



quarterly COMMENTARY 2011|Q3

the quarter in review



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The Monster Must Be Fed

It's a terrible thing to create a monster. At first it starts small and seems quite manageable as it doesn't take much to maintain and it serves you. As it continues to grow, however, you

become more concerned with your ability to keep it properly fed. Finally you realize you must continue to feed it or it will eat you! This is unfortunately the sad predicament that many developed nations, including the U.S., find themselves in at the moment. For decades the U.S. and European nations have fueled their economies via consumption made possible by credit creation (debt). This debt monster began small and was beneficial to economic growth on the way up, but now has an insatiable appetite. It must be fed or it threatens to bring down the consumption economies that depend upon it. The following excerpt from *Investor's Business Daily* (Safety Net Outlays Top Personal Taxes By \$100 Billion in 2011, August 30, 2011) states the problem in the U.S. quite well.

“The federal government will spend about \$100 billion more this year on social benefit programs than it will collect in personal income and payroll taxes. Back in 2000, the government had \$720 billion left over from personal tax receipts – more than 7% of gross domestic product (GDP) — after fulfilling its safety net obligations. This reversal highlights how much the government is supporting household demand amid high unemployment, and helps explain why cutting deficits will be a grind unless growth picks up.”

The developed economies are awash in debt from 30 plus years of credit creation and deficit spending. In real terms, the debt-to-GDP ratio of 18 countries in the Organization for Economic Co-operation and Development (OECD) nearly quadrupled between 1980 and 2010. Quadrupled in 30 years! The end of the great Keynesian experiment is upon us. The politicians and central bankers of the world are facing quite the conundrum. The developed economies are now so dependent upon deficit spending that if significant budget cutbacks are enacted the already weak economy will worsen, unemployment will rise, and tax receipts will fall, thereby further exacerbating the budget deficit. If spending continues at the current pace, however, at some point in the not too distant future the financial markets face systemic financial collapse. Politicians and central bankers have clearly chosen to continue feeding the monster, thereby forestalling the day of reckoning while still attempting to cobble together a plan. Here is the evidence of them feeding the monster.

- The American Recovery and Reinvestment Act of 2009: \$787 billion
- Proposed American Jobs Act: \$485 billion
- Cash for Clunkers: \$3 billion
- Federal Reserve Quantitative Easing 1: \$1.7 trillion
- Federal Reserve Quantitative Easing 2: \$600 billion
- Federal Reserve Operation Twist: \$400 billion
- Troubled Asset Relief Program: \$700 billion
- European Financial Stability Facility (EFSF): \$440 billion

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“Gold is simply the reciprocal of the world’s faith in the institution of managed currencies.”

Jim Grant

“Politicians are trying to solve the problem of too much debt by playing for time. This will fail.”

Boston
Consulting Group

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We dare say that many financial market participants want the powers that be to continue feeding the monster. If they don’t, there will be a steep price to pay. Everyone knows that Greece is going to ultimately default as there is no plausible scenario under which they can ever repay their debt. The hope is that the default, when it comes, will be “orderly” and not lead to contagion in sovereign debt markets and a banking crisis in Western Europe that has the real potential to spread globally. History tells us that sovereign defaults normally happen in clusters and are not always orderly. As David Rosenberg often says, “forewarned is forearmed!”

Strategy

We remain very concerned about the systemic risk the financial markets face from the ongoing global sovereign debt crisis. As we have been saying for more than 3 years, a debt crisis cannot be fixed with more debt. The can is just being kicked down the road and the ultimate day of reckoning will be made that much worse. Politicians and bankers fear the economic and social costs of doing the right thing. What is the right thing? Restructuring the debt that can never be paid, recapitalizing European banks, and instituting long-term structural reforms towards fiscal sustainability. The time for short-term fixes is over. At this point, we see no evidence that politicians are ready to embrace such structural reforms. As this sovereign debt crisis moves into the next phase we expect the following:

- Increased volatility in financial markets. Expect wild swings in markets as investors trade

upon headlines and rumors surrounding how policymakers are going to “fix” the problem. Markets will soar higher as policymakers agree to “solutions” only then to sell-off dramatically as these “solutions” begin to fail over time and the same problems reemerge.

- Policy makers will respond in force to a spreading crisis. The Europeans will not allow the Euro currency to dissolve without a fight as the consequences are quite severe. One of the most important questions is whether they will attempt to get out in front of this crisis (not their history) or react in a forceful way to the crisis as it unfolds. In addition, the Chairman of the Federal Reserve, Mr. Ben Bernanke, stands ready to act with even more quantitative easing (money printing) if the economy weakens further and deflationary threats reemerge. Policy makers are not going to stand by and do nothing if/when the crisis intensifies.
- Sub-par economic growth in developed nations will continue. The total indebtedness of developed nations and consumers will likely keep economic growth in a 1 to 3 percent range barring some major coordinated policy initiative.
- Investors will increasingly question the “risk-free” nature of sovereign debt. If Greece can default so can other European nations. As investors increasingly study the balance sheets of developed nations the notion of what is an appropriate “risk-free” rate may well begin to change. This will include the U.S. Treasury market at some point in the future unless substantive change is enacted.
- Fiat (unbacked) currencies will become questioned. The longer governments and central banks attempt to fix this sovereign debt

“Global markets are addicted to the juice (money printing); without it – valuations fall.”

Fred Hickey

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crisis with more debt and money printing, the greater the risk that fiat currencies will become questioned as investors lose faith in the promise of governments to responsibly manage their currencies.

Given such a backdrop, we continue to favor precious metals and mining stocks and underweighting the general equity market. The precious metals markets experienced significant volatility along with the overall equity market in the month of September. Part of the reason the gold market corrected in late September was the selling of gold by some hedge funds in order to meet margin requirements and investor redemptions. As gold was one of the few asset classes positive for the quarter and the year, it became the go-to asset to sell and thus a victim of its own success. None of the fundamental reasons for owning gold have changed. The world continues to drown in debt with global debt to GDP at 350% versus 225% during the great depression. Politicians and central banks continue to attempt to “solve” the crisis with more deficit spending and money creation thereby further debasing their paper currencies. This is why physical demand for gold and silver actually increased as the paper price of these

metals fell. Institutions awaiting such a pullback increased their allocations to this market as insurance against the unfolding sovereign debt crisis and the ongoing policy response of more money printing. The unfortunate truth is there is no way out of our global debt problems without some level of pain or more money printing. We are pretty sure which option policymakers will continue to choose. The sooner politicians institute structural reforms, the sooner we will be on the road to a durable recovery. Until then we plan to remain invested in precious metals and mining stocks and underweight traditional equities in an effort to preserve and grow your capital through this crisis. While volatility can be unsettling for even the most seasoned investors, we continue to believe precious metals remain one of the very best asset classes to own in this environment.

We appreciate the trust you place in our services and remain ever vigilant in helping you meet your financial goals.




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

	Performance (%)		
	1 Qtr	1 Yr	5 Yr*
Dow Jones	-11.49	3.83	1.37
S&P 500	-13.87	1.14	-1.18
Russell 2000	-21.87	-3.53	-1.02
Barclays Capital Agg. Bond	3.82	5.26	6.53
Gold	8.02	24.26	22.14
Silver	-13.05	37.97	21.40

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