



Managing Your Future

And

Your Children's

June 2011

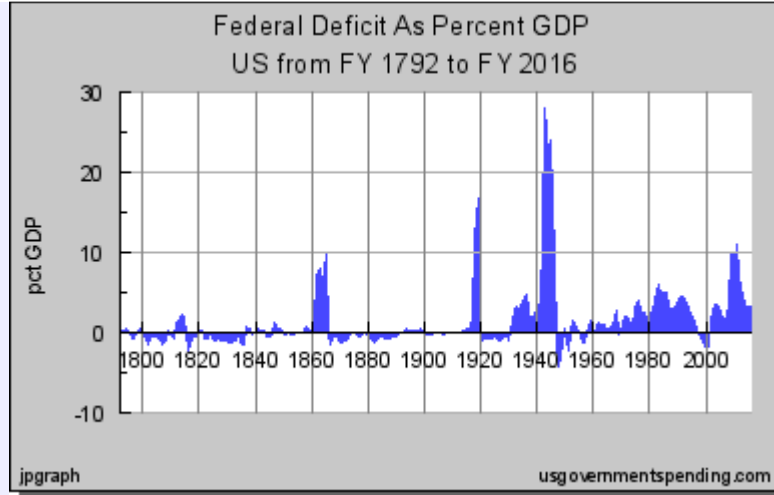
About 224 years ago on May 25, 1787 a relatively small group of men gathered in Philadelphia, Pennsylvania and ultimately crafted what now stands as The Constitution of the United States of America. Over those next three weeks, through intense discussion it became clear that rather than amend the existing articles, the Convention would draft an entirely new frame of government. Throughout those hot summer months the group discussed such points as how much power to allow the central government. Ultimately, through the work of many minds, the Constitution was settled upon and what that represented still stands as a model of collective thinking, cooperative statesmanship and the art of compromise. Our nation's founders understood the difference between opportunity and entitlement. They believed in certain key values including the prudence of thrift, savings and limited debt. They took seriously their stewardship obligation to the country and future generations of Americans.

Looking back we now discover that the truth is we have strayed from these key, time-tested principles and values in recent decades. To ensure that our collective futures are better than the past it is imperative that deficits are brought under control.

Believe it or not, to win our independence and achieve ratification of the U.S. Constitution, the U.S. only had to go into total federal and state debt equal to 40 percent of the size of its then fledgling economy. Fast forward to today, when the U.S. is the largest economy on earth and a global superpower – but total federal debt alone is almost 100 percent of the economy and growing rapidly. Add in state and local debt, and the total number is about three times as much as the total debt we held at the beginning of our Republic – and it is headed up rapidly. In fact, our total federal debt has more than doubled in just the past ten and a half years.

The two major peaks of the federal deficit in the 20th century occurred during World War I and World War II. Deficits increased steadily from the 1960s through the early 1990s, and then declined rapidly for the remainder of the 1990s. As the chart below shows, the federal deficit went over 10 percent of Gross Domestic Product (GDP) but four times in its history. The first was in the 1860's during the Civil War, then again during WWI, and at its all-time height during WWII. The fourth time and the only time not directly attributable to war occurred in the aftermath of the financial crisis of 2008. The chart also tells a somewhat conflicting story in that the differential between the two WW's in the 20th century dwarf by comparison where we currently find ourselves. At its height, the deficit in WWII was 102% of GDP! Still there are multiple reasons why we should not be running a deficit of this magnitude. Key to that recovery was the major industrial output of the US and the relatively little competition it faced in that regard. Times have changed.

US Federal Deficits since the Founding



Over the past 50 years the US has drifted from the position of the world's leading creditor nation to the world's largest debtor nation. We have also become unduly dependent on foreign nations to finance our excess consumption. Many of these foreign investors have shunned our long-term debt due to concerns over future interest rates and the longer-term value of the dollar. And PIMCO, the largest Treasury bond manager in the U.S., also recently sold their Treasury security holdings due to a lack of adequate return for the related interest rate risk.

And who is now the largest holder of Treasury securities? If you said China, you would be wrong for it is the Federal Reserve. The Fed may be able to hold down interest rates for a period of time; however, they cannot hold them down forever. The Fed's debt purchase actions are just another example of how Washington policymakers take steps to provide short-term gain, while failing to take steps to avoid the longer-term pain that will surely come if we fail to put our nation's fiscal and monetary policies in order. Remember the precepts of the Founding Fathers deciding about just how much power to allow the central government?

So precisely what does all this mean to you?

Let's start with where we presently sit. Currently, our National Debt as a percentage of GDP is approximately 65%. However, when the recession was overtly rearing its ugly head in 2007 that percentage of GDP was but 43%. In a paper just published by Joseph Gagnon a Senior Fellow at the Peterson Institute for International Economics, he states that this percentage of GDP is expected to rise to 155% by 2035 or in simple terms beyond the level at which normal economies can be expected to destabilize. Now it should be noted that such analysis is based upon a 'do nothing' approach, which should be out of the question. It should also be clear to everyone that our current economy is still somewhat fragile and thus to purposely raise taxes now and cut entitlement programs would indeed address the deficit, but it would have the dual effect of negatively impacting the recovery and thus be a severe threat to any sustained recovery. An immediately noticeable impact would be higher interest

rates, which are good for investors, but bad for borrowers. It would also negatively impact home sales as this action would translate into fewer buyers and more pressure on foreclosures. Further, borrowers are corporations such as GM, Chrysler, Ford, GE, IBM and just about every corporation in the 30 Blue Chip stocks comprising the Dow Jones Industrial Average. In short while we as investors and depositors are earning meager returns, the reverse effect is that corporations are borrowing cheaply enabling them to re-invest in their respective businesses and thus grow, which in turn helps their stock price. In more realistic terms, if an individual earns \$100,000 a year yet spends \$155,000 it doesn't take a genius in math to figure out that this is a prescription for financial ruination, assuming it goes on unchecked for many years. Somewhere down the road this individual will arrive at a crisis point. This is the point at which his/her credit is cut off. The US is the world's largest borrower. As such we carry the world's largest debt and in turn the largest budget deficit. At some point the ability for the US to borrow effectively at its present rate will be challenged if left unattended. We do not expect this to be the case, but **when** the debt problem is addressed is a crucial question as it requires a delicate balance, but it is not out of reach. Therefore some combination of a tax hike and cuts in entitlements is definitely in the offing, just when, remains to be seen.

Clearly deficit reduction is a top priority in Congress not only to the well-being of this generation, but that of our children and their children.

While the markets are unpredictable, managing your financial future shouldn't be. We apply those very same principles of collective thinking in devising financial plans for our clientele and the adaptation of this collaboration results in helping you achieve the goals mutually set out and agreed upon in your financial plan. A Financial Plan that combines a disciplined approach to financial management, risk assessment and the practical application of our proprietary model, which ultimately determines your investment strategy. Remember, we have never had to tell a client who followed our advice that they couldn't afford to retire or didn't have the necessary funds to pay for their children's education. We take your financial well-being personally and we care.

Sincerely,

A handwritten signature in black ink, appearing to read 'Richard Gonzales', written in a cursive style.

Richard Gonzales
Chief Operating Officer

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