



quarterly COMMENTARY 2011|Q2

the quarter in review



J. William Waltman, Jr.
CPA, CFP®



Eric E. Foster
CPA, CFP®



2076 Lakeside Centre Way
Knoxville, TN 37922
www.pyawaltman.com
Phone: 865.693.6301
Fax: 865.693.6302

A Tale of Smoldering Debt and a Fat Pitch!

Do you smell that stench? It is the smell of smoldering sovereign debt. It briefly turned into

flames in Greece before the European Central Bank (ECB), in their “wisdom,” threw another pile of money on the fire to suffocate it for the time being. It will likely flare up again within months. Portugal and Ireland have already had flare ups with more likely to follow. The sovereign debt of Italy and Spain is smoldering, but sparks have yet to ignite. The ECB wants to ensure the crisis does not involve these countries, as they are likely too big to fail and too large to bail out. The ECB is not run by idiots. Why do they continue to grant loans to nations such as Greece that cannot pay back the debt they already owe? The answer is to avoid a near-term default by Greece that may set in motion a contagion in the debt markets of periphery European countries, resulting in a banking crisis. European financial institutions own over \$500 billion of peripheral government debt (i.e. Portugal, Ireland, etc.). The ECB has purchased so much debt from countries that are unable to repay their obligations that a default may render the ECB insolvent. The following excerpt from Bill Bonner, author of the financial column “The Daily Reckoning,” states the sovereign debt mess in Europe quite well.

- “The ECB didn’t just cough up 90 billion Euros for Greece. It also lent 106 billion Euros to the Irish, 44 billion Euros to the Spanish and 48 billion Euros to the Portuguese. If these loans go bad, the ECB will face insolvency.
- Fool? Knave? As you can see, the ECB is both. Perhaps it once lent to save the world. Now it lends to save itself.
- What will happen when the credit runs out? That’s the trouble with the kick-the-can-down-the-road approach to debt. You end up down the road; and there’s the can! If the borrowers cannot make good on their debts to the ECB, the bank will run out of money and have to issue capital calls to its member national central banks.
- The Germans, for example, will get a bill for 27% of the necessary funds. Other central banks will be asked to put in lesser amounts. But many of the member banks are the same as those that desperately need financing from the ECB. This will probably force Germany and France to shoulder larger percentages of the bank’s financing requirements and may force the weak banks out of the system altogether.”

And then there are Japan and the United States. Both have staggering debt loads and an insatiable appetite to accumulate even more debt. This has not mattered to the bond market, yet. As of

— continued on page two

this writing, U.S. lawmakers continue to debate spending cuts and tax increases in an effort to garner the necessary votes to raise the debt ceiling by approximately \$2 TRILLION. Think about that for a moment. We have moaning and gnashing of teeth in Congress to come up with \$2 trillion of spending cuts over the next 10 YEARS and we need \$2 trillion in deficit spending over the next 18 months just to keep paying our bills! We expect the debt ceiling to be raised prior to August 2nd with \$2 trillion or so in spending cuts agreed to over the next 10 years. The tougher choices on spending and taxation required to get this nation on a sustainable path will be left for the 2012 presidential election.

So what has been the return on investment to the United States for the trillions of dollars in deficit spending and the Federal Reserve's two rounds of quantitative easing (money printing) totaling approximately \$2 trillion? Not much. It has taken nearly \$4 of balance sheet (credit/money) expansion to create \$1 of additional economic activity. Pretty pathetic!

Let's briefly review some of the metrics of this economic "recovery."

1. At 131 million, payrolls are actually lower now than they were in March 2000. Over an 11 year period of flat employment, the population has risen by nearly 30 million. A net job loss over a 10 year period is unprecedented since the advent of reliable tallies in 1890 according to the Liscio Report.
2. On average, 23 months after a recession ends, total nonfarm payrolls have recovered by more than 200% of the jobs lost from the recession. We are heading into year 3 of this expansion and only a bit more than 20% of the job losses have been recouped.

3. We have yet to see private payrolls increase by more than 275,000 in any one month. We have never had a recovery at this stage of the cycle where that had yet to occur.
4. Home prices have fallen 33% peak-to-trough, which exceeds the 31% drop during the Great Depression.
5. Consumer confidence in an expanding economy averages around

100. In recessions it typically averages in the 70s. Recent consumer confidence numbers have been in the 60s. In fact, confidence is actually lower today than it was after the October 1987 stock market crash, the aftermath of the 9-11 tragedy or the collapse of Lehman Brothers. So much for the average American believing in the recovery story.

6. The U.S. gross domestic product grew at a paltry 1.9% in the first quarter of 2011. If it had not been for the 2% payroll holiday initiated in January, the economy may well have contracted in the first quarter.

7. This recovery is tied for the second weakest on record despite the unprecedented stimulus injected into the system via deficit spending and money creation.
8. Gas prices are up over 30% from this time last year. This might be bullish if it were the result of sharply rising demand. However, it is not.

Much of the developed world remains smoldering in debt while governments and central banks continue to paper-over structural problems with more money and debt to forestall making tough choices now. But isn't this changing in the U.S.? Not really. Even under the most "draconian" plan put forth to date by Congress, the deficit

"The Federal government continues to spend money that no one seems to have, while Ben Bernanke prints the dollars that fewer and fewer people seem to want."

Bill Bonner



quarterly COMMENTARY 2011|Q2

would be cut by roughly \$4 trillion over the next ten years. The part they don't tell you is the debt would still grow by roughly \$3 to \$4 trillion over that same 10 years. And the nasty little secret about all these so called savings is the assumptions they are based upon. An excellent op-ed in the Wall Street Journal penned by Lawrence Lindsey detailed a few of these rosy assumptions. First, the current average borrowing cost on U.S. Treasuries is 2.5%. The long-term historical average for Treasury borrowing is 5.7%. If U.S. Treasury rates just return to their long-term average, interest costs will amount to an additional \$4.9 trillion over ten years. Bye-bye \$4 trillion of savings. Second, the growth forecasts for the economy are believed by many economists to be overly optimistic. Some economists believe a 2.5% growth rate holds historical precedent after a financial crisis. The President's February 2011 budget projects economic growth of 4% in 2012, 4.5% in 2013, and 4.2% in 2014. The ten year budget cost that results from missing the growth estimate by just one point for one year is \$750 billion. So if we grow at a 2.5% trend rate for those three years and miss the President's forecast by a cumulative 5.2 percentage points, we will incur an additional debt of \$4 trillion. The truth is there are no easy options left. Budget cuts in the order of \$8 to \$10 trillion are needed over the next ten years to get the U.S. budgetary system into long-term balance.

Which brings us to the fat pitch. What exactly is a fat pitch? It's when a batter at the plate gets a perfect pitch right down the middle that he can hit out of the park. In investing you rarely get such opportunities. Right now we believe such an opportunity presents itself with the precious metal mining stocks. Through June 30, 2011 gold was up 6.8% and silver was up 14%. One would logically conclude that the companies mining these elements and benefiting directly from their rising prices would also be up on the year. But the market is not always so logical in the short-term. The Market Vectors Gold Miners Exchange Traded Fund (GDX) was down 11.2% and the Global X Silver Miners Exchange Traded Fund (SIL) was down 12.8% through June 30th. Are the fundamentals of these businesses eroding? No, just the opposite. The earnings and cash flows for the second quarter will be very strong, well exceeding the results from the first quarter. Are the fundamentals for owning precious metals changing? Absolutely not. We refer you to the first part of this commentary for some of the reasons gold and silver remain firmly bid. Is the problem that the world has too few dollars and U.S. Treasury debt (hold your laughter please) or that the world has too many dollars and too much U.S. Treasury debt? Obviously, it is the latter. More and more investors are choosing to diversify their currency holdings away from fiat (unbacked) currencies to the world's oldest currencies, gold and silver. So why

the malaise in the mining stocks? In part, psychology. Many investment professionals are continually sounding the alarm that gold is in a bubble. This has had the knock-off effect of reducing interest in precious metal mining stocks. Interestingly enough, we recently found that in the last

Major U.S. Market Indices (All total return)

	Performance (%)		
	Qtr 1	1 Yr	5 Yr*
Dow Jones	0.09	32.37	3.59
S&P 500	0.10	30.69	2.94
Russell 2000	-1.61	37.41	4.08
Barclays Capital Agg. Bond	2.29	3.90	6.52
Gold	5.38	21.56	19.71
Silver	-7.53	86.87	26.76

Source:WSJ & Yahoo Finance, CME Group, iShares *Annualized Returns

— continued on page four



quarterly COMMENTARY 2011|Q2

great precious metals bull market of the 1970s, the mining stocks massively outperformed in the final few years of the bull market. In fact, the mining stocks continued to advance nearly a year after gold hit its peak in early 1980. Psychology had changed at that point from gold is a bubble to gold is going much higher and you must buy the dip. Another factor acting as a headwind to mining stocks is the presence of exchange traded funds (ETFs) that offer direct investment into gold and silver bullion. These ETFs have siphoned away investment dollars that, in the past, might have been deployed to mining stocks. Precious metal mining stocks are now the second cheapest they have been in the last 30 years. For instance, one large gold mining company is currently trading at about the same price as it was when gold was at \$750 an ounce. So the very product they are selling has doubled in price in the last several years, their earnings continue to improve, and the stock barely moves. Which means, of course, the valuation is getting more and more compressed. Like a coiled spring, we expect this and other stocks in this sector to release higher as the pressure from stronger profits forces an upward adjustment in valuation. While this sector has certainly hurt the performance of our accounts year-to-date, we remain very convicted about the fundamentals of owning precious metal mining stocks and remain convinced that those with the patience to see the thesis play out will be well rewarded. One of the most famous investors of all time, Jesse Livermore, stated it quite well when he said, "Men who can both be right and sit tight are uncommon. I find it one of the hardest things to learn." We remain convicted that our overall thesis is correct and thus we plan to sit tight.

A final note. As stated before, many investment professionals have been incorrectly calling gold a bubble since \$800 an ounce. A broken clock is right twice a day and so will these top callers be at some point. We believe gold will likely develop into a bubble over the next several years. We are carefully watching a number of metrics to gauge the soundness of this bull market and will remain diligent in protecting investor capital if the fundamentals underlying precious metals change. That being said, we believe one of the best sectors to preserve capital through this full market cycle given the current macroeconomic environment remains precious metals. Precious metal mining stocks are the "fat pitch," and we are ready to swing.

As always we remain ever vigilant in helping you achieve your financial goals.



2076 Lakeside Centre Way
Knoxville, TN 37922
www.pyawaltman.com
Phone: 865.693.6301
Fax: 865.693.6302

The information contained in this commentary has been provided by PYA Waltman Capital, LLC for general information purposes only. The information shall not constitute investment advice or an offer or recommendation to buy or sell any security, commodity or services. The products and services described in this commentary may not be available to, or suitable for, all investors.

Past performance does not guarantee future results. Market conditions can vary widely over time and can result in a loss of portfolio value.