. (Source: WSJ, July 6, 2011)

The Bond Market

Many investors continue to prefer bonds, even with interest rates at historically low levels. Although bond yields are low, many think that prices of Treasury securities could keep climbing (at the same time their yields are falling) as long as the economy continues to show signs of sputtering and the threat of financial chaos in Europe continues.

One of the major concerns of bond investors at this time is the possibility of rising interest rates, which can translate into losses for bond investors. As you probably know, interest rates and bond prices work opposite of each other. As interest rates go up, the value of bonds goes down. In a recent presentation, Daniel O'Neil, president and chief investment officer of Direxion Shares, said, "A 1% rate hike could drop the value of a 30-year U.S. Treasury Bond by 14.5%". (Source: Financial Advisor Magazine, July 2011)

The Current U.S. Budget Deficit

There is another dark cloud on the investment horizon—the ongoing political struggle concerning the federal deficit and the U.S. debt ceiling. It is important to remember not to confuse the *debt* with the *deficit*. The deficit is the measure of the amount of money coming in versus what goes out on an annual basis. Last year the U.S. tax revenues were approximately \$2.3 trillion and we spent \$3.8 trillion. Our deficit for only one year was \$1.5 trillion—that's 1,500 billions of dollars! That amounts to about 42% of the \$3.8 trillion in Federal outlays, which is equivalent to Washington borrowing \$0.42 of each dollar it is spending.

According to a recent Congressional Budget Office (CBO) report, our current national debt is \$14 trillion. The CBO estimates that we will be \$20 trillion in debt by 2015 and \$27 trillion in debt by 2021. This means in 2021, which is only one decade from now, the interest on \$27 trillion would consume ½ of all Federal tax revenue!

Many investors are also concerned whether the U.S. could *default* on its debt. Although it is possible for the U.S. to be downgraded to below a AAA status, most economists believe that there is very little likelihood that Uncle Sam would actually default. Think about it—in the worst case scenario, the Fed would simply run its printing presses to help the Treasury cover its debt. The debt would get paid off, but at a cost — this makes each dollar worth less, which leads to inflation. (Source: WSJ, April 19, 2011)

Despite all of these concerns, investors continue to keep lending money to the U.S. and assume policymakers will address and solve our fiscal problems before they lead to an actual crisis. Many take confidence in Winston Churchill's famous quote: "You can always count on Americans to do the right thing—after they have tried everything else." (Source: Fortune Magazine, July 2011)

The Debt Ceiling

The major debate in Washington today is whether the U.S. should raise its debt ceiling so it can borrow more money to stay afloat. The statutory ceiling on our national debt—our legal borrowing limit—is \$14.3 trillion. That limit was reached on May 16th, according to the Treasury Department. The Treasury says it can still operate until early August, when the ceiling must be raised by \$2.4 trillion. The Republicans want to raise the limit only if it is accompanied by spending cuts and no income tax increases. Democrats, on the other hand, want to raise the debt ceiling and have agreed to a \$2 trillion package of

spending cuts over the next decade, but also want to raise about \$400 billion in revenue by eliminating tax breaks and deductions from many taxpayers. There have been significant discussions and debates about what to do and there is a chance that there won't be any agreement by the August deadline. (Source: The Week, July 15, 2011)

If no agreement is reached, many people are concerned about what happens next. Nobody knows for sure, because this has never happened before. However, many economists warn that the dollar could crash, interest rates could rise significantly and equity markets could have a major meltdown. Foreign investors could also lose confidence that America is worth risking their money and that Washington is able to face and handle this crisis. Many investors believe that cutting expenses and reconciling our differences would illustrate to the world that we can make tough decisions in a crisis and reassure our creditors and increase faith in the United States. (Source: WSJ, June 4, 2011)

Inflation

Inflation is upon us, even if most reports on wholesale and retail prices downplay the immediacy of the threat. Many people forget that the inflation number quoted today is considered "core" inflation—an alternative CPI calculation that excludes most food and energy prices. Core inflation is supposed to provide a more accurate, long-term picture of price movement. Unfortunately, the dramatic rise of food and fuel costs can make core inflation figures seem widely off base. (Source: Kiplinger's Personal Finance)

Investors should care about inflation for a number of reasons including:

- Higher inflation often accompanies higher interest rates—bad news for bonds, as prices tend to decline when interest rates rise. Most bonds pay a fixed coupon rate, and inflation erodes the value of that payment over time.
- Rapidly rising prices boost operating costs for companies. If companies lack pricing power, those higher costs erode profits, which can lead to lower stock prices.
- Wall Street values stocks based on future growth prospects, and inflation erodes the present value of the dollar expected in the future. Higher inflation means lower P/E ratios, which could also mean lower stock prices.

One of the ways to keep inflation in check is to raise interest rates which can affect many different financial areas, including real estate. Home prices in many parts of the country have sunk to 2002 levels, effectively wiping out a decade's worth of home equity across the U.S. and

imperiling our fragile economic recovery as many Americans confront the falling value of their biggest investment.

At least a bit of good news—home prices slowed their pace of decline in April, feeding hope that housing is near a bottom. Unfortunately, tens of thousands of foreclosures are expected to leave markets bumping near their current level for the rest of the year. (Source: WSJ, June 29, 2011)

The U.S. Dollar

The dollar today is lower than at any time since major currencies began floating in 1973. It is 13% lower than it was 30 years ago and 28% below its 2002 peak. So what does that actually mean? A weaker dollar makes Americans poorer. In other words, U.S. paychecks buy less of what the world sells us. By pushing up prices of imports, it drives inflation. Not necessarily a big problem today, but potentially one in the future. The latest declines in the dollar have also contributed to the rising price of commodities such as gold. On the positive side, it gives exporting U.S. factories a boost by making their goods cheaper to foreigners at a time when the U.S. game plan is to rely more on exports. Many U.S. officials are unfazed by the dollar's steep slide, but might get more concerned if the dollar shows signs of disturbing other financial markets. (Source: WSJ, April 29, 2011 & May 5, 2011)



Potential European Defaults

Greek debt is in trouble—again. After a month of discussion, it seems likely that the International Monetary Fund (IMF) and the European Union will agree to roll over Greece's debt so bond holders will be paid in full. The reason for this is that most of the bond holders are banks. If Greece defaults, then important French and German banks will be in deep trouble.

In addition, Ireland, Portugal, Spain, and Italy may soon follow. This scenario is beyond the EU's bailout capability, and it would leave the European financial system in shambles because again, the banks are holding that debt. Unfortunately, many stocks in Europe fell as concerns rose about the health of the global economy and confidence regarding a resolution to the Greek debt situation. Over the last few days, it looks like they are finally working out a solution. Let's hope for the best.

Summary

A question that is always on investors' minds recently is this: "Is the market overvalued?" The answer is the subject of substantial controversy right now.

There are valid arguments and rationale indicating a positive economic outlook, but also pointing toward another recession and financial crisis. The stock market has roared back from its March 2009 lows, doubling in value in less than 2 years. However, the last part of the rally, which began last summer, largely has been driven by the Federal Reserve, whose policy of buying Treasury bonds to inflate asset values across the economy ended on June 30th.

Although many predictions are made, it is important to remember that it is impossible to actually predict the future. Not many people would have factored in a nuclear crisis in Japan or major developments in Libya, Egypt and Europe. Still, these events are not unlike many that have unfolded in the past: the internet bubble, the Cuban missile crisis or the inflation of the 1970s. We made it through these crises and we should be able to make it through these current problems we are faced with today.

Someone once said, "The world is only going to end once, and the odds are that it isn't now."

One of the biggest challenges investors face is how to tune out the prevailing mood of the market. Sticking with a long-term investment plan often requires ignoring the news, your friends' advice and even your instincts. Too often emotion, not logic, rules our investing habits, so the first step in declaring mental independence is realizing how these influences, known as biases, affect us.

While most investors understand that there will be some volatility in their investment portfolios, even the strongest of nerves can be tested when tsunamis, country-wide protests and bankrupt nations are constantly in the news. It is imperative to look at the long-term and remember that short-term volatility is something we cannot control.

Market fluctuations are based on emotion. Unfortunately, emotions can undo the best laid financial plans. Unfortunately, finance theory makes a basic assumption about investors: They behave rationally all the time. As you know, we work with you to develop a long-term strategy and our goal is to help our clients achieve your financial goals, especially through these difficult times. Prosperity is a process, and usually a slow one at that. Take a deep breath, stay calm and stick to your plan.

Someone said a long time ago: "When waters are calm, anyone can steer the ship. When waters are rocky, people want to see their captain."

If you feel the need to discuss your situation before our next review meeting, as always, please call our office

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This optimism about the future does not minimize the fact that we have gone through one of the worst economic periods in market history. Remember that equity markets are volatile and an investor may lose money and there is no guarantee that securities will appreciate. This material contains forward looking statements and projections. There are no guarantees that these results will be achieved.

The price of commodities is subject to substantial price fluctuations of short periods of time and may be affected by unpredictable international monetary and political policies. The market for commodities is widely unregulated and concentrated investing may lead to higher price volatility.

In general, the bond market is volatile, bond prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. The investor should note that investments in lower-rated debt securities (commonly referred to as junk bonds) involve additional risks because of the lower credit quality of the securities in the portfolio. The investor should be aware of the possible higher level of volatility, and increased risk of default.

Municipal bond offerings are subject to availability and changes in price. If sold prior to maturity, municipal bonds may be subject to market and interest risk. An issuer may default on payment of the principal or interest of a bond. Bond values will decline as interest rates rise. Depending upon the municipal bond offered, alternative minimum tax and state/local taxes could apply.

Investments in real estate have various risks including possible lack of liquidity and devaluation based on adverse economic and regulatory changes.

Additional Sources: Wall Street Journal (4/19/11, 4/22/11, 4/25/11, 4/26/11, 4/28/11, 5/5/11, 6/4/11, 6/24/11, 6/29/11, 7/1/11, 7/2/11, 7/5/11, 7/6/11, 7/7/11)

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