2013 Annual Economic Report

What Have We Become? – Where Are We Headed?
Protecting Capital in a Declining Empire

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“We live in a fiat currency system…the United States government can create an infinite number of dollars at no cost to meet its obligations. A Treasury bill is a promise that the government will give you U.S. dollars.”

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What We Have Become

Two weeks ago, America averted a fiscal crisis by raising taxes a bit. The “raise” amounted to about 6% of the annual deficit. This is what passes for “hard work” in Washington. They also decided on zero spending cuts; rather, they decided to increase federal spending by at least 19% in the next 4 years. One side argued, “We cannot borrow our way to prosperity,” while the other side argued, “Spending cuts will cripple the economy.” It is obvious to me *that they are both right*. Neither party has a plan to reduce the deficit, therefore, the national debt will rise further for the foreseeable future. The American way of life is sustained by borrowing. The deficit is unsustainable. No one disagrees.

The federal government spends 60% more than the taxes it receives each year, yet it will spend more until it has no more to spend, until the lenders stop lending.

The foundation of a nation is both political and economic. On both counts, America is severely fractured. The two political parties, and increasingly, our citizens, truly hate each other. The racial divide grows as does the divide between America’s wealthy and working Americans. On average families have a lower net worth than at any time in the past 43 years, and more Americans are the dependent on the government for food, clothing, and shelter. Neither spending cuts nor tax increases will lead to a stronger America. Neither side has new ideas. Still worse, political partisans have no more trust or good will towards the other side than do the Arabs and Israelis. The fractures grow. What have we become?

The present and growing levels of federal, state and municipal debt, along with the trillions of unfunded government liabilities put America’s solvency at grave risk.

Our view is a minority view. Investors are so confident in America because America can print unlimited amounts of cash and debt. At this time the consequences are muted, as we are largely borrowing from US citizen’s retirement plans and US bank deposits. In the following pages I share facts, questions, and concerns about the health and wealth of our nation, the threats to our nation, and sources of lasting wealth.

Summary:

Unless America implements a plan to reduce the deficit, a crisis is inevitable. Until it does, the US equity & bond markets are at risk of a serious decline. Investors are cautioned to reduce their holdings of US equities and add alternative currencies and hard assets to their portfolios.

Facts

1. From 1950-1980 federal debts grew by 350%, from $257 billion to $907 billion, 4.45% per year.
2. From 1982-2012 federal debt grew by 1450% from $1.14 trillion to $16.4 trillion, 9.63% per year.
3. *In the past 10 years, our nation's debt grew by 11.35% PER YEAR*.
4. In the past decade, 100% of new economic activity was created by debt.
5. At some point, interest rates will rise. No one disputes this. A one-half-of-one-percent (0.5%) interest rate increase will lead to additional interest costs of $80 billion per year.
6. Washington's economic forecasts do not include contingences for rising interest rate costs, new winter storms, new wars, higher unemployment, lower tax receipts, bank bailouts, etc.
7. Corporate and personal taxes will rise, and corporate earnings may decline.
8. When corporate earnings fall, U.S. stock prices fall.
9. When corporate earnings fall, corporations pay less tax and hire fewer workers.
10. When stock prices fall, tax revenues to the government fall and retirees become poorer.
11. Every proposal to "fix" our economy involves spending cuts, tax increases, or both. These tactics may result in *some* economic contraction, resulting in falling tax receipts to the IRS.
12. Borrowing and spending another $5 billion or $10 billion will not make America stronger.
13. America's economic problems appear circular and unresolvable. Einstein said it best: *"We can't solve problems by using the same kind of thinking we used when we created them." He also said, "Insanity: doing the same thing over and over again and expecting different results." Albert Einstein*

Questions & Troubles

1. Can the size of American debt ever be *too much* debt?
2. If so, what amount of debt would be *too much*?
3. Who will tell you when we have borrowed too much?
4. Would rational people limit their spending at any point? When?
5. Wealth is the absence of the need to borrow. Does a "wealthy" nation need to borrow money to survive in increasing amounts nearly every year for close to 40 years?
6. Would a wealthy nation "pay" the interest on their bonds with more bonds?

The White House forecasts that its deficits will add about $100 billion to the debt *every month*. In the future what will a congress do that congresses of the past 5, 10, or 20 years could not do? Perhaps the new policies will lead to a healthy and growing economy, however, I do not see meaningful differences between the fiscal policies of the current administration and fiscal policies of the last 10 or 20 years. If the policies of congress do not turn our economy around, our nation may be more than $20 trillion in debt within four years. If interest rates rise to 5%, the interest would cost $1 trillion dollars or about 100% of our total income taxes. America may become a stronger country in the next 4 years, but maybe not. As the author stated in the Forbes article, "***The United States government can create an infinite number of dollars at no cost,"*** but things change over time and, often, they change at the worst possible times.

Our Investment Outlook

No matter what happens domestically, we will still owe China over $1 trillion. China is our biggest foreign lender and a serious economic competitor. Our politicians use the term “trading partners” to describe our relationship with China. Partners? Really? Many Americans believe that we will never have to repay China or anyone else. They say China is in the weaker position than the U.S.

Which country is more vulnerable?

> 1) China has plenty of cash and a fast growing economy, even independent of U.S. buying. However, it will need new buyers of its manufactured goods as it grows.
> 2) The U.S. desperately needs cash and buyers for bonds that do not pay interest and can be sold only in small amounts. Moreover, the U.S. does not allow China to buy U.S. farmland, mines, oilfields, timber or high technology products, which make up 90% of what they need.

China may develop a domestic consumer class that can absorb its own production. China is helping third world countries develop and open markets for their goods. China’s military and its holdings of U.S. bonds give it significant leverage in negotiating with the U.S. congress and every country in the world.
Asia is growing. Western societies are not. 2.5 billion Asians require (and will always require) commodities such as copper, nickel, and precious metals for industrialization. Asia is now the largest consumer of commodities. That is not likely to change. Asians have tasted modern life. They work hard, and they will prosper. With little or no safety net, Asians have no choice but to work hard at wages of less than half of those in Western societies. With Asia’s extraordinary work ethic, low taxes, and lack of employee rights (let alone employee benefits), the West poses no challenge to their manufacturing growth and, likely, dominance.
What are America’s choices if China or other major U.S. debt buyers stop or reduce their buying of our debt? We need China more than they need us. Interest rates will rise.
The purchasing power of the U.S. dollar will shrink. Taxes will rise, our imports will likely decline, and commodities will significantly increase in value relative to the U.S. dollar. Commodities have lasting real value. “Money,” printed at no cost in unlimited quantities, holds little promise of holding value. America does not have the ability to repay its debt. When the masses recognize this fact, the markets will very abruptly decline. In our view, the “safest havens” are currencies of the strongest countries and commodities that will remain in demand all through time. There are two likely “safe havens”: real estate and precious metals.

The U.S. Markets Have Never Been Stable or Reliable
That Will Not Change.

Long-term investors in the U.S. markets have not been well rewarded for the risks they've taken, and now the risks are rising. Over the past five decades, the U.S. markets have risen and fallen by 15% to 25% several dozen times. Occasionally the declines have reached 40% to 60%, and a few times the market has rocketed up by 75% to 100%. Over the long term, the major indexes have not beaten the inflation rate meaningfully.

Before making adjustments for taxes and Inflation, here is how the U.S. markets have performed:

- Over the past 5 years, the Dow Jones Average has gained nothing.
- Over the past 10 years, the Dow has risen an average of 5.5% per year.
- Over the past 20 years, the return was 6.1% per year.
- Over the past 30 years, it's been 9%.
- Over the past 40 years, the Dow gained an average of 6.65% per year.

After taking into account the damage caused by inflation and paying taxes on gains, those returns are hardly exciting. My experiences in the past 35 years have taught me to ***buy*** only when the market is very weak, not before, and to ***sell*** only when the market is strong, and to invest in assets that will be in demand over the very long term.

The prices of securities fluctuate, some more so than others. The price of a stock is not what a company is worth. If it were, its price would move in tandem with the degree to which a company creates wealth. In the short run, prices do not reflect company value, rather they reflect the current mindset and the emotions of investors. The actual value of a giant 100-year-old company with a clean balance sheet that sells its products world-wide actually changes very little over a year or two, but its stock price may fall or rise by 40% or more in just a few years. Such price movements are irrational.

Big price movements are upsetting when they go against us. We must remember to sell after prices have risen dramatically and buy after they've fallen significantly, not the other way around.

A friend told me, "Some things don't seem to matter much, right now, like our debt. But," he continued, "When those things do matter, nothing else will seem to matter." -Joe Wilkinson

The Arithmetic

We can estimate the amount of debt we can actually pay-off using basic arithmetic.

- Our nation's debt is $16.4 trillion. Think of a nation's debt as a mortgage on America. To pay off $16.4 trillion over 50 years at 2.5%, we'll need to make annual payments of about $640 billion.
- When a government sells bonds, it is just like a mortgage. If it is not a "mortgage," what is it?
- Income taxes collected by the government after the new tax-hikes will be about $1.3 trillion.
- If we don't cut spending, we must raise income taxes by 50% to pay off the debt in 50 years.
- Congress told us last week that if we raise taxes by even 10%, the economy would collapse.
- We need $1.2 trillion to close the deficit, but they increased taxes by only $60 billion. They say that when they raise taxes, spending declines, and we "need" Americans to spend more.
- The total amount of taxes that Democrats fought so hard for and that Republicans fought to "protect" is only about 6% of the deficit. Both parties acted as if life on earth depended on their vote. Why?
- When will they/we pay-off this debt? (If we never have to repay the debt, why not borrow more, much more?)
- When borrowing for a home, bankers tell us to keep our mortgage payments (principal and interest) around 30% to 35% of our incomes.
- What LAWS apply to a government when it fails to repay its debt?
- When lenders demand that we repay our debt, how will the conflict be resolved?
- How much can a nation spend on interest payments, as a percentage of its total tax revenues?
- If Americans do not want any of their taxes to be ear-marked to pay off our debt, then we will demand that our children to pay-off the money that we spent, out of their incomes. Is that "nice"?
- Have you ***ever*** heard ***any*** politicians mention how we, or our kids, could possibly pay off the debt?
- In the last decade, our debt rose from $6.23 trillion to $16.4 trillion. That is a 263% increase. Could it double again? And again? Then what?

Now What?

- Why didn't politicians correct this problem 10 years ago? 5 years ago? Or last year?
- Could it be that they cannot correct this problem? If so, what does that mean for U.S. stocks?
- If politicians cannot fix or correct this problem, what will happen to our economy, *to our nation*?
- Americans can't conceive of our government failing to pay bills, of going into default on its debt.
- Yet, the only way the government currently "pays" its bills is by borrowing more.
- I've never seen a government or independent economic forecast that shows how the United States can or will pay-off its debt. I am not sure what this means. I do not ignore this fact.
- Do you have reason to believe that congress will slow down its creation of debt, let alone stop it?
- When the government borrows money, a large percentage of those loans are purchased by the Federal Reserve Banks. Where does the Fed get money? Why haven't they always done this?
- Foreign nations may demand 5% or 6% (or more) in interest to loan us money. Then what?
- If foreign lenders require that we make interest payments in ***cash***, rather than accept more debt as a substitute for cash payments, where will we get the cash?
- If foreign lenders charge us 6% on the $5 trillion we owe them, it will cost us $300 billion in cash.
- That's about 25% of the income taxes the IRS collects.
- What percentage of your savings would you loan to a ***private*** company that has no ability or plan to repay you the money you loaned it?
- The ability of a nation to repay a loan, like a company, is determined by math, not intentions.
- Can we just tell bondholders that we will not pay interest or principal?
- Will we borrow until lenders shut us off from further loans?
- Specific steps to strengthen our nation remain outside our vision.
- What is a bond worth that pays no interest?
- What is a bond worth that cannot be paid back?

Basic Economics

- No government has ***ever*** created an ounce of wealth; they ***take*** what the private sector produces.
- Wealth is produced by discovering, making, and/or selling things or services.
- Government is an obstacle to discovering, making and selling goods and services.
- Government creates paper money, but paper money is not real or lasting wealth.
- If “paper money,” which can be created at no cost, was real wealth, there’d be no need to work.
- What did a car, house, wheat, corn, oil, copper, nickel, or gold cost 30 years ago?
- In the long run, history has taught us that commodities appreciate more than bonds.

The Political Problem

Clearly there are many more than two possible approaches to improving our economy, yet politicians only offer two possibilities: more or less government, more or fewer taxes, more or less military, more or fewer regulations. “We can't solve problems by using the same kind of thinking we used when we created them.” In the last 50 years, neither Democrats nor Republicans have come up with any new ideas. In our lifetimes, every president has spent more than his predecessor; both political parties have failed. If we do what we did yesterday, we will achieve what we achieved yesterday.

One Hope

Our nation’s problems seem overwhelming. Fortunately, America is home to millions of creative, intelligent, and compassionate people who care about you and me, even though they’ve never met us. They are dedicated to improving America. They are largely young and idealistic. Some are old and wise. At the end of World War ll, both Japan and Germany were nearly completely destroyed. Their major roads, factories, and sources of electric power were destroyed. They recovered and built great nations. We can too, but not until we have a plan to follow. We do not have such a plan yet. Truly, all we have is hope. Hope will change nothing; hope is neither a strategy not a reason to trust a politician. Sadly, both candidates offered no clear plan for recovery. I see little *reason* for optimism. I see no plans of rebuilding America into a world-class competitive productive force.

It is not my intention to discourage you, but to offer you an unbiased picture of the risks in the economy and the U.S. investment markets. I spend time studying economics ***because*** to protect your capital, we must invest in the strongest countries and in assets that will have lasting value. America needs a competitive middle class to support a modest-sized government. A larger government cannot create a competitive workforce, better health, or a growing middle class. Our one hope is that new people come into power with a new perspective, more like Lincoln and Einstein rather than Bush and Obama.

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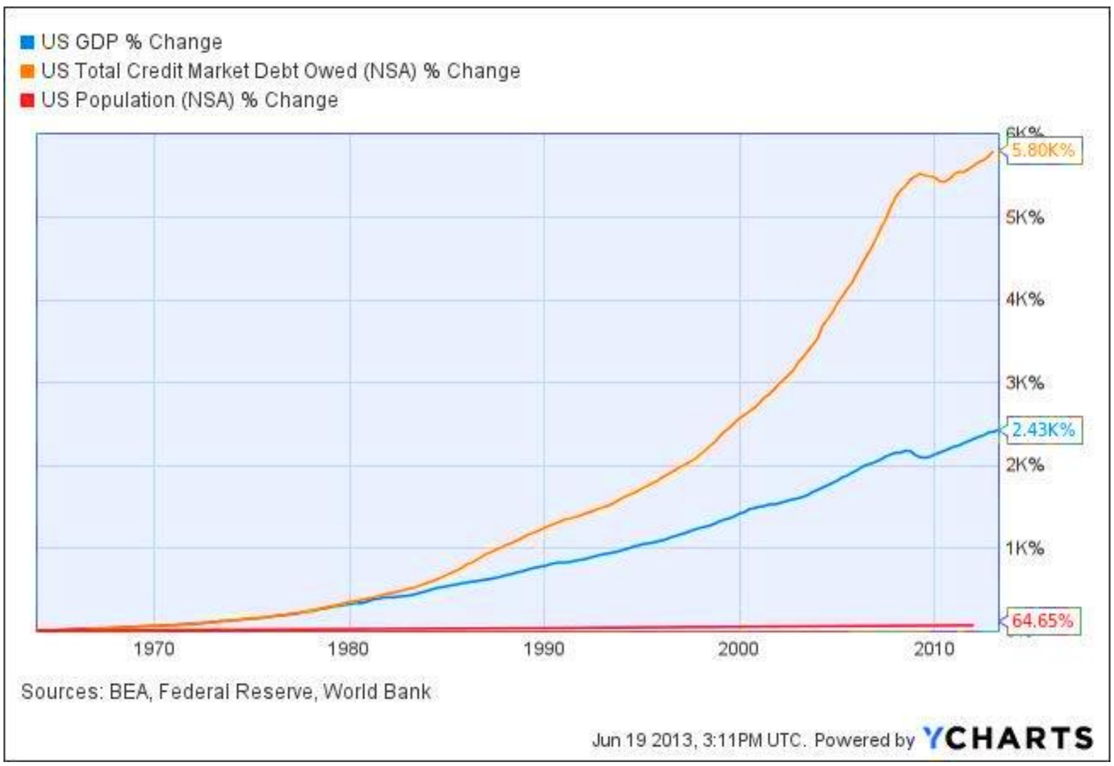
"Wealth is the absence of the need to borrow. If America were wealthy, it would not so desperately need to borrow increasing amounts of money to sustain its standard of living."

Ray Mullaney



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