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Full Faith and Credit

A Thirty-Eight Year Experiment in Fiat Money

fiat [Latin: "let it be done"] An authoritative and often arbitrary order or decree.

Charles B. Atwill, CFP®

THE NOBEL-LAUREATE ECONOMIST, Milton Friedman, wrote that **"the fate of a country is inseparable from the fate of its currency"**. In a bygone era, there was a common phrase, "as sound as a pound," referring to the strength of Britain's currency, the Pound Sterling. Britain enjoyed a tremendous trade advantage as a global economic power thanks, in large part, to its currency's high status around the world.

However, the pound's value declined throughout much of the first half of the 20th century as the U.S. dollar's global clout steadily grew. The torch was officially passed in 1944 at a hotel in Bretton Woods, New Hampshire. Delegates from the forty-four Allied nations convened to choose a

new world monetary system out of the ashes of The Great Depression and World War II. They chose the dollar – backed by U.S. gold reserves – as the new standard, thereby giving it the imprimatur as the exchange benchmark for the free world's monetary system.

By 1971, however, the high cost of the Vietnam War and LBJ's "Great Society" left America's treasury virtually empty. Instead of resorting to measures of fiscal discipline, the decision was made by the Nixon Administration to abandon the gold standard altogether. With no credible limit on the amount of dollars that could be created, the predictable decline in the dollar's *purchasing power* began.

Sixty-five years after the Bretton Woods conference, what benefit, if any, does having the world's reserve currency confer to the U.S.?

For one, it reduces the borrowing costs of the issuing government. Other nations with weaker currencies relative to the dollar pay more (in dollar terms) to borrow money. Second, global trade for the world's resources is primarily

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"Everyone is saying we should go to the western markets to scoop up [underpriced assets]. I think we should not go to America's Wall Street, but should look to more places with natural and energy resources."

- Chen Yuan, Chairman of China Development Bank quoted in the Financial Times, July 21, 2009

Economic and Capital Markets Outlook

Justin D. Harris, AAMS®

OUR PRIMARY GOAL in writing a quarterly commentary is to communicate important information about "Big Picture" trends we see developing in the global financial markets. We try to filter out the enormous flow of daily market noise and focus on identifying the few dominant trends playing out beneath the economic surface that directly affect investments and, ultimately, our collective standard of living as American citizens and taxpayers.

One of the most significant trends that has (stealthily) been in motion since 1971, when the current version of our monetary system was established, is the relentless decline in the purchasing power of the U.S. dollar.

On the front page of The Federal Reserve Bank of Minneapolis' web site, there is a calculator labeled **"What is a dollar worth?"** According to the calculator (based on the Consumer Price Index), a dollar's worth of goods and services bought in 2009 would have cost only **\$0.19** when purchased in 1971.

In other words, the dollar has lost **81%** of its purchasing power since that time. This works out to an erosion in value of approximately **4.5% per year**. At this rate, consumer prices within the economy *double* about every **16 years**, which we find egregious.

As a result of the Federal Reserve's monetary policies im-

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Investor's Corner

Justin D. Harris, AAMS®

Investment Implications of the Declining Dollar

Our unvarnished “Big Picture” assessment continues to be that the U.S. economy will likely remain bogged down in a severe (inflationary) recession over the next few years – primarily due to the following factors:

- national unemployment exceeding 20% and anemic growth in real wages/income at the consumer level;
- worsening mortgage default rates from 2009-12;
- shrinking tax revenues at the state and federal levels;
- increasing foreclosures across the entire U.S. real estate market; and
- foreigners intensifying the selling of dollars and dollar-denominated long-term bonds in response to \$2+ trillion annual U.S. government budget deficits.

Our view is that the U.S. is now experiencing just the beginning – not the end – of a multi-year period where the “bubble” economy built on enormous levels of unserviceable debt transitions to a more sustainable economy built on savings, capital investment, and the production of real goods. We do not expect this to be a very smooth transition.

In light of this outlook for global financial risk factors to

intensify, our overall investment strategy remains the following:

- **Emphasizing capital preservation** by holding short-term cash/cash equivalents for liquidity;
- **Hedging inflation risks from a declining U.S. dollar** by accumulating core exposure to hard assets such as gold/silver, energy, and global natural resource funds;
- **Adding exposure to short-term global bond funds** for income and non-dollar currency diversification;
- **Avoiding most U.S. corporate and municipal bonds for now** due to deteriorating credit quality, declining earnings/tax receipts, and principal loss from rising interest rates;
- **Viewing the broader U.S. stock market as very overvalued** at its current price level based on declining corporate earnings, historically low dividend yields, and the rising interest rate threat; and
- **Limiting investment exposure to U.S. real estate.** Our research shows that real estate prices will continue to decline for the foreseeable future as unemployment persists and residential and commercial mortgage default rates increase dramatically over the next 0-24 months.

AFCG Global Absolute Return Models

The *Absolute Return Models* are based on a “Core and Explore” strategy.

- The **Core** element functions as the more stable, income-oriented foundation of the portfolio.
- The **Explore** element focuses on capital appreciation, providing scalable exposure to more growth-oriented assets.

		Target Allocations by Model			
		Asset Class	Growth	Balanced	Conservative
Core	Cash		10%	20%	30%
	Gold / Silver Bullion		10%	10%	10%
	Global Fixed Income		10%	20%	50%
	Diversifying Fund of Funds		10%	10%	10%
	<i>Subtotal</i>		40%	60%	100%
Explore	Commodities		10%	10%	0%
	Inverse US T-Bonds		15%	10%	0%
	Global Resource Equities		20%	10%	0%
	Gold Mining Equities		15%	10%	0%
	<i>Subtotal</i>		60%	40%	0%
Total			100%	100%	100%

Economic and Capital Markets Outlook (continued)

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plemented since the stock market bubble burst in 2000, an escalation in the dollar's decline since then has contributed to global market instability. Importantly, there has also been a corresponding, tell-tale rise in the price of gold since 2000.

Over the past eight years, the U.S. dollar has lost **35%** of its value versus a basket of major foreign currencies. This is why it now costs so much to exchange dollars for Euros and travel around Europe.



Conversely, the dollar price of gold has risen from \$255 per ounce in 2001 to \$950 per ounce today — an increase of nearly **275%**. Historically, gold functions best as a store-of-value currency during periods of inflationary monetary policy and artificially low interest rates (rates held below the true rate of inflation).



Understanding the basic dynamics of how the dollar functions as the world's "reserve currency" and what its decline in value means is a crucial part of managing the real-world financial risks caused by inflation. The key financial concept to recognize is that the "weak dollar" trend is a direct economic consequence of monetary policy administered by the Federal Reserve to keep interest rates artificially low and fund trillions in federal spending, loans, bank bailouts, and financial guarantees with newly created money.

This decline in value is the effect of an increase in the total supply of dollars injected into the system relative to a more fixed supply of real goods. This is why "inflation" has been traditionally defined as "too much money chasing too few goods". The visible effect that we end up experiencing in the real world is literally the "inflation tax".

If the government runs large deficits and needs to issue Treasury bonds to fund these deficits and a willing central bank prints up new money to buy these bonds, this is termed "monetizing the debt" (or "quantitative easing"). The monetization process devalues the existing supply of dollars already in the system held by Americans and our foreign trading partners like China. A devaluation of the currency, in turn, then drives up prices for just about everything denominated in dollars — particularly for consumer staples such as food and energy where their supplies are relatively limited by comparison.

For centuries, classical economists have come to recognize inflation as a monetary phenomenon. The problem is that one generally will not hear mainstream economists or Fed cheerleaders interviewed on financial news networks acknowledge this fundamental law of economics.

As we know from history, there are certain periods of time when the financial equivalent of a "100-year flood" occurs that fundamentally alters the global economic landscape. The Great Depression of the 1930's and the stagnant economy of the 1970's accompanied by high levels of inflation are two recent examples of extraordinary economic dislocations that eventually concluded with dramatic changes to the global monetary system. We believe the bursting of the real estate/debt bubble that has been ongoing since 2007 qualifies as such an event. The eventual outcome is not likely to be friendly to the dollar.

A Recent History of the U.S. Dollar

Since 1971, the world has remained on a "fiat" dollar standard. This means that the "fiat" paper dollar we all use as currency derives its value only to the extent that i) it is declared legal tender (deemed acceptable to use to pay taxes and debts) by the government and ii) users/holders of the dollar maintain faith and confidence in its ability to provide a store of value for future economic transactions. The "faith and confidence" component is the critical part — as foreigners (e.g., China) lose faith in the dollar's function as a store-of-value, they recycle their dollar reserves at a faster pace back into the global economy in response to the dollar's accelerating loss of value.

Since the dollar is no longer backed by a finite supply of gold, it can literally be printed up by our central bank in any quantity deemed necessary. In 2002, Fed Chairman Ben Bernanke, acknowledged as much in his now-infamous

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speech “Deflation: Making Sure ‘It’ Doesn’t Happen Here”:

“Like gold, U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology called a printing press (or, today, its electronic equivalent) that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation.”

When we buy a toy made in China or a barrel of oil from Saudi Arabia, we send producers in these countries dollars in exchange for their goods. The dollars we send abroad end up being held as “foreign exchange reserves” in the accounts of foreign central banks and other financial institutions. This is why the dollar is known as the world’s “reserve currency” – it is the currency that is most widely used and accepted as the international standard for trade and is the basis for pricing critical global commodities such as oil. This is the crucial point to grasp in order to understand the current fragile nature of the fiat dollar-based monetary system.

The Fed and the government cannot continue taking such drastic financial measures as they have over the last two years to backstop the world’s entire financial system without adversely affecting the foundation of the system – faith and confidence in the integrity of the U.S. dollar.

Our trading partners such as China, India, Russia, and others are now becoming increasingly wary of continuing to accept and hold dollars and dollar-denominated Treasury bonds. In fact, they are increasing efforts to diversify out of dollar assets and lock up longer term supplies of tangible assets like gold, copper, and oil, while vocally expressing

their growing concern about our country’s extreme fiscal and monetary policies.

Conclusion

It is our best judgment that the negative economic events we are now experiencing are the cumulative effects of a fundamental problem with our debt-based fiat currency. We anticipate that this will likely culminate in major changes being made to the world’s monetary system within the next few years— a process not unlike what transpired during the tumultuous 1970’s.

Our research indicates that we are in the early stages of this major transitional process whereby the dollar’s role in the world economy will be lessened to some degree. The question is whether this will be an orderly adjustment or something more chaotic.

We consider abnormally high levels of inflation—a global currency event—to be a very material risk to investments during this transition period ahead.

As portfolio managers, we are taking a proactive approach at the investment level to address and manage this growing systemic risk. We are focused on hedging against a resumed downtrend in the dollar’s value by diversifying into sectors that offer real (after-inflation) return potential. Owning gold/silver, energy and natural resource stocks, and non-dollar fixed income securities are several strategies that we are gradually implementing.

On a more positive note, we remain optimistic that ongoing negative economic events will hasten a much-needed return to fiscal restraint, transparency, and accountability on a national scale. We see positive signs (dare we say “green shoots”) developing as more and more Americans become aware of the need for fiscal and monetary responsibility to return to Washington.

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settled in dollars. In many ways, this gives the U.S. a comparative advantage in resource acquisition versus other countries with weaker currencies that must be converted into more expensive dollars. A country's currency is supposed to serve as a placeholder of real value for use in trade of tangible goods and services. If a currency's function as a store of value becomes diminished, stronger proxies for it will likely emerge.

For instance, if a government chooses to "print" an *infinite* amount of its paper currency, the value would be diminished by the increase in supply. One would want to find "scarcer" and more stable things of value to own—perhaps the currency of a fiscally sound country, or non-paper, tangible assets like:

- Precious metals
- Oil and Gas
- Agricultural products

- Land
- Minerals and Ore

Now, what if major countries *around the world* were simultaneously engaged in printing vast amounts of their own currencies in order to stimulate their local economies? Investors, on a global scale, would be forced to find safe-havens outside of their own currencies, as well as the dollar, all at the same time. In this case, monetary inflation (the printing of money), leads to broader price inflation as investors *exchange* their paper money for real assets. U.S. dollars, Japanese Yen, Euros, Pounds, and Chinese Yuan – all get traded in increasing quantities for goods of more enduring value.

In light of all the paper currencies that have come and gone over time, it should be no surprise that gold and silver have retained their value as stores of wealth for millennia.

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ATWILL FINANCIAL CONSULTING GROUP, LLC is a fee-only investment advisory firm located in Richmond, Virginia. Our investment professionals, serving in a fiduciary capacity, provide investment management, financial planning, and other advisory services to our clients.

Our Services

- ◆ Investment Management
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