CAUBLE & HARRE WEALTH MANAGEMENT

PETER B. HARRE, CFA
Principal

12977 NORTH 40 DRIVE, SUITE 213
ST. LOUIS, MO 63141
OFFICE 314.576.1112 MOBILE 314.495.7100
peter@caubleharre.com

April 5, 2011

The first quarter continued the trend established last year. Each quarter investors were greeted by steadily and slightly better economic indicators and better than expected corporate earnings. Institutional investors, for the most part, were buyers of stocks throughout the year, and individual investors began moving funds back into equity mutual funds at the beginning of this year. These trends continued during January and February. The valuation of the market moved up as well, although not to extreme levels. By valuation I refer to the price earnings ratio. Prices were moving up and earnings were also moving up. At the end of February, the PE ratio was such that continued earnings gains expected through 2011 would have moved the level down to historical norms.

Of course we have to wait until December to book 2011 earnings gains and bad things can happen before then. Both the events in Japan and the unrest in the Middle East and North Africa injected uncertainty and negative economic inputs into the market. Risk tolerances declined and the market sold off. They have since recovered. Remember that there are always levered investors (people investing with borrowed funds) in the markets somewhere. When they decide to get out, prices will swing down over a period of days or weeks (depending on the size of their aggregate participation).

Corporate earnings could certainly continue to surprise. At this point, however, we have experienced a period of sustained higher prices for agricultural and material commodities. Investors want to see how companies can maintain their profit margins when their input costs are increasing. Some companies may be able to raise prices. Others may not. I have mentioned before the importance of GDP growth (Gross Domestic Product) as a condition for companies as a group to grow their revenues. Certainly, we are experiencing GDP growth. Lower profit margins could offset some of the benefit of higher sales. I believe that investors are waiting for first quarter earnings to be announced to hear how companies are dealing with this issue.

Higher energy costs act like a tax increase. Consumers that pay more for energy will have less money to pay for other things. I do not see how the Middle East and North Africa situation can settle down to something that looks like the status quo of the last decade. As a rule, dictatorships are not always bad. If a populace is not ready for self rule, a dictatorship can provide some important benefits and protections for a society. By ready, I mean that they have the knowledge, wisdom and institutions to run a society that contains property rights and the rule of law. Of course, there are not a lot of checks and balances in a dictatorship, and this is where kings can turn into tyrants.

Simply getting rid of the ruler does not suggest that things will go smoothly after that. I expect that the millions of people in these countries that have been living under some version

of a leader with solitary rule will continue to voice their dissenting opinions, and that the subsequent events may cause energy supplies to be more volatile or uncertain than they have been. This could easily result in higher prices over a sustained period of time.

Domestic sources of energy will likely continue to attract attention and discussion. Consider a November 29, 2010 Wall Street Journal article. The technology for running cars on natural gas has been around since the 1930's. Guess how many cars exist today that run on natural gas? 11,400,000 or so. Guess how many of these are in the U.S.? About 110,000.

The country with the most CNG (compressed natural gas) vehicles is Pakistan (2,300,000) followed by Argentina (1,800,000), Iran (1,665,000), Brazil (1,632,000) and India (935,000). The article was a real eye opener for me. I know that you can buy a Honda and GM vehicle from the factory that is CNG powered. There are companies that can convert vehicles for you as well. Filling one can be difficult. Right now, you can go to one Laclede Gas filling station in St. Louis to fill your vehicle. Honda used to have ownership in a company that made filling devices for your home. These were about the size of a vacuum cleaner and would mount to the wall of your garage and tap into your gas line.

Can you imagine being able to fill your vehicles at home? I wonder if there are any large oil companies or filling stations that would be against this technology flourishing? Nobody wants to store large quantities of gasoline at their home, but the natural gas supply and infrastructure is already there.

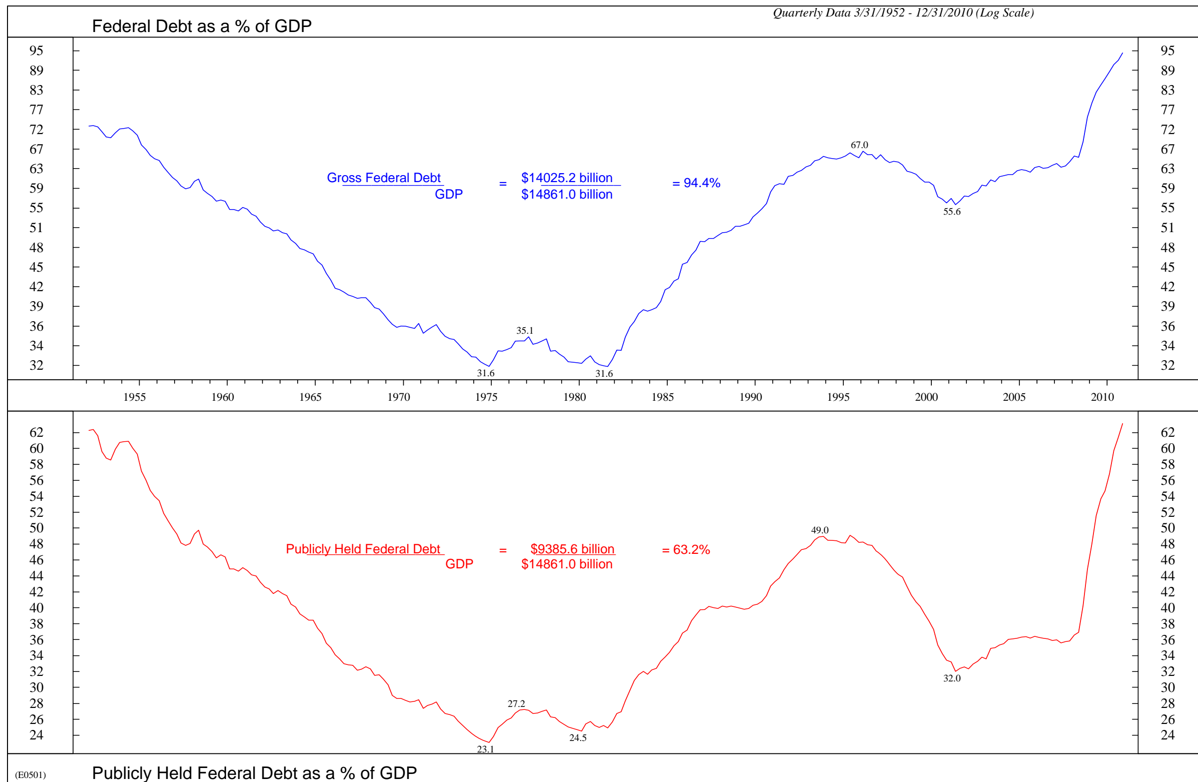
Honda put the company into bankruptcy and sold the assets. They were purchased by another company, but I cannot figure out if new devices are widely available. As soon as I can run my John Deere on CNG I will be sold.

Before moving on to the next section, I will summarize by stating that companies in general are in good shape. They do have rising input costs which call into question whether they will be able to maintain their currently high profit margins. If they cannot, this will be a negative for prices. Because prices are not extremely high right now, this issue alone does not cause me great concern.

If the economy continues to expand (this can include the global economy for multi-national companies), top line revenue growth can help offset lower margins and help continue the earnings growth.

This next section of my letter will discuss an issue that I believe deserves additional comment. This problem, if not addressed adequately, could begin to have negative implications for the market short term, but most certainly in the intermediate term. I believe that it is the biggest risk facing our economy and the markets in the intermediate term. The conversation will not be fun, but it will hopefully be informative.

I need to talk about the Federal debt, the recent increases in the debt and why it is important. I will start with a chart that you have seen before.



The top chart refers to the Gross Federal Debt. As of 12-31-10 it totaled $14.025 trillion. The bottom chart is Publicly Held Federal Debt. As of 12-31-10, it totaled $9.385 trillion. The difference is Federal debt that is not held by the public. This totaled $4.64 Trillion. What is this debt? Most of it (about $2.9 trillion) is the Social Security, Medicare and other 'trust funds'. Why do they show up as debt and not as an asset? In years past, when the dollars collected in payroll taxes were more than payments to beneficiaries, the government would take the cash and spend it, replacing the cash with an IOU in the form of a Treasury bond.

2010 was the first year that the taxes collected were less than payments out. What this means mechanically is that the Government needed to sell a Treasury bond to the public, take the cash and pay off the private bond held by the 'trust fund'. While it is true that no new borrowing takes place, it is also true that the borrowing is shifted from a captive borrower to a public borrower. Think of it as you borrowing from a bank in order to pay off a loan from a friend or family member. You still have the same level of debt, but the questions asked and the cost of the debt might change when the bank gets involved.

Before I talk about where we are going, let's take a look at where we have been. As the economy has grown, the size of Government has grown. This makes sense and does not seem nefarious. From 1977 to 2001 the size of Government increased by a 2.25% real rate per year

on average. This is to say that Government expenditures grew at this rate above and beyond inflation. From 2001 through 2008 the pace of growth increased to a 3.86% real rate of return. This is post 9-11, fighting a recession and wars in Afghanistan and Iraq. Things really picked up in 2009. From the beginning of 2009 through the end of 2011 the growth rate jumps to over 7.3% per year or 23% cumulatively. What are we getting for this?

Why is this important? Whether you are a big government person or small government person, if you are going to borrow money you have to find someone to lend you the money. If you become a questionable borrower, a potential lender might charge you a higher rate of interest for the privilege of using money that is not yours.

Higher interest rates can cause the value of investments that have cash flows to fall. This includes stocks, bonds, commercial real estate and residential real estate (basically every investment). Higher mortgage rates will not help the current housing market.

It also matters because we have to pay the debt back at some point. At the very least, we might pay more for interest expense since all of this borrowing is not locked in at a fixed rate for 30 years. What are the implications of growing the size of government by 23% over 3 years?

In order to grow expenditures by this much, the government will increase the amount of publicly held debt from $6.369 trillion as of 12-31-08 to $10.667 trillion as of 12-31-11 (estimated). This is an increase of 67%. This is also a lot of extra product (Treasury notes and bonds) to sell into the marketplace. It is true that it is not yet 12-31-11, so we have not reached this level yet, but the debt stood at $9.485 trillion as of 1-31-11.

Who is buying this extra product? Let's look at the period January 2009 to January 2011. The table below shows the foreign holdings of Treasury debt (Dept. of Treasury, in trillions)

	January 2009	January 2011	Increase
China	$727.4	$1,154.7	$427.3
Japan	626.0	885.9	259.9
Oil Exporters	186.2	215.5	29.3
United Kingdom	131.1	278.4	147.3
Brazil	127.0	197.6	70.6
All Others	1,279.5	1,721.3	441.8
Total Foreign	3,077.2	4,453.4	1,376.2

The amount of publicly held Treasury debt increased by $3.116 trillion over this period. Foreign holders purchased $1.376 trillion of this debt, or 44%. China and Japan were the two largest foreign purchasers. Between November of 2010 and June of 2011, the Federal Reserve was planning to purchase $600 billion of debt. This is the QE 2 that is talked about.

Between now and the end of this fiscal year (Sept 30), there is another $1 trillion of incremental debt that has to be sold to investors. At some point, the Federal Reserve will stop buying. Japan will not likely have the extra funds to purchase our debt for the foreseeable future. Can we continue to convince China to buy more?

To recap, we have boosted our publicly held debt by 50% so far since 2008 with plans to continue on to 67% by the end of this fiscal year. So far, we have been able to sell this debt into the marketplace and to ourselves. How long can this continue?

Unfortunately, it gets worse. Beyond the next $1 trillion by year end, the current budget proposal calls for another $3.766 trillion of new debt over the next 5 years. This means increasing our publicly held debt from $6.3 trillion at the end of 2008 to $14.4 trillion in five years. The government can increase the debt even more than this. These numbers assume additional borrowing just for the expected budget deficits. Over the last three fiscal years (08, 09, 10) the federal debt increased by more than $800 billion above and beyond the $3.1 trillion official deficits. This occurred through supplemental spending bills that never made it into the official budget. Do we have guarantees that this will not continue to occur?

I am assuming that the President knows of this situation. In his President's letter dated February 2009 (part of the 2009 budget) he states "Finally, while we have inherited record budget deficits and needed to pass a massive recovery and reinvestment plan to try to jump-start our economy out of recession, we cannot lose sight of the long-run challenges that our country faces and that threaten our economic health-specifically, the trillions of dollars of debt that we inherited, the rising costs of health care, and the growing obligations of Social Security. Therefore, while our Budget will run deficits, we must begin the process of making the tough choices necessary to restore fiscal discipline, cut the deficit in half by the end of my first term in office, and put our Nation on sound fiscal footing."

I do not believe that taking our publicly held debt from $6.3 trillion to $14.4 trillion (and potentially more) is one of these 'tough choices necessary to restore fiscal discipline".

Congress is no better. They did not even bother to pass a budget for Fiscal Year 2010. They are still bickering about it. Can you imagine being responsible for spending trillions of dollars and not even bothering to pass a budget? Even when you did not need a vote from the other party to do so? Even now, they seem to be arguing about cuts of $30 billion to $60 billion when I think they should be talking about $600 to $800 billion of cuts per year.

Let me add two more things to think about. The growth in debt is only expected to be $6 trillion more beyond today's level because the President's budget expects tax receipts to increase by 60% over the next 5 years. Get your checkbooks ready. Also, remember the Social Security Trust Fund? To the extent that there are more expenditures than income, even more Treasury debt will have to be sold to the public.

One could blame all politicians over the last 40 years for our problems. The last two examples of fiscal responsibility were Clinton's second term and Nixon's terms up until impeachment. There is no third place.

Cries of potential bankruptcy have been heard before. I remember reading Bankruptcy 1995 by Harry E. Figgie, Jr. (Little Brown and Company, 1993). This was written just after the 1990-1991 recession. At the time, we had seen the Government spend 23% more than they brought in (on average) for 10 years running. This was a higher rate than World War II when the average annual rate was 64% during the period 1941-1951.

Obviously, we did not go bankrupt in 1995. What did Mr. Figgie miss? I am not sure that he missed anything. His book was a call to action, and whether his book played a role, the elections of 1994 forced the Government to become more fiscally responsible. Growth in outlays from 1994 through 2001 grew at 1.2% per year in real terms.

Even better assistance came from the internet and technology revolution that transformed the business community. Receipts grew over this same period by 4.6% per year in real terms. The result was our first budget surplus in 30 years. From 2001 through 2003, the Government began to spend this new wealth boosting spending by 11% while receipts fell 14%. As the economy began to grow again, receipts gained 27% from 2003 through 2007 and spending continued to climb by 11%. In 2007 the Government only spent 6% more than it brought in. Unfortunately for us, a lot of the economic growth during the 2003 to 2007 was due to the steroids of low interest rates and lenient underwriting standards on real estate loans.

As previously stated, the Government spent 23% more than they brought in annually, on average, from 1981 through 1992. From 1993 through 2002 the Government spent 3.5% more annually than they brought in. From 2003 through 2007, this increased to 14% more annually. The big change has occurred recently. Over the four years 2008 – 2011 we are spending on average 55% more than we bring in annually. The World War II period (spending 64% more than we brought in) was a fight for our existence. If we are spending a similar amount today, what is the equivalent crisis?

Let's assume that our politicians will not deal with this problem. What happens from an investment perspective? When a system has too much debt, there are three options available. The system can pay the debt down, default on the debt, or if it can print money, it can inflate its way out of the debt.

Paying down debt is deflationary. Prices tend to fall over time as people redirect funds from spending to debt reduction. In this scenario, you want to hold dollars and do not want to hold gold. Defaulting addresses the problem quickly, but the loss of wealth felt instantly by holders of the debt can have significant negative effects. It would be crushing for some and painful for others.

The U.S. has an advantage in that it can inflate its way out by printing money. This is the scenario that I think is more likely, and the one that has been chosen so far. In this scenario, you want to own assets in currencies other than the dollar and you want to own gold. I expect gold to be viewed as an alternative currency until the Euro can get its footing. Since there is so much debt elsewhere in our system, there is probably political cover for this alternative, even though the longer term effects can be quite damaging.

Note that Europe does not have the option to print money. They will need to either pay the debt down, default or employ a combination of both. If we print money, it means more dollars and fewer Euros globally.

The point of this conversation is to state that the Federal debt and spending situation has the potential to become a major driver of investment returns rather than one input of many. We will continue to try to stay ahead of the curve. Please call with any questions you might have about your portfolio.

Regards,

Peter. B. Harre, CFA