

A Critical Moment

Second Quarter 2010

We would like to be a little more serious this time. Things are not going well in the country or the world, and this isn't going to be easy. Is it a "New Normal" as our friends at PIMCO say? Well, in some ways it is. With the massive deleveraging of financial institutions and households taking place, there isn't much credit, and no one is spending, except the government. And the government stimulus has not proven to be very stimulative to anything except the public payrolls.

As always, we will eschew a lot of data and sources, this isn't Barron's after all. You have many sources of good data; here we will try to focus on the big picture and make sense of it, if we can. A few bullet points to consider:

Good news – economy is growing a little, in fits and starts, unevenly

- Weighed down by deleveraging and reregulation (two out of three ain't bad for PIMCO¹), but still growing a little.
- No inflation in sight; deflation is the fear right now.
- Interest rates extremely low.

Bad news – 10-20% unemployment, a large portion of which is structural

- We may have missed the chance to cut it down with a huge stimulus package, which appears to have been ineffective.
- Now these people are out of work for the long run, and we have a structural problem.
- Official numbers (9.5% at last count) badly underestimate the real numbers.

More bad news, and the big constraint on any course of action we might choose: huge government spending, debt and unfunded liabilities growing worse by the day; total federal debt next year is expected to exceed \$14 trillion.

¹ PIMCO is probably wrong about deglobalization; globalization is a tidal wave, unstoppable. The world will continue its rapid evolution into a new global economy, with many bumps and crises along the way, but nonetheless moving steadily and rapidly forward.

**From here
you can see
everything.**

In response, President Obama appointed a National Debt Commission. Alan K. Simpson (R), a former senator from Wyoming, and Erskine B. Bowles (D), White House chief of staff under President Clinton, head this bipartisan effort to address the problem.

Mr. Bowles recently said many alarming things, among them: "This debt is like a cancer." The point: we now have official White House and bipartisan confirmation that the debt is a catastrophe, and as we said in previous letters, out of control and unsustainable. There won't be any marvelous cost savings or revenue increases to solve the problem; there is no hope of that. The only question remaining is whether we will take effective action in time.

At the State Level

Interesting News - Union employment numbers – shedding light on employment and state deficits

- Public vs. private sector union compensation – large premium for public employees, far bigger than *all state deficits combined!* In other words, if public employee compensation was cut to private levels tomorrow, the deficits would become surpluses.
- Retirements often start as early as age 50, with full wages and benefits – unfunded by over \$3 trillion.

Many states are in big trouble, saddled with huge bloated payrolls and unions they can't deal with; the deficits are soaring. California is a case in point; we often look out the window in the morning to see if we have fallen off the edge of the country yet. Arnold tried to make changes in his first term, but failed, and the problems are far bigger than ever now.

I thought I might get some insight from watching the original Terminator the other night, and I did! The same story, a perfect forecast of Arnold's political future. He starts out naked, dropped into a strange place as a "man" on a mission. Within seconds he is greeted by the locals and stabbed. But he's tough, he handles the first batch of girly men and persists. He is then shot many times with various firearms, thrown from a fast moving car, hit by a truck, blown up, burned alive, beaten with a large metal pipe, and ultimately crushed completely flat.

The good news, after all that, is that states are prohibited by law from running deficits. They can (and do) play some games, but unlike the governments of Greece and the U.S., they can't borrow to fund deficits. While the debt of these two countries soars close to or even beyond 100% of their GDP, the state shortfalls are still a very small fraction of the "GDP" of each state. Despite the headlines, these states will have to close their deficits and they will have to pay the interest on their muni bonds, they are required to by law and cannot declare bankruptcy. Some municipalities can go broke, and have, so careful credit

analysis and monitoring is essential, but overall muni bond credit is solid despite the headlines. Good news indeed.

What Now?

Can you forecast the elections and government actions? PIMCO is trying. They hired a government guy to help them cope with the New Normal, and I can't blame them. But it is a dicey business at best.

Elections in November contain the potential for substantial change in Washington, and therefore in the policies that we are all so concerned about, including taxes, healthcare and government spending generally. Who can confidently predict the series of events and outcomes we will see over the next two years? *And who knows how and when the markets will react to these things?*

The point is that, while we are likely to be in for a rough ride, the overall economy may well be OK, and markets, which look out into the future, may do very well, or no (as they say in Minnesota). As always, this business of trying to guess where the market is going is a fool's errand, a trap waiting for the unwise and unwary. As difficult as it may be to stick with a disciplined strategy, it is far better than the punishment the market can administer to people who try to time it.

If you have the right risk level, the right mix of equity and fixed income, stick with it. If you are not sure, let's talk soon! We are always here to help.

Sincerely,



Roger C. Hewins III

President

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