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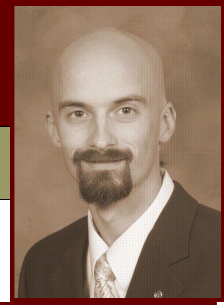
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May 31, 2011

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TPWC Market & Economic Update

By Jeff McClure

Of Markets, Economies, and Debt

Confusing News

According to the Commerce Department, as well as virtually every economist whose comments I have read, the recession and recovery are now over and we are in “expansion.” As a recent article in *Time* magazine put it:

*“The good news is that the American economy is back to its pre-crisis size. The U.S. GDP is now about \$13.5 trillion, a bit above where it was in 2007, before the financial crisis. The bad news is that we are producing the same amount of goods and services as in 2007 with 7 million fewer workers.”*¹

Meanwhile, the Federal Reserve Board continues to execute “QE2,” a program designed to provide emergency stimulus to the economy. Conservative talk show hosts and politicians are proclaiming imminent doom for the nation unless we dramatically cut federal spending. State and local governments are doing just that, cutting as property and sales taxes fall. Last, but not least, every month brings a new announcement that some aspect of the housing market or consumer spending is sinking.

All that bad news could easily convince any reasonable person that we are

sinking into an economic depression. Then someone notes that corporate earnings are at record levels, manufacturing is not only at a record level, but is expanding faster than at any point in the last half century, and the stock market has very nearly doubled in two years.

If that weren’t enough, about a year ago it appeared that Greece was going to sink the Euro. That crisis was proclaimed as “resolved.” Then it was Ireland’s turn and again “mission accomplished” was announced by the European Central Bank (“ECB”). Just as things seemed to be getting back to “normal” Portugal was “discovered” to be facing an unsustainable debt load and would need an immediate rescue. Now it is Greece again. This time the ECB and the Germans are expressing a great reluctance to loan good money after bad and it looks like a Euro Zone country may go into default.

Just as I was digesting all of this, Standard and Poor’s revised Italy’s outlook to “negative.” Concern is now being expressed about the status of Spain’s economic stability and the ability of its banking system to survive without assistance.

What is Really Going On?

Historically about twice per century post-medieval western civilization goes through a relatively large economic displacement. Typically one of those is inflationary and one is deflationary. Most of us are at least vaguely familiar with the deflationary event we commonly refer to as “The Great Depression” which occurred in the 1930s. We are also mostly familiar with the fact that we had a bout of market decline and inflation during an economic event that started in 1973 and lasted at least until 1983. Those were the two episodes of the 20th century.

In my opinion, we are now well into the deflationary event of the 21st century. We are also into some uncharted water in that we are not in a depression. Historically, the type of financial collapse we have seen in the last two years and which is still underway in Europe has resulted in a major socio-economic depression. The traditional solution to that depression has been a major war in which a phenomenal quantity of debt is generated by the winners and total collapse by the losers.

The situation in Europe is not terribly out of line with that historic scenario. Those countries that appear to be

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coming out of this crisis on top, led by the United States, are doing so with an uncomfortable debt load. At the same time those countries which propped up their government's popularity by lavishing excess benefits on their populace are being rendered insolvent with all the pain associated with it.

The Markets in Perspective

If a picture is worth a thousand words (and I think it is) then the top graph on this page tells a story about the return of the stock market over the past ten years. A decade ago, in 2001, the S&P 500 Stock Index was around 1300. Today it is around 1300. As you can see from the red line on the second chart, with dividends reinvested, the Index really rose from 1256 in 2001 to 1656 in 2011. That equates to about a 2.8% average annual rate of return for the period. Unfortunately, the Consumer Price Index (CPI) rose at an annual rate of 2.38% for the same period, effectively reducing the gain to zero.

There is also a second, blue line on the bottom chart. That represents a Markowitz asset allocation² with an expected rate of return of 10% created based on the historic data available in April 2001. The actual nominal return of that allocation was around 6.5% for the period.

Lessons to be Learned

What can we learn from this?

Probably the most important lesson is that the future is always uncertain. The ten years leading up to April 2001 saw the S&P 500 rise by almost 15% per year. Looking back ten years at that

point one could easily conclude that high double digit returns were to be the norm going forward. Another lesson might be that when market returns are either unusually high (as they were in the 1990s) or unusually low (as in the last decade) the next decade is likely to reverse that trend.

We are not chained to some market index return. The major stock market indexes represent only a portion of the investment universe. Markowitz's *Mean Variance Optimization* demands a far wider diversification. That



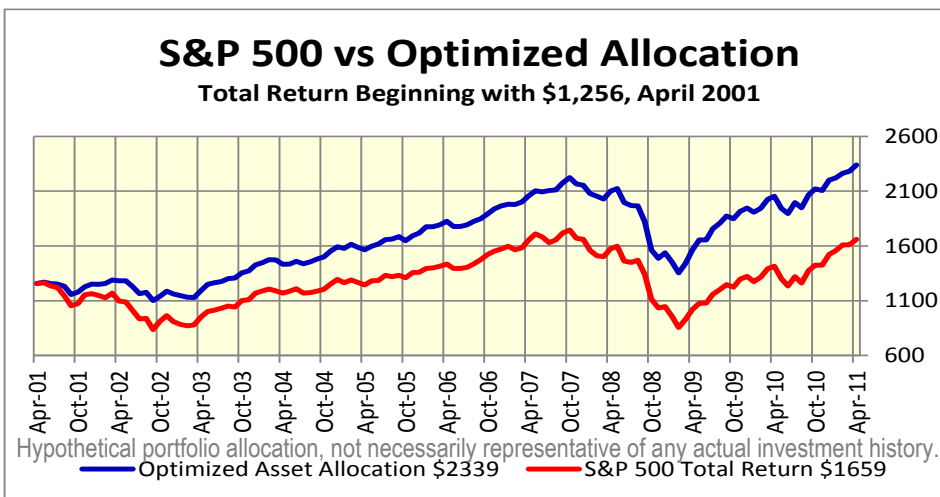
diversification, applied in a rigorous, disciplined manner has historically resulted in either a higher return with similar variation or as good a return as the indexes with less variance.

media focus is on debt, default, and multiple financial crises?" My point is that despite all that has transpired over the more than half century since Markowitz wrote his paper, an investor who followed that discipline has not only survived but prospered in the face of crisis after crisis.

Currently the crisis *du jour* is either the U.S. federal debt and deficit or the threat of financial collapse in the Euro zone. Both are very real problems, but neither are actually a serious threat. That is a bold statement, but all

I know about history and the system in which we function argues that I am right.

Meanwhile, the odds are that you, gentle reader, are very confused and more than a little worried about the state of our nation, the economy, and the world financial system. Perhaps I might be able to shed a little light on those dark subjects. Fair warning is in order here. The evidence as I see it will be in harsh contrast with the headlines and, for that matter, the talking heads that seem to be continuously proclaiming the end of the world.



The End of the World

Harold Camping, a Christian fundamentalist radio talk show host, recently declared that the beginning of the end of the world would be on May 21. The final culmination and the end-of-the-end was to occur in October

of this year. As May 21 passed with at least most of us still here, he has now announced that the Rapture actually happened, but no one noticed. He is still predicting the end will come in

Relating Markowitz to All Else

You may quite reasonably be asking at this point, "Why the lesson on Markowitz, diversification, and asset allocation at this moment when the

October.

We humans seem to be unduly fascinated by these things. I, just for the record, announced on our radio show that the world *would not end* as predicted by Mr. Camping. As far as I can tell, that was the really unnoticed announcement!

Momentarily either the budget deficit, the President's policies, or the Euro crisis is, according to no small number of pundits, going to bring about the end of the world as we know it. I have heard Glenn Beck announce the end of the financial world was at hand more than a few times. All of those prophets have something in common. End of the world forecasts get a *lot* of attention. Even when they are completely wrong, we keep coming back for more.

Mr. Camping was at least as adamant about the imminent demise of earth back in 1994 as he was recently. Mr. Beck very firmly stated back in 2009 that by now the dollar would be worthless and we would be in a massive depression. Still, I get calls every time he updates his doom prediction. Notably he never admits he was wrong.

So, here is my prediction. The world is not about to end. Even the world financial situation, which has some very real issues right now, is not about to collapse. More, I predict that a decade from now we will look back at a far better economic record than even the most optimistic of us can imagine today.

Having shared my conclusions, here are the issues we face and the real implications of those issues.

The Federal Debt

The Treasury of the United States owes \$9.654 trillion in redeemable debt as of April 23, 2011. The Gross Domestic Product (GDP) of the United States for this year is estimated at \$15.5 trillion. That means we have a public federal debt equal to about 64% of our GDP. The actual interest being incurred and paid by the Treasury on that

debt is at 2.498%. That means we are paying about \$241 billion in interest payments per year.

The rest of the \$14(+) trillion federal debt is owed not to any holder of Treasury securities, but to ourselves in the form of obligations to pay future Social Security, Medicare, and other domestic "entitlements."

Now for the perspective: Germany is considered by many to have the healthiest of the European major economies. Its *public* debt equated to 80% of GDP at the end of 2010 according to the *International Business Times* February 21, 2011 edition. The German Federal Statistical Office announced that the public debt stood at \$2.72 trillion dollars and had risen 18% in one year. In the previous year it had risen 21.9%.

“The world is not about to end... A decade from now we will look back at a far better economic record than even the most optimistic of us can imagine today.”

More importantly, Greece is on the verge of default. The largest holder of Grecian sovereign debt are German banks followed by the European Central Bank ("ECB") While the exact numbers have not been released, if Greece executes any kind of default or "restructuring" its debt will no longer be eligible to be held by German banks or the ECB. Germany is the only major nation in the Zone which has the wherewithal to bail-out those banks. In doing so Germany could easily wind up with public debt greater than 100% of GDP. More on that later.

In short, the United States does *not* have a current debt crisis. Interest on our federal debt amounts to just over 11% of our budgeted expenditures for FY2011.

Two Aspects of the *Real* Problem

First, we are indeed borrowing a heck of a lot of money each month. Our actual borrowing needs this year will run about \$500 billion. The good news is that there appear to be plenty of very willing lenders, *and* the growth in our GDP may well be quite sufficient to cover the real borrowing.

U.S. GDP is estimated by several economists, who I believe are very realistic, to be about 3.5% for the year. If that is a reasonable number, then tax receipts should rise by about \$110 billion. *If* we could limit our future expenditure growth to no more than the CPI (inflation) then over the next three decades we would not only eliminate the deficit, but get a real handle on paying down the debt.

The problem is that unless major laws are changed *and* taxes are increased, that will not happen. If one considers the future obligations of Social Security, Medicare, the Prescription Drug Benefit Program, and Military Retirements, then all the numbers I cited above get radically different.

Note that I have not mentioned the general Defense Budget. That is a current expenditure and I consider it one of those areas a cost cut now would mean a huge cost increase later.

The long term problem is that we *owe ourselves* a truly staggering amount of money in the form of Social Security, Medicare, Drug Benefits, and Military Retirements.

We currently owe those programs about half as much as the total public debt. Worse, we owe interest on the debt we owe ourselves. If we include the funding we are theoretically making for all the future benefits to be paid to Americans by the federal government, the federal debt rises to very nearly 100% of GDP.

Just a few years ago (2003), a Republican President in concert with a Republican controlled Senate and House of Representatives passed the Prescription Drug Care Benefit into

law without a single penny of cost cutting or new revenue. In fact, the Congress and the President lowered taxes that year. More, that same law prohibited the administrators of the Benefit from negotiating with the pharmaceutical companies to get the kind of discounts that even corporate plans have achieved. The total cost of that program alone is estimated at \$19 trillion over the next thirty years. I find it quite ironic that Representative Boehner voted for and publically supported that program but is now demanding budget austerity and threatening to put the government into default unless spending is cut immediately.

There are some hard choices that need to be made in the near future. Those choices must include a reduction in retirement benefits *and* an increase in taxes. No matter what the politicians say, the reality of the numbers is there.

The Immediate Domestic Crisis

There is a potentially much larger crisis facing us right now. Frankly, if we are to believe that the bond market investors have it right, then there is nothing to fear. Interest rates on U.S. Treasury obligation have been falling for the past several weeks.

The risk is that if the House of Representatives does not increase the debt ceiling in a couple of months, then the federal government will be forced to cut spending by about 38%.

In all likelihood the Treasury would continue to pay interest and principle on Treasury securities as it was due. We can easily afford to do that. What would cease would be things like payments to federal contractors, military personnel, payments to states for Medicare, and a host of other payments

and services that we have come to accept as part of the life we live.

I also believe that the ensuing collapse in services and payments would throw us into a relatively severe recession which in turn would dramatically reduce tax revenues. If it were to continue, that would require yet further cuts in spending, which would worsen the recession. Would we survive that scenario? Yes, without a doubt. I am also sure that the ensuing economic pain would cause the elections in 2012 to result in a landslide for the Democrats.

The Conservative Caucus in the House is pretty radical, but I doubt that their idealism extends to political suicide!

The Crisis in Europe

The European fiscal crisis is not going to be as easy to either predict or solve. If Greece defaults or “restructures” its debt, it will leave the European Central Bank as well as many other banks in Germany and France in a worse financial condition than Lehman Brothers was in as it collapsed!

It is quite clear that Greece is incapable of functioning under the 20%(+) interest rates it is paying for short term borrowing. Its austerity measures have put it in a severe recession and as a result tax revenues are collapsing even as interest rates on its obligations are soaring. Either the Germans and other “wealthy” countries will intervene with non-recourse loans (bail-outs) or the results will be very, very unpleasant for all of us.

We are the world’s largest exporter. Europe buys a lot of what we sell. If they derail, our train will be severely

delayed. It will be educational to see what that herd of cats comes up with.

The Source of the Debt Crises

We here in the United States are tending to treat our debt crisis as if it somehow is ours alone. The two government chartered (and now largely government owned) mortgage institutions, the Federal National Mortgage Corporation (FNMC or “Freddie Mac”) and the Federal National Mortgage Association (FNMA or “Fannie Mae”) are often blamed for the whole debt crisis. If there were any truth in that assertion, then the crisis would be contained in the United States.

Factually, the residential real estate crisis is far worse in Ireland and Spain than here. The size of the real estate collapse in Ireland would have literally bankrupted the entire country had the European Central Bank and the International Monetary Fund not stepped in with low interest loans. As bad as our crisis was, and is, we were able to handle it with our own funds.

The source of the now world-wide credit crisis is a repeating story that goes as far back as we have historic records. It is actually far worse in Europe than in the United States. While our problem is very real and very painful, the sovereign and mortgage debt crisis in Europe has the potential to be devastating to the Euro and will effect every nation, person, and company in Europe. As to what effect it will have on us here in the United States, only time will tell, but we have survived European devastation before and certainly can again.

Stay tuned. This drama is not over.

¹ *Time* May 30, 2011, page 36, “A Flight Plan for the American Economy.”

² Markowitz allocation refers to an allocation structured according to *Portfolio Selection* by Harry Markowitz as published in the March 1952 edition of *The Journal of Finance*. The allocation referenced consisted of 27% Larch Cap Value, 12% Mid Cap Value, 4% Large Cap Foreign Value stock funds, 34% Conservative Allocation Funds, and 13% GNMA funds. Asset classes are represented by Morningstar Fund Categories, which are composed of the average performance of all funds in the categories listed as tracked by Morningstar

Past performance is no guarantee of future returns. For tax or legal issues consult with a qualified tax advisor or attorney. Information in this letter should not to be used as investment advice. Individual portfolio design must be tailored to individual needs, values, risk tolerance, and objectives.