The Delta Group

A FINANCIAL ADVISORY FIRM
Volume 26, No. 1, Jan 2010, Eric Drew Dahl & Patricia J. Williams, Editors

Overview:

What a ride, eh! 2008's death spiral turned into a rocket launch that witnessed market gains of 60% off the March lows. With unemployment at 10 percent plus, trillion dollar budget deficits, and the US dollar heading towards Argentina, the market's bounce reflects perceptions of better times coming in 2010.

Naysayers worry that the third quarter GDP gain of a meager yet positive 2.2% was driven largely by government consumption and spending which, by nature, is temporary. Borrowing and spending an economy out of debt hasn't worked for Japan's two decade recession and won't work for us either. Although politically sensitive to the struggles of the citizenry, the government's effort to better the mood is mortgaging our future.

The decade began with the U.S. owing $5 trillion which has more than doubled today and is expected to double again by 2019. Not coincidentally, our currency has lost more than half its value over the same period.

John Maynard Keynes, the famed and often quoted economist opined almost a century ago: *"The best way to destroy the capitalist system is 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."*

Adding insult to misery, the $20T estimate doesn't include Social Security commitments, prescription drug obligations and future Medicare payments. These "unfunded" legislated liabilities total in excess of $100T!

The obligations of Fannie Mae and Freddie Mac the mortgage behemoths, whose financial wanderlust provided the seed to the real estate bubble, must not be ignored. A promise without currency is called a Ponzi scheme.

Economic

The estimate for unemployed and under-employed workers is guessed at ~17% nationally, 20% in CA, with 7M jobs lost in 2009. Great Depression levels of ~25% are a downturn away. Business entered survival mode mentality during last year's crash, laying off workers, canceling projects, and preserving capital. Uncertainties regarding the cost and eventual tax levy of Washington's agenda, along with restrictive bank lending, have held back business expansion, and job creation.

So how do we benefit from the government's stimulus spending spree? Does it make us more competitive worldwide or allow small business to be more profitable, or promote job creation in the private sector? Perhaps, hardly, and not a chance!

Government doesn't create jobs – the private sector does. Government merely redirects dollars taxed from wages and profits generated from productive resources in the real economy. DC mustn't forget a simple truth: wealth has to be created before it can be shared. Only profitable businesses dare add workers.

During 2009, the Federal government has added ~10,000 bureaucrats a month. The increased role of the public sector comes at the expense of growth and prosperity in the private sector. Could the government actually swallow the economy?

Speaking of frugality, our poor state of California is short again with a $20B deficit projected through the next fiscal year. The number could go higher as the state suffers under the weight of a deflated housing bubble, over-regulation, and tax-generating businesses heading to other more profit-friendly states.

Although the US and world economies are expected to grow through 2010, the strength of the real, un-stimulated economy is unclear.

Comparisons to the 1970's are becoming more valid, a period of payback for the previous decade's government largess from Johnson's Great Society and the Vietnam War.

That sputtering and inflationary economy earned the moniker "stagflation" as financial markets went miserably sideways for many years. The charade ended with double digit inflation, gold prices rising twenty-fold and Fed policy increasing short term rates above 20%. Picture that.

Investment

Virtually all investment segments were positive last year, save for the super-safe Treasury bonds which lost their luster as investors ventured out and took on risk when it became apparent the world was not collapsing after all, at least in 2009.

Last year's newsletter suggested a conservative allocation, preferring assets which provide an immediate return via monthly interest or quarterly dividends, with some growth thrown in for good measure. It was a good year, although the decade for stocks had the lowest ten-year return over the last 80 years. The broad market lost about 10% of its value over the ten-year period, a reminder not to take anything for granted, e.g., real estate never loses value. We discovered, though, that being a successful long-term investor might exceed our mortality.

We move into 2010 with no significant changes anticipated, aside from being wary of a market correction. The Fed, strongly motivated not to choke off the recovery, has stated they will keep rates low through year-end. Today's Fed strategy can have negative consequences tomorrow. Near zero interest rates lends itself to a weak currency and rising gold prices, and soon inflation. Everything imported, plus energy and materials cost more. If the Fed won't, we have to watch our wallets, and the "real" value of our bank accounts.

Today, we happily measure the value of our portfolios in dollars. Yet, as was the case in the 70's, a more productive measure was in purchasing power. We have a notion that a $1M portfolio can safely provide about $50k in annual income. Good, but how much will the $50k buy? Rising taxes will take a bigger chunk, as will increased health care and utility costs.

2008's successful money market mattress strategy, an effective scheme to protect capital, offers no purchasing power protection. Since inflation erodes the value of money, a "risk free" return is a guaranteed loss.

On the other hand, the price of gold has represented a store of value since the beginning of time. The precious metal increased 25% this past year – four-fold during the past ten – reflecting waning confidence in paper money. As the government continues to "print" dollars, expect this trend to continue.

Structuring portfolios to benefit from inflation, and not suffer from it, continues to be our primary long term objective. Tangible assets are an ideal compliment to fixed income paper assets.

Conclusion

Our 30-year experiment to create wealth from debt has failed as the scheme to buy three leveraged houses as a means to early retirement ended badly. The government's welfare/debt expansion remedies the symptoms, yet doesn't treat the cause.

Government will print and spend money for as long as the market will buy it. When the punch bowl empties, watch out. Oh, that's our job.

In the meantime, we can't predict market movements, but we can control risk. We can save more and spend less. Rid ourselves of debt. Manage our own welfare. We will survive and prosper.

This feels like the eye of the hurricane.

Many thanks for your continued support and patronage. We will make every effort to make the coming decade more prosperous than the last.