



Q1 2011 Review and Commentary

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“Unless entitlements are substantially reformed, I am confident that this country will default on its debt; not in conventional ways, but by picking the pocket of savers via a combination of less observable, yet historically verifiable policies--inflation, currency devaluation and low to negative real interest rates.” - Bill Gross, PIMCO *Investment Outlook* April 2011

Taming Leviathan

A Thought-Provoking Outlook from the “Bond King”

[Charles B. Atwill, CFP®](#)

LEVIATHAN, WRITTEN BY THE ENGLISH PHILOSOPHER Thomas Hobbes in 1651, theorizes that having a strong central government (the “Leviathan”) is necessary to guarantee a social contract among citizens. In its absence, he famously opined that life – in the state of nature – would be “...nasty, brutish, and short”.

While Hobbes’ political beliefs may be appealing to those inclined towards central planning, the principles he advocates are inconsistent with true free markets and the intent of the U.S. Constitution. Furthermore, a strong central government requires financial resources expropriated from the private sector. And governments must eventually come to terms with the economic reality of running out of money to fund promised benefits.

As our own “leviathan” has now grown to truly epic proportions and the U.S. debt behemoth hits the statutory borrowing limit of \$14.3 trillion (see **“The Debt to the Penny and Who Holds It”** at [TreasuryDirect here](#)), I thought it would be worth sharing comments from a recent monthly *Investment Outlook* written by one of the world’s most respected bond market experts and investment managers, Bill Gross of PIMCO.

In his April commentary appropriately titled **“Skunked”**, Mr. Gross examines the deteriorating U.S. fiscal situation and once again forthrightly sounds the alarm about the third rail of politics – the unfunded programs of Medicare, Medicaid, and Social Security. These social insurance programs combined with other *non-discretionary* spending

comprise 75% of the U.S. budget. Entitlements alone amount to at least \$65 trillion in unfunded liabilities. We have read other credible reports that put this unfunded liability at over \$100 trillion.

As Mr. Gross states, when all of the U.S. debt categories are added together, “this country appears to have an off-balance-sheet, unrecorded debt burden of close to 500% of GDP! We are out-Greeking the Greeks, dear reader.”

He goes on to emphasize this key point about inflation:

If so, and if the USA were a corporation, then it would probably have a negative net worth of \$35-40 trillion once our “assets” were properly accounted for, as pointed out by Mary Meeker and endorsed by luminaries such as Paul Volcker and Michael Bloomberg in a recent piece titled “USA Inc.” However approximate and subjective that number is, no lender would lend to such a corporation. Because if that company had a printing press much like the U.S. with an official “reserve currency” seal of approval affixed to every dollar bill, that lender/saver would have to know that **the only way out of the dilemma, absent very large entitlement cuts, is to default in one (or a combination) of four ways: 1) outright via contractual abrogation – surely unthinkable, 2) surreptitiously via accelerating and unexpectedly higher inflation – likely but not significant in its impact, 3) deceptively via a declining dollar – currently taking place right in front of our noses, and 4) stealthily via policy rates and Treasury yields far below historical levels – paying savers less on their money and hoping they won’t complain.**

What Mr. Gross is saying is the same thing that we have been routinely writing about in our commentaries for the past several years--the U.S. (like many empires before it) is opting to sacrifice the value of its currency by

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resorting to the printing press in order to make good on its unfunded obligations. Currency devaluation through money-printing is an inflationary and covert default process. Global market participants are beginning to wake up to this and are responding by exchanging U.S. dollars and bonds for more tangible stores of value like gold, silver, and oil.

In the case of the U.S., its currency happens to be the world's reserve currency used to settle international trade. And as we have warned about in prior newsletters, a policy of dollar devaluation is a very destabilizing undercurrent in the global financial markets. The declining U.S. dollar remains one of the major investment themes that we have been integrating into client portfolios over the past few years.

As long as the Federal Reserve continues down the inflationary path of zero interest rate policy ("ZIRP") and quantitative easing ("QE"), we will continue to diversify into contra-dollar assets classes for protection. In the current environment, we view most fixed income securities such as U.S. bonds as triple threats to capital from inflation risk, credit risk, and interest rate risk.

A Note About USA Inc.

The research report, *USA Inc.*, that Mr. Gross mentions in his monthly commentary was created and compiled by lead analyst, Mary Meeker, in February 2011. It has been endorsed in the Foreword by George P. Schultz, Paul Volcker, Michael Bloomberg, Richard Ravitch, and John Doerr.

USA Inc., was written to accomplish the following:

"This report looks at the federal government as if it were a business, with the goal of informing the debate about our nation's financial situation and outlook. In it, we examine USA Inc.'s income statement and balance sheet. We aim to interpret the underlying data and facts and illustrate patterns and trends in easy-to-understand ways. We analyze the drivers of federal revenue and the history of expense growth, and we examine basic scenarios for how America might move toward positive cash flow."

We encourage our readers to take some time to download and view a copy of this important and eye-opening report at www.kpcb.com/usainc/.

We have also posted a link to *USA Inc.* and other similar reports regarding the serious U.S. fiscal condition

on our website in the "[Educational Resources](#)" section. [Note: We invite everyone to visit our recently updated website at www.afcglc.com].

Our Investment Focus

We rely on our newsletter to communicate our "big picture" economic analysis and outline AFCG's broader investment strategy. In the recent cover letter that accompanied quarterly performance reports to clients, I detailed the following trends and issues affecting U.S. consumers and investors that I would like to reiterate:

- **Consumer Price Inflation**, which we are concerned about and have been taking defensive measures against for the past two years, is now **here**. Our outlook is for the average cost of essential goods and services to increase by **at least 5% per year** for U.S. consumers with even higher double-digit inflation being a risk going forward.
- **Interest Rates** remain at artificially low levels. Money market, savings accounts, CD's, and U.S. bonds have negative real rates of return when adjusted for a loss of dollar purchasing power. This fact puts additional financial pressure on retirees and those on fixed incomes to seek higher returns in more volatile assets in order to maintain their standards of living. Unfortunately, this is one of the more harmful aspects of the Fed's current monetary policy and government deficit spending.
- **Precious Metals** in the form of gold and silver bullion continue to be a primary asset class we want to accumulate and hold as the value of major global currencies diminishes amidst a sovereign debt crisis in the U.S. and Europe. We embrace periodic corrections as a necessary event to shake out weak hands in the market and provide additional buying opportunities within a bull market.
- **Energy**, particularly crude oil, is in a global supply/demand imbalance that may be with us for some time as spare production capacity is limited to meet rising demand — and this is without any major supply disruptions occurring in the chaotic Middle East and North Africa. A weaker dollar also materially impacts the price of gas at the pump as imported oil costs U.S. consumers more.

Our focus is to continue investing in those sectors of the global economy that benefit most from a weakening U.S. dollar and increasing global demand for natural resources such as gold, silver, oil, coal, fertilizer inputs, uranium, and critical elements used in steel production, consumer electronics, and the defense industry.

AFCG Absolute Return Models May 2011

Target Allocation by Asset Class

Asset Class		Global Growth	Global Growth & Income	Global Income & Growth	Global Income
Growth & Total Return	Equities	60%	40%	20%	0%
	Allocation Funds	19%	16%	21%	31%
	World Bonds	0%	16%	30%	39%
	Cash/Cash Equivalents	1%	8%	9%	10%
Precious Metals	Gold/Silver Bullion Fund	20%	20%	20%	20%
Total		100%	100%	100%	100%

Economic and Capital Markets Outlook

Justin D. Harris, AAMS®

In our [Q3/Q4 2010 Review and Commentary](#), we concluded that the Federal Reserve’s policy of printing money to buy the bulk of U.S. Treasury bond issuance through June 30, 2011, (“Quantitative Easing Part 2”) was tantamount to the U.S. government declaring bankruptcy. Since the end of 2010, market events have further confirmed this assessment.

The U.S. appears to have entered into a debt and currency crisis period. Government monetary and fiscal policy actions taken over the past decade—and the last two years, in particular—are negatively affecting the value of the U.S. dollar. This is an inflationary process that is driving investors to seek shelter in hard assets for capital preservation.

Inflation and the U.S. Debt Crisis

The above analysis can be succinctly depicted by the following formula:

Fiat Currency + An Activist Central Bank = Currency-Induced Cost-Push Inflation

In other words, monetary and fiscal policy actions taken at the highest level filter down to the rest of us in the economy in the form of the following:

- a weaker currency and associated loss of purchasing power;
- low interest rates that penalize prudent savers; and

- higher prices for food, healthcare, energy, insurance, and imported goods from China and elsewhere.

This is the warning message that Bill Gross and other respected money managers and economists have been issuing since the Fed began “Quantitative Easing” in March 2009.

The fiscal and monetary policies that the U.S. is pursuing are also causing increased risks in the U.S. bond market.

The formula becomes even more evident when viewing it in chart form (**see Page 4**) by comparing the U.S. dollar index (the value of the dollar vs. a basket of foreign currencies of our major trading partners) to the market prices of gold, silver, oil, and commodities.

Money-printing that devalues the U.S. dollar can have the *shorter term* effect of boosting the broader stock market (**see Chart 1**). This is the so-called “wealth effect” that the Fed hopes will help mask structural problems still plaguing the underlying economy, banking system, and real estate market.

Over the *longer term*, U.S. companies and U.S. consumers are hurt by higher inflation caused by a weaker dollar (**see Chart 2**). Wealth in society becomes concentrated in fewer and fewer hands and the income disparity that develops from a declining currency causes more and more Americans to suffer a lower standard of living.

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Economic and Capital Markets Outlook *(continued)*

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Prices for core goods and services rise over time to reflect an increase in the U.S. money supply:

Seniors Have Lost 32 Percent of Their Buying Power Since 2000

May 19 (PRNewswire)--“Seniors have lost almost one-third of their buying power since 2000, according to the Annual Survey of Senior Costs, released today by The Senior Citizens League (TSLC)...to put it in perspective, for every \$100 worth of expenses seniors could afford in 2000, they can afford just \$68 today.”

A senior with an average Social Security benefit in 2000 received \$816 per month, a figure that rose to \$1,072.30 by 2011. However, that senior would require a Social Security benefit of \$1,414.70 per month in 2011 *just to maintain his or her 2000 lifestyle.*”

The above article demonstrates why AFCG 1) does not use reported CPI numbers as a true measure of real-world inflation and 2) emphasizes investing for inflation protection at the portfolio level through our asset allocation strategy.

For investors, allocating capital away from conventional U.S. assets (stocks and bonds) and into hard assets during an inflationary cycle is essential for wealth preservation.

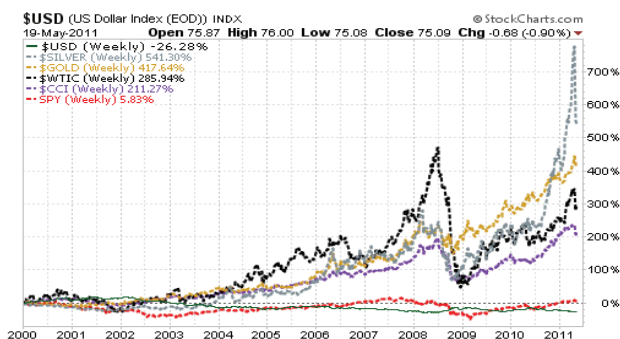
Chart #1 shows the *short-term* effects of U.S. dollar devaluation caused by the Fed’s “Quantitative Easing Part 2” policy that began in August 2010:

<u>Chart Symbol</u>	<u>Return (8/1/10 - 5/19/11)</u>
U.S. Dollar Index (\$USD)	- 7.91%
Silver (\$SILVER)	+ 94.49%
Crude Oil (\$WTIC)	+ 25.13%
Continuous Commodity Index (\$CCI)	+ 27.95%
Gold (\$GOLD)	+ 26.46%
S&P 500 Large Cap U.S. Stock ETF (SPY)	+ 22.96%



Chart #2 shows the combined *long-term* effects of U.S. dollar devaluation caused by the Fed’s reactionary monetary policies since the Tech Stock Bubble burst in 2000:

<u>Chart Symbol</u>	<u>Return (1/1/00 - 5/19/11)</u>
U.S. Dollar Index (\$USD)	- 26.28%
Silver (\$SILVER)	+541.30%
Gold (\$GOLD)	+417.64%
Crude Oil (\$WTIC)	+285.95%
Continuous Commodity Index (\$CCI)	+ 211.27%
S&P 500 Large Cap U.S. Stock ETF (SPY)	+ 5.83%



As the chart above illustrates, the broad U.S. stock market and the U.S. dollar are mired in a structural bear market, while hard assets and real money (gold and silver) continue to outperform based on superior fundamentals.

Our outlook is for these fundamentals to remain firmly intact until the Fed makes a serious change in monetary policy to defend the dollar, and the U.S. government meaningfully reforms entitlements to get control of the U.S. budget.

Despite recent jawboning by various officials to the contrary, we do not expect any material reforms will be made until markets and our creditors like China force the issue. And we do not expect *that* to be a smooth process. In fact, we are seeing more signs that this process is underway:

S&P’s Downgrade of U.S. Ratings Outlook

April 18 (MarketWatch)--“Our negative outlook on our rating on the U.S. sovereign signals that we believe there is at least a one-in-three likelihood that we could lower our long-term rating on the U.S. within two years, Mr. Swann said. The outlook reflects our view of the increased risk that the political negotiations over when and how to address both the medium- and long-term fiscal challenges will persist until at least after national elections in 2012.”

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Economic and Capital Markets Outlook (continued)

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While AFCG does not put much faith in S&P as a ratings service, it is significant that even S&P has now broached the subject of a possible U.S. debt downgrade. The problem for investors is that markets are forward-looking and are not going to wait around for S&P to state the obvious—after the fact.

Markets are already downgrading the U.S. and its currency—a downgrade that is reflected in the relentless rise of gold and silver prices since 2000.

Global investors, including our trading partners, have been actively diversifying out of their huge U.S. dollar reserve positions for the last several years. We expect the velocity of this monetary process to increase as Brazil, Russia, India, China, and South Africa (“BRICS”) and other Asian nations recently indicated:

BRICS Demand Global Monetary Shake-Up

April 14 (Reuters)--“The BRICS are worried that America’s large trade and budget deficits will eventually debase the dollar. They also begrudge the financial and political privileges that come with being the leading reserve currency. ‘The world economy is undergoing profound and complex changes’, Chinese President Hu Jintao said. ‘The era demands that the BRICS countries strengthen dialogue and cooperation’.

In another dig at the dollar, the development banks of the five BRICS nations agreed to establish mutual credit lines denominated in their local currencies, not the U.S. currency.”

Asia Seeks to Diversify Record Foreign Exchange Reserves as Dollar Falls

May 3 (Bloomberg)--“Asian nations are pooling funds to strengthen regional investment, in a step toward diversifying record foreign-exchange holdings as the U.S. dollar declines.

Ten Southeast Asian Nations, along with China, Japan, and South Korea, plan to discuss an infrastructure fund to boost investment in roads, ports and utilities at a meeting of finance officials that started today in Hanoi. Policy makers have agreed to look for “new avenues” for reserves, the Philippine central bank chief said last month, urging greater use of China’s yuan.

More than a decade after the 1997-98 Asian crisis depleted reserves and forced countries from Indonesia to South

Korea to seek bailouts, the region’s holdings have risen to about \$6 trillion, half held by China. With the dollar remaining the dominant reserve asset, the currency’s decline threatens to erode returns on Asia’s stockpile.”

In addition to foreign nations, some of the world’s mostly highly respected U.S. money managers and investors have expressed the same concerns about the U.S. dollar and are allocating capital accordingly:

Buffett Says Avoid Long-Term Bonds Tied to Eroding Dollar

March 25 (Bloomberg)--“Warren Buffett, the billionaire who urged Congress in 2009 to guard against inflation, said investors should avoid long-term fixed-income bets in U.S. dollars because the currency’s purchasing power will decline.”

Texas University Takes Cue From Kyle Bass to Hold \$1 Billion in Gold Bars

April 16 (Bloomberg)--“The University of Texas Investment Management Co., the second-largest U.S. academic endowment, took delivery of almost \$1 Billion in gold bullion and is storing the bars in a New York vault, according to the fund’s board. The decision to turn the fund’s investment into gold bars was influenced by Kyle Bass, a Dallas hedge fund manager and member of the endowment’s board...

‘Central banks are printing more money than they ever have, so what’s the value of money in terms of goods and services.’ Bass said yesterday in a telephone interview. ‘I look at gold as just another currency they can’t print any more of.’

AFCG agrees wholeheartedly with the above assessments expressed by Mr. Buffett and Mr. Bass.

Oil Market Update

Besides precious metals and the U.S. bond market, the other key market we watch intently is the global oil market. The reasons are as follows:

- oil is the lifeblood of modern civilization and the global economy;
- the U.S. is the world’s largest oil consumer;
- the U.S. must import over 50% of its daily oil needs;

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- about 50% of this daily need is supplied by imports from Venezuela, the Persian Gulf, and Africa; and
- China, the world's largest total energy consumer, is now importing over 50% of its domestic oil need which is growing at 7-10% per year.

Very simply, the U.S. domestic oil supply-demand imbalance is hanging over the head of the U.S. economy and the global financial markets *every single day*. This makes oil import dependency a primary economic factor for us to follow closely and incorporate into client portfolios for risk management purposes.

AFCG's Investment Strategy

We have recently updated our investment models to address the following events that have occurred in the global markets since our last quarterly newsletter including:

- widespread civil unrest throughout the Middle East and North Africa with oil supply disruptions;
- the U.S. hitting the statutory debt limit;
- the Fed giving mixed signals about its continued purchases of U.S. bonds under a formal QE program; and
- natural disasters affecting global food production.

For client accounts where exposure to Equities (Stocks) as a broad asset class is appropriate, we have been reducing

cash balances and adding additional investments in the following sectors:

- direct and indirect exposure to Canadian farmland and development-stage potash and phosphate (fertilizer inputs) projects. Farmers on a global basis will be forced to increase crop yields in response to declining food supplies, population growth, and improving diets in emerging market countries such as China;
- energy companies (coal, oil, gas, and uranium) with production and in-ground reserves located in North America away from conflicts in the Middle East and North Africa; and
- exploration/development-stage mining projects that are developing critical deposits of specialty elements outside of the Chinese-controlled production chain.

We have also added a value-oriented global asset allocation fund and a short-term multi-sector bond fund to our investment models for additional diversification.

We expect financial markets for the rest of 2011 to focus on the U.S. debt situation, instability in the Middle East and Africa, and rising food and energy prices.

Sources:

1. Bloomberg (www.bloomberg.com)
2. Stockcharts (www.stockcharts.com)
3. PIMCO (www.pimco.com)

4. U.S. Energy Information Administration (www.eia.doe.gov)
5. MarketWatch (www.marketwatch.com)

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Our Services

- ◆ Investment Management
- ◆ Modular Financial Planning
- ◆ Total Wealth Planning (TWP™)
- ◆ Financial Consulting

For more information, please contact us for our brochure.

Contact Us

Forest Plaza I
7201 Glen Forest Drive, Suite 205
Richmond, VA 23226

Phone: (804) 672-0040
Toll-Free: (888) 300-2517
Fax: (804) 672-2006
E-mail: info@afcgllc.com
Web: www.afcgllc.com