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Running on Fumes: Update on the Debt Supercycle

Eighteen months ago the *Client Quarterly* featured a discussion of the Debt Supercycle, described as that “long-running feature of the post-World-War-II era” through which “the belief that authorities are always willing and able to reflate tends to encourage successive rounds of debt-driven speculation.” However, this time around the wave of retrenchment has held the upper hand over efforts to reflate.

Americans’ net worth took an estimated eleven-trillion-dollar hit in 2008, roughly equal to their collective disposable income. Consumers clearly have become a tougher sell, and the savings rate is rising. Businesses are hunkering down in the face of suddenly slack demand. Monthly job-losses have been large with the unemployment rate recently topping 8%. Congress and the Administration look to counter with large dollops of federal spending.

The Last of the Big Subprime Borrowers

Those no-money-down, low-teaser-rate mortgages may be a thing of the past, but Uncle Sam is still taking advantage of very cheap money and hoping rates don’t surge too soon. At this writing 90-day to one-year Treasury bills yield just 0.23% to 0.69% (yes, that’s *annualized*). Short-term U.S. Treasury debt has been the mattress of choice for global capital willing to settle for precious little return *on* the money in order to ensure a return *of* the money.

That’s a blessing for now as federal borrowing needs have soared and will continue to do so in the months ahead. But with the deficit headed for unprecedented levels in both absolute and relative terms, economists may start to worry that we’re entering a “debt trap” where the cost of carry is not supportable by the larger enterprise that is the U.S. economy.

So far that’s not the case. In fiscal 2008, ended last September, the federal government’s net interest expense rose less than 5% over 2007, despite a 15% jump in its outstanding debt.* Fiscal 2009’s net interest expense is actually running *lower*, even with huge new borrowings. This is the lovely side of rolling and adding debt at rock-bottom rates.

But there is a catch. If stimulus spending and the economy’s natural recuperative powers *do* prevail, interest rates would be expected to rise, boosting the cost to carry all that debt. And that’s the *optimistic* case. If the economy stays weak, low rates may hold, but the government’s borrowing needs will be even higher. Also, the average maturity of outstanding Treasury debt has been getting shorter, so a greater share of it will have to be refinanced sooner.

How deep is this hole?

The last crisis point along this curve was in the mid 1980s; the federal deficit actually peaked in relative terms at 6% of gross domestic product in 1983. Deficits had risen for 14 years but moderated after that. The ratio of debt-to-GDP topped out in 1993 at 49.4%.

It looks like we’ll blow through *both* those records this year. The recession is dampening tax receipts even as federal spending balloons to perhaps 27% of GDP, a level not seen since World War II. The 2009 *deficit* may hit \$1.7 *trillion*: about 12% of GDP and more than 40% of the budget itself. Can we work our way through this as we’ve done before?

In 1983 interest rates were much higher than today, but they were headed lower. About 80% of federal debt was held domestically, the economy was growing, and we weren’t staring the baby boomers’ retirement in the face. Federal tax revenues were rising and continued to do so at a pretty healthy pace over the balance of the 1980s and ‘90s.

Today, interest rates on government debt *can’t* go much lower, nearly half the debt is in foreign hands, and the economy is reeling. Through the first five months of fiscal 2009 federal receipts are *down* more than 10%, led by a 45% collapse in corporate income taxes. Getting the federal fisc back in shape may take quite a while.

A Few Glimmers

The debt supercycle may appear to be sputtering on fumes, but there are some positives out there. Many consumer prices are down (see accompanying

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* **Note:** This analysis uses “debt held by the public” as the operative measure. That’s external debt incurred to finance ongoing federal spending. In setting its statutory debt ceiling the government *also* counts as “debt” certain “trust fund” balances (Social Security, Medicare, etc.). These balances represent a ledger of past tax collections in excess of expenditures for those programs, plus credited interest. They provide a philosophical and statutory basis for paying future benefits, but do *not* represent a current external debt servicing burden. Nor do they represent actual savings set aside to pay those benefits.

Questioning Diversification Amidst the Wreckage

This great bear market has been notable for the lack of any real hiding place in the wide world of equity and fixed income markets. In the crisis that swept the financial world, hardly any sector has been spared, except, of course, for cash and cash equivalents. Some have even questioned whether diversification and asset allocation still make strategic sense.

Even through the train wreck of the past year diversification has provided some cushioning. As shown in the table below, not all sectors have been trashed equally. And the *degree* of decline in a portfolio can matter a great deal. Consider the difference in results over the past year for the average "Flexible Portfolio" fund (-30%) versus a blend of 75% domestic and 25% foreign *stock* funds (-48%). Recovery from the former requires a gain of 43%, the latter over 92%. The fact that both are daunting numbers shouldn't cloud the material difference in those respective tasks.

There's also the question of positioning for recovery. Investors have fled markets far and wide for the apparent safety of cash, short-term Treasury securities, etc. But at some price level capital should be drawn back to the potential for higher returns. It's not easy to determine where that pull will be greatest or the sequence in which different market sectors or regions may find favor with investors once again.

Some observers see bonds as the probable, perhaps even necessary, focal point of initial recovery. After a very trying 2008, key sectors of the domestic bond market have been more palatable in recent months. Tax-exempt municipal bond yields in particular have drawn investor interest, making that sector a rare source of positive returns so far this year.

Another area that may bear watching is emerging Asia. Those markets took a big hit in 2008, but observers note the region's underlying growth potential, healthier foreign exchange reserves, and lower debt levels compared to most developed nations.

Emerging market funds have been pretty volatile, but they are the one major equity fund category posting meaningful returns over the past decade. Some contend that the U.S. economy and markets must lead the world out of this bad patch. That may be right, but there's still a case for staying... diversified. §

RMD Takes a 2009 Holiday

In the final days of 2008 and amidst the pummeling of Americans' retirement portfolios, Congress and President Bush approved the Worker, Retiree, and Employer Recovery Act of 2008. It suspended required minimum distributions (RMDs) from IRAs, 401(k) plans, and similar retirement accounts for 2009. Those who normally would have to take a distribution can elect to keep the money working in those tax-deferred accounts and avoid that taxable income this year. But there are a few wrinkles.

If you turned 70½ during 2008 but did *not* take your initial RMD in 2008, you still must get that one done by April 1, 2009. That distribution is still calculated using the value of the account as of December 31, 2007.

If you turn 70½ in 2009, you now have until December 31, 2010, to take your *first* RMD, which will be for tax year 2010, based on your account's value as of December 31, 2009.

If you have an inherited IRA, and you are taking withdrawals under a five-year deadline to fully withdraw the balance, you can skip the 2009 distribution, effectively extending that timeline by a year.

If you *need* to take a distribution for current spending, you certainly may. But liquidating from some account *other than* your IRA, and avoiding the taxable distribution, could be a better option this year. For many retirees, each additional dollar of taxable income also increases the share of Social Security benefits subject to income tax. With no IRA distribution in 2009, one might be able to reduce estimated tax payments. After all, it is a "holiday." §

Performance Summary: Major Mutual Fund Categories*

Mutual Fund Category	Total Return w/ Dividends and Capital Gains Reinvested --- Annualized through Mar. 6, 2009 ---				
	YTD	1 yr.	3 yr.	5 yr.	10 yr.
Large-Cap Stocks (Core)	-22.5%	-45.6%	-17.2%	-8.4%	-4.4%
Mid-Cap Stocks (Core)	-21.9%	-47.0	-18.2	-7.5	1.6
Small-Cap Stocks (Core) †	-26.7%	-47.1	-20.8	-8.8	2.0
Foreign Stocks †	-23.3%	-51.5	-16.7	-4.6	-0.3
Emerging Market Stocks †	-14.9%	-58.1	-14.7	0.8	7.4
Flexible Portfolio	-11.4%	-30.0	-8.6	-2.4	1.7
General Bond	-4.3%	-9.5	0.5	1.9	4.7
Int'l Income (non-U. S.) †	-6.8%	-10.7	2.5	2.7	4.7
High-Yield Taxable Bond †	-1.3%	-24.5	-7.5	-2.4	1.0
General Municipal Debt	4.3%	-3.8	-0.1	1.0	2.9

* Source: Lipper, as reported in the *Wall Street Journal*, March 7, 2009.

Past performance is NOT indicative of future results.

† Small-cap stocks and high-yield (lower rated) bonds pose greater risk and price volatility than securities of larger, well-established companies. Securities of companies based outside the U.S. may be affected by currency fluctuations and political or social instability to a greater extent than U.S.-based companies.

High Profile Scandal Offers Constructive Reminders

The financial world was stunned recently by the revelation of one of history's largest apparent investment frauds. Bernard Madoff, a long-respected figure on Wall Street, admitted that his exclusive advisory service was really a Ponzi scheme. Ponzi was an early 20th century swindler, and such schemes generally involve raising money from investors and purporting to generate returns, but in fact just making payouts to some investors with funds "invested" by others.

Mr. Madoff's fraud appears to have run into the tens of billions of dollars over the past few decades. Apparent victims include many wealthy individuals, established charities, international banks, and investment firms that specialize in placing client money with private managers and hedge funds.

So how could so many seemingly sophisticated folks have failed to detect such a large, long-running scam? In hindsight the flags seem to have been rather obvious, but these same elements apparently were part of the attraction for some who were defrauded.

- Unusually steady and attractive returns through both up and down markets;
- Secretiveness as to the investment strategy;
- Outdated systems and statements with little transparency or online access for investors;
- An air of exclusivity and privilege surrounding access to the manager's services.

Basic precautions need not be complicated. They might include reviewing cancelled checks for appropriate endorsement; checking statements and confirmations for accuracy and consistency; verifying holdings directly with an independent custodian; and noting unusual procedures for withdrawing money. Also, if a portfolio showed strong results this past year, that fact alone might warrant a closer look. §

The Client Quarterly Turns 20

The *Client Quarterly* debuted in April of 1989, making this "Spring" edition the publication's 80th and an anniversary of some note. The *Quarterly* has focused on a few key themes played out across the evolution of dynamic markets, innovation in financial products and services, changes in tax law, and the shifting currents of a global economy. Those themes have included global growth opportunities, broad diversification, risk assessment, cost consciousness, and the sheer unpredictability of events that drive markets and shape our lives.

These 20 years have seen many periods of upheaval and apparent dislocation. None has rivaled this past year's sustained assault on the ramparts of what had been widely accepted as prudent investment practices.

Reviewing Your Estate Plan With a Higher Exemption

If you're reading this, it's obviously *not* too late for you to review your estate plan. And there's more good news. With the arrival of 2009 the federal estate tax exemption jumped from \$2 million to \$3.5 million, or up to \$7 million for a couple with appropriate planning in place.

There's still some uncertainty about *future* estate taxes. Under current law the federal estate tax is scheduled to disappear in 2010, then come roaring back in 2011 with the much lower exemption and higher rates from a decade ago. With the federal government running huge deficits it's hard to imagine Congress allowing the estate tax to go away even for a year. President Obama has indicated support for locking in the 2009 levels, so many see that as a likely scenario.

In any event, it may be worth checking your estate plan to make sure it still makes sense with the higher exemption. In a typical plan a couple may have established a bypass trust designated to receive "amounts up to the federal exemption" at the first death. The idea is to make full use of *each* spouse's exemption. Income from the trust generally is available to the surviving spouse, but the ultimate beneficiaries are usually the next generation.

But with the higher exemption, such a provision might direct too much into the trust and leave a relatively small share of a couple's assets readily available to the surviving spouse. He or she may be able to tap the principal of the trust, but that can trigger legal issues and possible friction with other beneficiaries.

The higher exemption also may imply some strategic changes for disposing of significant IRAs or other retirement plan accounts, as well as highly appreciated assets. Life insurance put in place for estate liquidity is another element that should be reviewed.

The estate tax exemption isn't the only change in circumstances this past year. Declining values across a range of financial assets and real property may suggest a need to review charitable bequests and other aspects of your plan for disposing of those assets.

Finally, even though the federal estate tax exemption has seen a big jump, a number of states, including Washington and Oregon, have effectively decoupled from federal law. Those states' tax schemes may claim a meaningful chunk of an estate even if it wouldn't incur *any* tax at the federal level – yet another reason to consult carefully and periodically with your estate planning professional. §

Maybe a few lines from these page have helped prepare readers for these trials, and maybe not. As noted in the past, cautious optimism has been a winning long-term bet for investors. Holding to that view has never been quite so challenging as it is today. §

Running on Fumes ... (continued from page 1)

article on autos); lower oil prices in particular tend to ease cost pressures across much of the economy. Productivity growth has revived, although that's partly the statistical effect of businesses cranking out products and services with fewer workers.

According to the *Bank Credit Analyst*, corporate balance sheets are actually in reasonably good shape

So Many Cars, So Few Buyers

What is it about politicians and auto makers? It seems every country with a "domestic" auto industry is rushing to prop up these beleaguered emblems of industrial prowess. Government-guaranteed loans are being extended along with incentives for those few folks actually in the market for a new car (or two).

In recent years many of the same governments actively promoted the expansion of their domestic auto makers. According to *BusinessWeek*, global production capacity had grown to nearly 90 million cars a year. Current demand is way down, and production has scaled back to around 65 million vehicles.

Cars and trucks are hardly the only manufactured goods in oversupply. The world's producers of semiconductor wafers are estimated to be running at just 62% of capacity. North American steel makers have temporarily shut down 16 of their 29 blast furnaces. That crimps demand for raw materials. Global oil consumption is running some five million barrels *per day* below production capacity.

Of course making a car uses *all* that stuff, which helps explain why so many politicians are trying to entice you to take the plunge on a new ride. That's good news if you really *need* one. §

outside the financial and auto sectors. Many companies used the 2003-2007 recovery to cut debt and build cash reserves. The recent pullback in sales was sudden and deep, from nearly a 10% growth rate to a 10% rate of *decline* in less than a year. Operating profits for the Standard & Poor's 500 fell 37% over the past two years and may be down another 15% in 2009. But the earnings cycle should turn at some point.

That raises the question of valuation. Productive assets around the world are for sale at some of the lowest relative prices in a generation. Might they go lower? Sure. Is the long march of human enterprise and progress at an end? Probably not. §

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