Interest Rates Unattractive

May 2011 Client Letter

I sure would feel more comfortable if an attractive interest-rate environment accompanied today's stock-market gains. While the Dow is up over 7% YTD, the yield on a five-year Treasury note is a lowly 1.7%. But a competitive interest-rate environment has not been a priority of the Federal Reserve. Instead, the Fed has kept its core short-term interest rate near zero while spending heavily on bonds to keep longer rates low.

By keeping rates low, the Fed has been able to recapitalize banks and prop up the financial system. Essentially, banks are allowed to borrow from the Fed at rates much lower than those available to you and me—near 0% interest. The banks then use the cheap borrowed money to buy longer-term Treasuries, lock in a nice profit, and boost their balance sheets. As banks become healthier, businesses and consumers are lured into using their credit cards again. Savers who are unwilling or unable to accept low yields on CDs and bonds jump into the stock market, which helps sustain the rally. As the markets rally, paper wealth is created and consumers head back to the shopping malls. With a wave of the magic money wand, the Fed has given the appearance that the financial crisis has been mitigated and a recovery has begun.

Today, many of the bankers who played a large role in creating the financial crisis are profiting once again, with large salaries and bonuses. On the flip side are the nation's 50 million retirees, who have been significantly compromised through low interest rates received on their lifetime savings. It's almost as if the retirees have financed the bank bailout. The rising stock market has helped the likes of Bill Gates, Warren Buffett, and Larry Ellison finally began to recover their losses and get richer and richer. Meanwhile, younger families, college graduates, and hourly workers, who tend not to have sizable investment portfolios, benefit less from the market rally.

Thanks to the Fed's easy-money policy, the dollar has weakened, contributing to higher food and energy prices. These inflationary pressures hit retirees who operate on a fixed income and make it difficult for younger families, college grads, and hourly workers if their incomes do not keep pace with the rising costs.

And so we have an odd

environment where the Dow Jones Industrial Average is currently on pace for its third consecutive year of solid appreciation, yet millions in our country are financially challenged. Many who are not financially challenged are concerned about the direction of the country's finances. Not a day goes by without discussion and reports on the country's annual deficits and budget problems.

Take, by example, this headline from the *L.A. Times* on May 16: "U.S. Hits Debt Limit and Takes Actions to Postpone a Default." How worried should you be? The headline is of course referring to the U.S.

hitting the congressionally mandated debt ceiling. When a country spends more than it collects in taxes, it must borrow. But since the U.S. hit its debt limit in mid-May, borrowing is no longer an option. Sounds like a problem—especially since the U.S. is running trillion-dollar deficits. In order for the country to borrow more, Congress must raise the debt limit. If it doesn't, the U.S. could default on its debt—roiling financial markets. For being faced with an event with such cataclysmic consequences, the financial markets don't seem too worried. Treasury yields are falling, not rising as one would expect if default were anticipated.

Why is the bond market so relaxed? Investors understand that the debt ceiling debate is a game of political chicken. Republicans are using the issue as leverage to negotiate a much-needed deficit-reduction plan. Congress will most likely raise the debt limit before it becomes a problem, and the U.S. won't default on its debt—at least in the short term. In the longer term, U.S. solvency is not as clear.

The Congressional Budget Office projects trillion-dollar deficits for the next two years and a gross debt-to-GDP ratio well above 100% over coming years. And that is according to overly sanguine economic assumptions. Greece, Ireland, and Portugal all required bailouts at levels of debt to GDP near or below those projected for the U.S.

If the U.S. doesn't pass a deficit-reduction plan, does it risk default? Yes, but not in the way you may think. You see, the main difference between the U.S. and the euro area's peripheral countries is that the U.S. can print money. Greece, Ireland, and Portugal cannot. In the euro area, the European Central Bank is the sole supplier of money. The only way for Greece to reduce its debt is to collect more taxes than it spends. In the U.S., we have another option for reducing the debt burden—inflate it away. Given the choice between an outright default on government debt and a soft default via inflation, policy makers will always choose inflation. Investors in U.S. Treasuries shouldn't worry about losing principal; they should worry about losing purchasing power.

You can be sure the world's global central banks are worried about losing purchasing power in U.S. Treasuries. Global central banks hold over 30% of outstanding U.S. Treasury securities. They fully understand the consequences of failing to pass a comprehensive deficit-reduction plan. Some are even questioning the dollar's role as the

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world’s reserve currency.

Will the U.S. Dollar Lose Reserve Currency Status?

What are the prospects of the U.S. losing reserve currency status, how soon could it happen, and what would the consequences be?

When you read that the U.S. is at risk of losing its status as the world’s reserve currency, it is important to understand that the dollar is not *the* world’s reserve currency, it is *a* reserve currency. Yes, it’s the primary reserve currency, but the euro, yen, and pound are also important reserve currencies. In fact, IMF data shows that dollar currency reserves make up 61% of allocated global currency reserves—down from 71% 10 years ago.

So the question isn't whether the dollar will lose its role as the world's reserve currency. The dollar's importance in global currency-reserve portfolios has been gradually declining for years. The question is whether the dollar's share of global currency reserves will decline suddenly. Analysts concerned that foreign central banks could wake up tomorrow and decide to liquidate their dollar reserves must ask themselves what would be purchased in place of dollars.

The Swiss franc would be at the top of my list. Switzerland is a neutral country, and the franc has proven over many decades to be a hard currency. We own francs in many portfolios for some of the same reasons. Why aren't global central banks buying more francs? Because the Swiss economy is too small. There are over $9 trillion in global currency reserves. Switzerland's GDP is only $500 billion.

The U.S. is the world's largest economy, with annual GDP of $14 trillion. Though it isn't a country, the second-largest currency bloc is the euro zone, with GDP of more than $12 trillion. The third-and fourth-largest economies are China and Japan—both with GDP of about $5 trillion. The fifth-largest economy is the U.K., with GDP of $2.1 trillion. Once you get past the five largest economies (counting the euro zone as one), you are looking at countries such as Brazil, Canada, and India. All have annual GDP of less than $2 trillion. When there are only two economies with GDP of more than $9 trillion, it should be clear that size is a major limiting factor in replacing the USD as the lead horse in global currency-reserve portfolios.

What are some of the other limiting factors? Convertibility is an issue for some countries, namely

China. An inconvertible currency doesn't serve much purpose as a reserve currency. China is also still a command-style economy. There may be some foreign governments that are comfortable investing in light of China's ruling party, but there are many more that prefer a stable democracy and an established and transparent rule of law.

Another important factor for a reserve currency is military power. If you are a foreign central banker responsible for investing the reserves of your country, do you want to worry about a rogue nation attacking the country you are investing in? Though the risk is small, an adverse outcome could result in a total loss of capital. Any country lacking the means to properly defend itself is unlikely to take a leading role in currency-reserve portfolios.

When you consider the currencies large enough to replace the dollar, it is difficult to come up with a credible scenario in which foreign central banks suddenly liquidate dollars. What would these banks buy in place of dollars? The only currency that is even a potential contender is the euro. But the euro is a young currency, and its sustainability remains in doubt. Who wants to put most of their eggs in that basket?

Over the long term we expect that the dollar's share in currency-reserve portfolios will decline, but the adjustment will be gradual, not sudden. In my opinion, there is no viable alternative to accommodate a sudden move out of dollars.

What are the investment implications of a gradual decline in the dollar’s share of global currency reserves? As fewer dollars are purchased by global central banks, there could be pressure on the dollar to decline—but the more likely scenario is that there will be pressure on U.S. Treasury rates to rise. If foreign central banks stop buying dollars, they stop buying Treasuries. The drop in the number of non-price-sensitive buyers would likely push up U.S.

yields. Higher U.S. yields would likely result in greater demand for U.S. Treasuries, both at home and from abroad. Which asset classes are the losers in such a scenario? Long bonds and riskier assets. If investors can earn higher returns on full-faith-and-credit-pledge Treasuries, they will demand greater returns from higher-risk assets—and that means lower prices.

The federal government's fiscal and monetary policies have created uncertainty and concern. And the Fed's great money flood has complicated investment strategies. Many investors have fled the relative safety of money markets, CDs, and investment-grade bonds in favor of high-growth opportunities from the stock market. We view this shift as a misallocation of capital that could end up hurting many investors.

In general, we continue to favor a balanced portfolio that includes a mix of both stocks and bonds. While interest rates on bonds are much lower than in years past, we do not believe the dust has settled from the 2008 financial crisis. Stock-market volatility remains a constant threat, and shorter-term investment-grade bonds both provide a predictable stream of annual income and help to reduce overall portfolio volatility.

To diversify away from the dollar, we include a mix of gold and foreign currencies. Today, many of our favored foreign currencies are expensive, so we are limited in how much we can purchase. Recently, though, we added to our Swedish holdings. Sweden is a country we favor for many reasons, which I will highlight in June's letter.

Have a good month, and as always, please call us at (888) 456-5444 if your financial situation has changed or if you have questions about your investment portfolio.

Sincerely,

Matthew A. Young

President and Chief Executive Officer

P.S. Currently, a three-month T-bill yields a lowly 0.05%. At some point, though, rates will begin to rise. Surges in interest rates are one of the biggest concerns for bondholders. We are implementing several strategies to deal with such an environment. One strategy is to gain exposure to debt securities whose interest payments adjust regularly. Floating-rate funds invest in bank loans made to lower-quality companies. The rates on these loans usually adjust every 30 to 90 days several percentage points above LIBOR. As rates rise, the yield on banks loans will rise as well.

P.P.S. An eventual rising interest-rate environment will likely be accompanied by inflation. Dividend payers, especially those that raise their payout annually, can have special appeal during inflationary periods. Unlike the interest received from most bonds, dividend payers offer the potential for a higher dividend payment each year, helping to preserve the purchasing power of an investment portfolio. Our Retirement Compounders equity portfolio has an approximate current yield of 4.5%. The Retirement Compounders portfolio of 32 securities invests in select sectors of the market, including energy, pipeline companies, utilities, and consumer staples. International holdings include Canadian, Brazilian, Swedish, and Swiss securities.

P.P.P.S. One of the few securities we own that does not pay interest or a dividend is gold. And gold is perhaps the only security we own whose price we hope declines in value. But as long as the U.S. printing presses continue to rumble and other concerning issues persist, we believe gold to be a necessary component of an investment portfolio. We are not as enthusiastic about silver. No doubt silver can act as a hedge against grim world developments, including inflation, currency debasement, and geopolitical fallouts. But in our view of late, gold appears to be the more stable metal of the two. There are several reasons for this. Silver has a much lower price compared to gold, which can be more attractive to the speculative crowd. The market for silver is much smaller than the market for gold, also lending to higher relative volatility. Lastly, central banks tend to favor holding gold over silver in their reserves, which helps with gold's stability. In 2005, we started buying gold. Today, a combination of gold and foreign currencies accounts for approximately 10% of our clients' portfolios.

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