



Q3 2009 Review and Commentary

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Coming to Terms

Understanding the Great Inflation/Deflation Debate

Charles B. Atwill, CFP®

WHEN DESCRIBING ECONOMIC CONDITIONS, consumer price trends, monetary and fiscal policy, and asset bubbles, the terms “inflation” and “deflation” are often bandied about. With the Federal Reserve engaged in an unprecedented amount of new money creation and Congress spending considerably more than it collects in taxes (by the widest margins in history), the great inflation/deflation debate is much more than just an academic exercise.

From an investor’s standpoint, correctly identifying which of these two paths (*inflation* or *deflation*) we might be going down is essential to managing risk—and generating returns.

Given all of the confusion and misinformation surrounding the subject of inflation, we thought it might be helpful to provide a short overview of the issues at hand, particularly

as they relate to how we manage money for our clients.

Price Inflation vs. Monetary Inflation

Two major schools of thought in economics currently drive the inflation/deflation debate, and to a large degree, the very definitions of these terms. Among the adherents to the theories of British economist John Maynard Keynes (the majority of mainstream economists and policymakers), the definition of “inflation” can be distilled down to this:

*A general increase in the aggregate
prices of goods and services, over time.*

There is another group of economists who posits a subtle, but fundamentally different definition from that of the Keynesians. Here, we will take a few liberties and lump together two schools – the *Austrian School* (Friedrich Hayek, Ludwig von Mises, Murray Rothbard, et al.) and the *Monetarist School* (principally, Milton Friedman, Anna Schwartz, and Alan Greenspan). Within this generally free-market camp, Milton Friedman’s definition is probably

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“Deficit spending is simply a scheme for the confiscation of wealth. Gold stands in the way of this insidious process. It stands as a protector of property rights.” - Alan Greenspan, “Gold and Economic Freedom”, The Objectivist, 1966

Economic and Capital Markets Outlook

Justin D. Harris, AAMS®

TO PLACE THE INFLATION/DEFLATION DEBATE into meaningful context, one must look to market price signals generated by certain asset classes that have traditionally served as important objective indicators. Without a true understanding of the cause and effect dynamic surrounding changes in money supply growth that eventually lead to changes in a currency’s purchasing power, it is very difficult to see clearly through financial distortions in the markets caused by chronic inflation.

Historically, major debtor nations have preferred it this way to enable expropriation of financial resources from the productive private sector with the “inflation tax” to pay for excessive spending that cannot be funded solely from tax

revenues. In fact, even John Maynard Keynes wrote about this very issue. In his book, “The Economic Consequences of the Peace”, published in 1920, he said:

“Lenin is said to have declared that the best way to destroy the capitalist system was to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens... Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all of the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.”

Well, there is one asset class that has a long-term track re-

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Economic and Capital Markets Outlook (continued)

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cord of correctly diagnosing the destructive forces of inflation that emerge in certain economic cycles. This monetary asset is gold. When expressed in dollar terms, a rising price of gold signals that the dollar is declining in value and savers/holders of dollars are losing confidence in the fiscal policies backing the value of the paper currency.

Within the last month, the gold price has touched \$1,070 per ounce, breaking out decisively above \$1,000 and rising **24%** since its April low of \$859 [see chart].



The price of oil has also risen **118%** since its February low of \$37 per barrel further confirming a shifting global preference for hard assets over paper dollars [see chart].



The price increases in both gold and oil correspond to global demand for tangibles amidst a renewed decline of **15%** in the U.S. Dollar Index since March [see chart].



Viewing these price signals in chart form provides a picture perfect example of why we employ an Austrian economic analytical framework focused on the monetary/political actions that affect the value of the U.S. dollar. Allocating capital to investment sectors that go up in value to hedge inflation as the dollar is devalued is integral to our strategy.

Do Low Interest Rates Signal Deflation?

Another way to translate the inflation/deflation debate into real-world economic terms is to consider whether, as a saver, you are rewarded or penalized for the risk of holding a particular currency as a store of value. In the case of the dollar, interest rates are near **0%** on short-term cash instruments. And the 10-year U.S. Treasury note yields less than **3.5%** hovering around 50-year lows [see chart].



So, why are interest rates so low in the face of a record federal budget deficit of **\$1.4 trillion** for fiscal 2009? The answer is simple. The Fed and government want them this way for specific policy reasons—which are *not* friendly to the dollar or the average saver/investor who needs income.

Central banks have been directly and indirectly buying up (i.e., monetizing) government debt securities as the buyer of last resort at the margins to keep interest rates artificially low in an attempt to prop up the real estate market. This has the consequence of *penalizing* prudent savers with punitive interest rates yielding less than the true inflation rate. We believe this dynamic is also causing a dangerous bubble in the broader bond market as investors continue to seek higher yielding fixed income investments fraught with escalating credit/default, inflation, and interest rate risks.

Key Point: As we have emphasized throughout our 2009 “big picture” updates to clients, policy actions being taken at the federal level in response to the credit crisis are having an adverse effect on global faith and confidence in the value of the U.S. dollar. We expect materially higher inflation accompanied by rising interest rates to emerge as a dual-threat to traditional asset classes (i.e., stocks, bonds, and real estate) going forward under the current policy regime.

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Economic and Capital Markets Outlook (continued)

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Conclusion

Our overriding assessment based on the hard data remains that economic conditions—particularly unemployment [see chart page 5] and mortgage delinquencies/foreclosures in real estate—continue to worsen in the Main Street economy. Perceived economic improvements are primarily the results of experimental monetary actions taken by the Fed to artificially inflate certain segments of the financial system at the expense of the dollar and tax-payers.

While there is growing talk of the Fed implementing a monetary “exit strategy” at just the right time (which we deem nearly impossible) to prevent the dollar’s decline from becoming disorderly, we believe it is just that—talk. Any attempt to do the right thing by raising interest rates dramatically to defend the dollar and curtailing monetization programs created to bail out insolvent entities in the banking system is, in our judgment, politically unfeasible.

We have recently studied a number of well-supported research reports regarding the horrendous fiscal condition of the United States. All of the measures available to the policymakers to address the structural economic problems boil down to three options:

1. Default outright on U.S. debt obligations (treasuries and mortgage-backed securities) and/or unfunded entitlement programs like Social Security, Medicare, Medicaid, etc., in the years ahead. **(Less likely)**.
2. Balance the budget and live within our means provided for solely by (declining) tax revenues. **(Less likely)**.
3. Continue to inflate away a large portion of the \$75+ trillion in unfunded government obligations by printing money. **(More likely)**.

Therefore, we expect that the national “funding crisis” for expensive government stimulus/entitlement/emergency programs (such as an imminent re-capitalization of the FDIC) to continue to become evident in the global currency markets. And currency market problems tend to spread into the bond markets causing interest rates to spike and prices for consumer goods to rise due to limited supplies.

Our guiding investment strategy is to focus on managing the increasing financial risks we witness daily in the global markets. Major portfolio themes that we continue to invest in for our clients through a diversified asset allocation approach include:

- **Hedging inflation and global currency risks** from the declining dollar by owning a Gold/Silver bullion fund and Precious Metals mining stocks.
- **Restricting income-oriented bond purchases** to shorter term global bonds to mitigate interest rate risk and obtain non-dollar currency exposure.
- **Allocating 1/3 of the portfolios to short-term cash/cash equivalents** in money market funds and U.S. Treasury bill instruments for liquidity.
- **Accumulating core investment positions in Energy, Emerging Markets, and Natural Resources** through sector mutual funds and exchange traded funds (ETFs) on price corrections into 2010.
- **Maintaining core exposure to a Rising Rates fund** designed to go up in value as interest rates rise (prices fall) on long-term U.S. Treasury bonds.
- **Limiting exposure to the broad U.S. stock market** due to extreme overvaluation in favor of allocating the portfolios to more undervalued sectors such as Precious Metals, Energy, and Agriculture.

Our *Absolute Return Models* are based on a “Core and Explore” strategy employing a tactical asset allocation.

- 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.

AFCG Absolute Return Models

		Target Allocations by Model		
Asset Class		Growth	Balanced	Conservative
Core	Cash / Money Market	10%	15%	20%
	Gold / Silver Bullion Fund	15%	15%	15%
	World Bonds	10%	10%	20%
	Allocation Funds	10%	20%	40%
	Rising Rates Fund	15%	10%	5%
	Subtotal	60%	70%	100%
Explore	Global Resource Equities	40%	30%	0%
	Energy Equities			
	Gold Mining Equities			
	Emerging Market Equities			
Subtotal	40%	30%	0%	
Total		100%	100%	100%

Investor's Corner

Justin D. Harris, AAMS®

New Roth IRA Conversion Rules for 2010

Under current IRS rules, households with annual earnings over the \$100,000 Modified Adjusted Gross Income ("MAGI") limit are restricted from converting a Traditional IRA (or an eligible employer-provided retirement plan such as a SEP-IRA, 401(k), 403(b), etc.) to a Roth IRA. Beginning in 2010, a significant provision in the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA") does the following:

- **Permanently repeals the \$100,000 MAGI limit for Roth IRA conversions in 2010 and beyond.**
- For Roth conversions completed in **2010 only**, the resulting tax liability can be spread out and reported on income tax returns filed in **2011** and **2012**.
- Taxpayers who are married filing separately are now eligible to convert.

Key Point: The availability of the new Roth IRA conversion rules in 2010 offers an extremely valuable retirement, tax, and estate planning opportunity for anyone who has previously not funded a tax-advantaged Roth IRA or has been ineligible to do so under the IRS annual income limitation.

Roth IRA Overview

The defining characteristic of the Roth IRA is that you make after-tax contributions (i.e., forgo a current tax deduction) and any earnings on your contributions grow tax-deferred. Subject to certain qualifying rules, withdrawals from a Roth IRA can then be taken completely tax-free.

By contrast, Traditional IRAs (and most employer-provided retirement plans) typically contain pre-tax contributions that you make to reduce your current income taxes. When tax-deferred money is eventually withdrawn from these types of accounts, it is fully taxable at ordinary income tax rates. Additionally, account owners are typically required to begin taking taxable minimum withdrawals each year called "Required Minimum Distributions" ("RMDs") no later than April 1 of the year after they reach age 70½.

Fortunately, the Roth IRA does not have the dreaded RMD problem. There are no required distributions associated with Roth IRAs during the lifetime of the account owner or spousal beneficiary. If a Roth IRA owner or spousal beneficiary does not need to take withdrawals for retirement income, the account can pass untouched to a designated non-spouse beneficiary (e.g., a child). With a Roth IRA, an RMD is not required until a non-spouse beneficiary inher-

its the account—and even then, the properly designated beneficiary can stretch tax-free qualified withdrawals from the inherited Roth IRA over his or her own life expectancy.

Under the existing Roth IRA rules, this "stretch" aspect can potentially provide a huge tax benefit for multi-generational estate planning purposes. In other words, if properly structured, the Roth IRA can be the financial gift that keeps on giving—tax-free—for many years.

Key Point: With appropriate planning, it will be possible in 2010 for anyone with eligible tax-deferred money sitting in a retirement account—regardless of household income—to create a pool of longer term tax-free money via a full or partial Roth conversion. Taking proactive steps to diversify tax exposure across investment account types (taxable, tax-deferred, and Roth) can help manage tax risk and maximize after-tax investment returns.

Roth IRA Conversion Basics

When you convert tax-deferred money from a Traditional IRA or an employer-provided plan, it is a fully taxable event at ordinary income tax rates. The basic premise behind the strategy is that by initiating a Roth IRA conversion, you are opting to pay taxes now at historically low tax rates in order to avoid paying higher taxes in the future. After 5 years have passed and the Roth IRA owner reaches age 59½, investment earnings from a Roth conversion are eligible to be withdrawn tax-free. [Note—you can always withdraw an amount equal to your original after-tax contribution and/or conversion at any time free of taxes and penalties.]

The one major caveat is that the income tax liability resulting from a Roth conversion should generally be paid out-of-pocket with other savings when you file your tax return. If you have to take cash out of your tax-deferred retirement account to pay the conversion tax liability, then the Roth conversion strategy can lose its appeal.

Another consideration is that you can manage "tax bracket creep" by doing partial Roth conversions each year in defined amounts that keep you from moving into a higher marginal income tax bracket. This makes it worth running "what-if" scenarios and tax projections with your CPA to determine an optimum amount of tax-deferred money to convert.

For 2010 only, anyone who does a Roth conversion will be able to elect to defer the income tax liability into 2011 and 2012. However, some of the Bush tax cuts from 2001 are scheduled to sunset on January 1, 2011. So, any tax-deferral election should take a potential reversion to higher income tax rates in 2011 and beyond into consideration. In some cases, it may make more sense to pay taxes in the

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Investor's Corner (continued)

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2010 tax year depending on what a household's specific tax situation is projected to be over the next three years.

One other strategy that can apply to high-income earners in 2009, who are ineligible to make regular contributions to a Roth IRA, is to make non-deductible (after-tax) contributions to a Traditional IRA and then convert in 2010. Please be aware that this is a more complex strategy due to filing requirements and the "pro-rata" rule that applies when you have both pre-tax and after-tax money in a Traditional IRA. Obtaining professional advice before implementing this is recommended.

Key Point: As it is currently legislated, the Roth IRA conversion opportunity in 2010 is a rare tax gift from Congress and can provide a prudent way for investors to hedge the likely risk of experiencing higher taxes in the future. The U.S. government is projected to run at least \$1.5-2.0 trillion annual budget deficits for the foreseeable future at a time when tax revenues are declining due to the on-going recession. Alarming, the deficit numbers do not include over \$75-100 trillion in unfunded liabilities for Social Secu-

rity, Medicare, and other government-backed programs. Therefore, we expect that the current low tax rates in the U.S. have only one way to go and that is up – potentially way up – to help fund projected government expenditures.

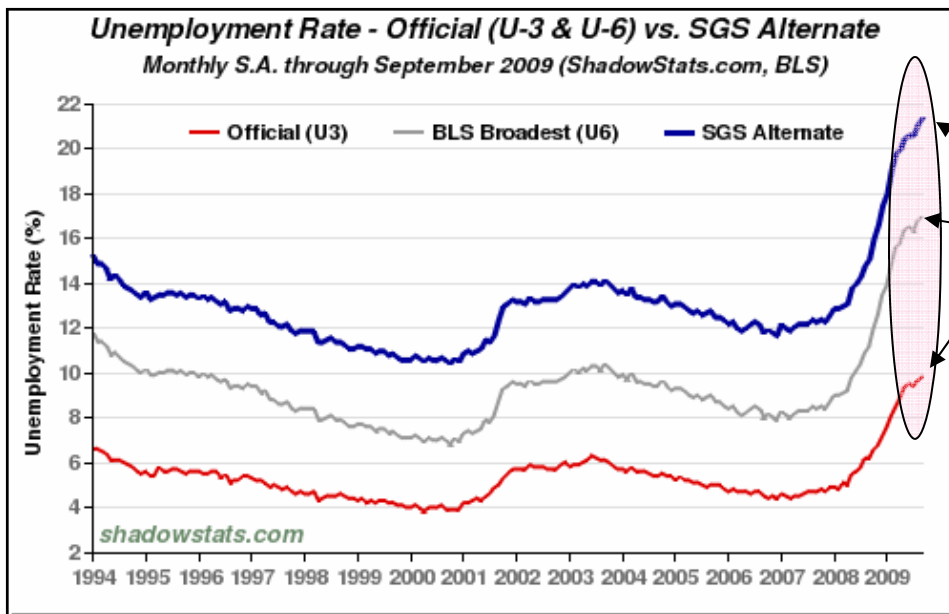
Conclusion

Do not wait for 2010 to plan! The IRS rules governing IRAs and employer-provided retirement plans are some of the most convoluted in the tax code. An appropriate tax avoidance strategy for one household may be entirely different for another. We highly recommend taking some time in 2009 to consult with your professional advisors, and, as appropriate, formulate a coordinated plan to take advantage of the new rules.

Traditional IRAs and qualified retirement plans containing pre-tax money have embedded income tax liabilities that are often overlooked and could seriously erode the after-tax value of these accounts upon withdrawal. A few hours spent planning in 2009 could potentially make a very meaningful difference in reducing income taxes down the road for you and/or your heirs.

John Williams of *ShadowStats.com* provides some unique insights into the unemployment picture. His analysis takes publicly available Bureau of Labor Statistics data and modifies it to strip out reporting biases, statistical adjustments, etc. The chart below illustrates the (significant) differences among the three estimates.

- "Official" Rate (U3): Unemployed for 15 weeks or longer, actively seeking work
- Broadest Measure (U6): U3 plus "discouraged" workers and part-time workers seeking full-time employment
- *ShadowStats* Estimate: U6 plus "discouraged" workers unemployed for more than 12 months
 "Discouraged" = No longer looking for work



By all measures, unemployment remains a serious problem for the economy.

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closest to being the consensus position:

“Inflation is always and everywhere a monetary phenomenon.”

The differences? Keynesians define inflation by its more recognizable (lagging) *effect*—rising prices. The Austrian and Monetarist Schools define inflation by its more hidden *root cause*—an increase in the money supply.

The definition of inflation we use—and convey in discussions with clients—is grounded in the understanding that inflation is “always and everywhere a monetary phenomenon” attributed to deficit spending by governments and an expansion of the Fed’s balance sheet.

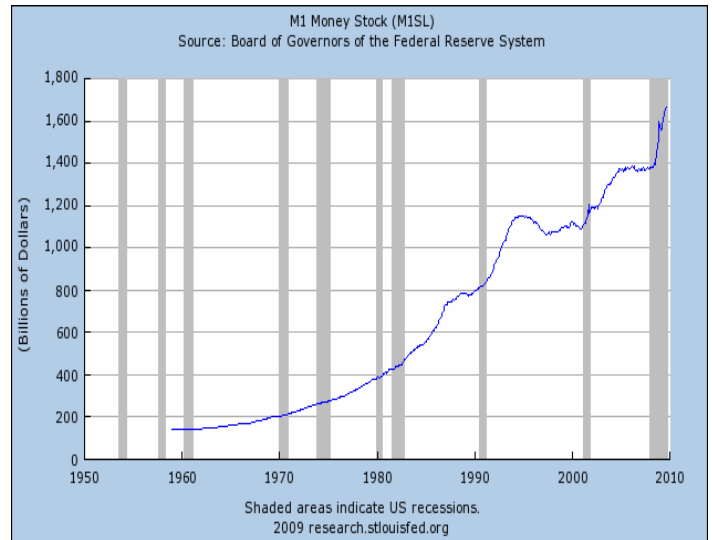
What about Deflation?

For true “deflation” to occur, there must be a sustained *contraction* in the money supply, which causes a currency to fundamentally *strengthen* in value. Examples of this are rare because in a *fiat* monetary system the base money supply must perpetually *expand* or the system collapses [see **graph**].

Asset bubbles will pop from time to time (e.g., tech stocks in 2000 and real estate in 2007) and prices will fall for some consumer discretionary goods (e.g. flat-screen TV’s, luxury goods, etc.), but current monetary doctrine advo-

cates deficit spending and re-inflating the money supply to counteract “undesired” market corrections. True deflation is forestalled and the net effect is another round of inflation.

Short of a complete reversal of monetary and fiscal policies made at the federal level, all signs point to continued money printing by the Fed over time as the only viable political response to the ongoing economic crisis.



Sources:

1. www.stlouisfed.org
2. www.caseyresearch.com

3. www.bloomberg.com
4. www.stockcharts.com
5. www.shadowstats.com

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

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- ◆ Modular Financial Planning
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- ◆ Retirement Income Planning
- ◆ Qualified Retirement Plans
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Contact Us

2924 Emerywood Parkway
Suite 100
Richmond, VA 23294

T: (804) 672-0040
Toll-free (888) 300-2517
F: (804) 672-2006
E-mail: info@afcgllc.com
Web: www.afcgllc.com

For more information, please contact us for our brochure.