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the BENEDICT *REPORT*

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ARE THINGS GETTING LESS BAD?

A few of you have commented that it has been quite a few weeks since we have mailed out a *Benedict Report*. Some have also asked when we are going to send out more frequent *REPORTS* via email.

The response to the first comment is that I have had so many articles floating around in my head, and some on paper, but I haven't taken formal action. I have many people tell me this is the only financial thing they read. So, how in the world do I write something that is relatively easy to read using simple examples that makes sense of a world that seems out of control?

I can't, but will try by breaking it into smaller bites in future *REPORTS.* In this issue you will find a Question and Response format for much of the newsletter in an attempt to cover a lot of topics that are related and diverse at the same time. In the future, we will add more detail on specific topics.

As for a more frequent electronic version, be patient. It will come!

We are a world awash in debt and that debt needs to change. It is changing within the corporate sector and the consumer sector as both groups are paying down rather massive amounts of debt…or "deleveraging"- as the economists call it.

However, at the same time our government, like many other governments in the Western world, is taking on massive amounts of new debt. Very, very bright economic minds tell us that if corporations and consumers are "deleveraging" then the government has no choice but to take on more debt, or add "leverage."

I was raised on a small farm where most people were far from rich but most had a high dose of common sense. And, to most of those people, borrowing more never solves the problem of over-indebtedness; it only prolongs the problem and makes it bigger. Thus, I struggle a great deal when our leaders appear to be fast-and-loose in their borrowings and future commitments. I do recognize, however, that we are just coming out of a massive credit problem and business recession. But, quite frankly, I don't think throwing money at the problem is the solution.

Our political leaders have had their focus on programs that they feel will make our country better and fairer, and maybe they are right. But, many of us feel as though they have been focusing on adding exciting new enhancements to our ship while the rest of us are staring at the big cracks in the hull and the intake of massive amounts of water. So, here we are. One side is set on making life better and the other side is saying it doesn't matter because we are sinking fast. Who is right? I don't think it is really that simple and maybe the rest of the *REPORT* will add to this.

THE DELEVERAGING OF AMERICA

Almost every reasonably educated, aware person who has a bad health habit or a bad financial habit knows deep in her or his heart that some day they have to change their ways or an outside force will force drastic action on them. We can keep puffing on the smokes or eating the deep fried goodies or slugging down the high fructose laced soft drinks all we want, but we know deep in our hearts that our actions are unsustainable, just as we know credit card debt, lack of savings and unbridled spending are also unsustainable…we just don't know when that day of reckoning will be or how it will play out.

Our federal government is like the couple next door who is borrowing to pay their day-to-day bills. This is not sustainable. This type of fiscal management didn't work for General Motors and it won't work for the good old U.S.A. We just don't know exactly how it will end or when. We have simply over-borrowed on a grandiose scale for many years and at some time, we must *pay the piper*.

One theory is that the government will just keep printing money, making our money less valuable and the world will finally quit lending us money at low rates resulting in out-of-control inflation in the future.

Another theory is that the massive decline in asset prices, which will be followed by a big increase in taxes to try to reduce the deficit, will create a deflationary economy that spirals downwards in a negative compounding manner.

As I addressed in the STATE OF THE UNION address in the January *BENEDICT REPORT*, I believe the solution would be an immediate recognition of the problem, an education of the citizenry and taking immediate steps towards a solution. This would entail immediately reducing government spending, the sale of assets and a totally new mind-set within Washington D.C. and the country as a whole. But, I seriously doubt this will happen. It is natural for our political leaders to postpone the inevitable until past the end of their "watch." And, I have little confidence that the populace is ready to see their pet projects moderated or eliminated.

Thus, we are left with the fact we are riding on a big ship that is headed in an unsustainable direction. And, we don't know how it will turn out, but we do know we need to protect ourselves as much as possible.

SOME QUESTIONS. . .

Before we get into what we are doing with our investment accounts in these unchartered seas, let's ramble for a couple of pages by commenting on questions we have been asked.

QUESTION: I keep hearing that what the government is doing will cause very high inflation in the future. Why is that?

RESPONSE: We, as a federal government, are very close to having borrowed more than we can ever pay back. We are close to the point where we can't possibly raise taxes enough to pay off the loans, even if the economy quickly turns around and even if we tax the "rich" at a rate of 100%. Thus, what does a government do: immediately reduce spending or just keep printing dollars in the theory they will be less and less valuable in the future, making it easier to pay off the previously borrowed money?

QUESTION: This borrowing phenomenon didn't just begin. Why is so much attention given to it now?

RESPONSE: First of all, most economists and most people will tell us that a reasonable amount of debt, especially debt used to acquire valuable assets, is financially astute and would even be considered prudent. I agree.

But, many years ago we started going beyond borrowing to acquire valuable assets; we started borrowing to fund day-to-day operating costs. But even then the borrowings were three or four percent of our Gross Domestic Product (GDP) and since the GDP was growing almost that fast, it wasn't devastating - - even if it was stupid.

Now things are a lot different. Because of the economic slowdown, government revenues have declined significantly and because our leaders have responded with significant increased spending, we are at the point where about 40 cents of every dollar we spend is borrowed money and we are making more future financial commitments. How long do you think we can keep this up?

I don't believe the concern is so much one political side vs. the other as it is economic common sense.

QUESTION: What do you think could be a solution to the debt problem?

RESPONSE: We cannot, as a government, just quit spending. The government is too engrained in our economy and our society, and it would be devastating for our economy and for many citizens. However, I would look into a ten-year program of reducing the size of the cost of the federal government to eventually eliminate the federal debt.

QUESTION: So you think we are in for high inflation?

RESPONSE: Not necessarily. I actually think we could have inflation and we could also have deflation as some parts of the economy go in different directions. For example, I believe real estate could *deflate* more in value while the cost of heating and cooling your real estate significantly *inflates* in cost. Food costs could *inflate* while automobile costs *deflate.*

It is hard to see high overall inflation when 10% to 15% of the workforce is idle or only employed part time and when there are vacant retail, office, manufacturing and distribution facilities on almost every corner.

The only way I see high inflation in the next few years would be if it is caused by a tremendous spike in energy costs.

QUESTION: By that you mean high oil and gasoline prices caused by the big oil companies?

RESPONSE: Energy costs could be impacted by a weakening dollar versus other currencies, thereby making the oil (and gasoline) cost more in terms of dollars. And/or we could see the Middle East go to war. And/or we could see more problems in other oil producing regions like Nigeria and Columbia, thereby reducing supply in the global marketplace. And/or we could see a political attack that closes the Strait of Hormuz. There does not seem to be a lot of excess production, so any major disruption could be a global problem.

QUESTION: So you are planning on oil prices going a lot higher?

RESPONSE: Yes and no. We do think this is a big risk. However, it is easy to make a case that prices will remain moderate. What if the U.S. Dollar strengthens against other currencies? In this case, oil would probably seem cheaper. What if the China economic miracle stalls for a few years? What if those Iraq oil fields start to produce? Also, I'm not one who wants to see oil rigs everywhere, but I was encouraged by the recent announcement by the President allowing more offshore drilling.

QUESTION: The government is printing all this money, doesn't that automatically mean high inflation?

RESPONSE: It isn't quite that simple. Let's back up a bit and look at our banking system. You deposit $10,000 in the local bank. The bank takes your money and is allowed to make $100,000 of loans. (This isn't the exact figure, but I'm trying to keep the math simple as well as the overall theory.) Thus, $90,000 of *new money* was created. That's been going on for years.

Then in 2008 the financial crisis hit and suddenly that $100,000 of loans that were created by the bank became almost worthless. If that is the case then $100,000 of *money* disappeared.

It seems to me, that at the same time, if the Federal Reserve created $100,000 of *new money*, then not much has changed in the overall money supply.

It certainly appears that many of our banks have a lot of loans on their books that are not worth anywhere near their "book value." I suppose this will be a future topic.

WHAT ARE "WE" DOING?

So, we are faced with the feeling that at some time in the future some bad economic things may happen, but we don't know what or when. We should all feel like a blindfolded person walking through the woods populated with blind hunters. But, before we commit hari kari, let us remember that we have never had a clear insight about the future. Oh, we may have felt we knew what the future would be, but in almost every case reality was far different than our expectations.

We believe the solution is awareness and a plan. Awareness that we don't know what is going to happen and a plan that provides us some hedge against the bad things that could happen and benefits from some of the good things that may occur.

The Plan should be prepared, if:

- Interest rates rise rather significantly
- Interest rates stay low for several years
- Inflation increases significantly
- Deflation or lack of inflation
- The U.S. Dollar gets significantly weaker
- The U.S. Dollar gets stronger

Our solution is a five-step approach as follows:

1. Generate as stable of an income as possible from dividends and interest that can compound or be withdrawn to provide a retirement income. Much of this income will come from dividend-paying stocks. This is our "foundation" and you need to focus on it.
2. Own stocks in globally dominating companies, especially companies that have very modest debt, high free-cash flow and a management team that knows how to create shareholder value. We feel these are assets that can adapt quickly to changes happening globally. We will write more on this in the future.
3. Moderate volatility and provide income with corporate bonds that come due in less than ten years.
4. Own assets that should benefit from an increase in energy prices.
5. Have a reasonable amount of each account allocated to be able to take advantage of a crisis. We call these assets our "dry bullets."
6. This isn't an "official" part of our Five-Step Approach, but where practical, allocate part of each account to investments that are not dominated in U.S. Dollars.
7. This also isn't an "official" part of our strategy, but when possible, we like to allocate part of the account to investments that have the potential to "outgrow" a stagnant economy. Sometimes these are smaller companies and other times they are companies in an industry that seems positioned to prosper when others may be struggling. We call this our "special opportunities."

MORE QUESTIONS!

QUESTION: If the big risk isn't inflation, what is it?

RESPONSE: We think there is the possibility of a spike in interest rates, which would create a lot of turmoil in the financial markets. The turmoil may turn out to be relatively short term, but during times of crisis, nothing feels short term. A lot of events could cause this interest rate scare, maybe China announces they will no longer buy our bonds, maybe the speculators who have been borrowing at short-term interest rates and investing in longer-term bonds will get spooked or maybe the oil producing countries say they are no longer going to price their oil in U.S. Dollars.

Despite talking about this potential risk, there isn't much we can do to "hedge" against it other than to have money to invest during the time of turmoil. And, our crystal ball may be totally foggy and this doesn't happen. The future is so easy to predict, but getting it right takes a little more talent.

QUESTION: What percentage of your accounts are in what you call "dry bullets?"

RESPONSE: Between zero and a lot. This depends on a lot of things. For example, if someone has significant assets in the bank or seems to have the financial and psychological make-up to handle market volatility, we may have zero "dry bullets." Conversely, a very risk-adverse account may have significant "dry bullets." The problem in this latter case is usually this same risk-adverse account needs to generate a relatively high current income and we are forced to seek higher income investments.

QUESTION: It seems I hear a lot about the government devaluing the dollar, thus why isn't Step 6 an "official" part of your strategy?

RESPONSE: With each account we have to make a judgment about what are the really big risks and what are the most valuable benefits the account can provide. For example, if someone is withdrawing heavily from an account, we usually focus on providing as high of an income as seems prudent. This focus on high income would limit our exposure to some areas.

QUESTION: What happens if the government does "devalue" the dollar?

RESPONSE: I can't believe it would be good. However, by randomly printing money we are unofficially devaluing the dollar. It just makes sense that, if we print a lot more dollars, each existing dollar has less value. Owning investments that are not priced in dollars should be a good hedge IF that currency stays strong. The problem is knowing whether these currencies will remain strong during times of crisis. For example, right now some of the currencies of countries that have abundant natural resources seem strong. But, to invest heavily in one of those currencies makes an account quite susceptible to a decline in commodity prices. One of the main risks to a "devalued" dollar to everyday U.S. citizens is that the cost of imported goods would probably increase significantly. While we can quit buying imported underwear from Wal-Mart, it is more difficult to get to work without using refined oil products. Thus, one of the best protections would probably include being frugal in one's energy consumption.

QUESTION: I'm a little confused, do you see inflation as a risk or not?

RESPONSE: Longer term it is easy to see significant inflation risk. Shorter term we may see some of the opposite, which may mean that today's low interest rates are here for several more years.

QUESTION: I lived through the inflation of the 1970's and early 1980's; why would they want to subject us to that again?

RESPONSE: Our governmental leaders are really a reflection of all of us, whether we like to admit it or not. And, it seems to be very American to want gratification today and worry about tomorrow...tomorrow. Also, we have cycled into the era in which quite a few of our current leaders did not experience the inflation of the 70's. I believe inflation is a result of weak political fortitude, but most of our elected representatives want to keep their jobs and power, thus they cave into this weakness.

QUESTION: So, I take it you have a pretty bleak opinion of our future?

RESPONSE: Actually, that's not totally correct.

I do believe that at some point in the future we are going to have to repay the money we are borrowing and part of the repayment may be much higher inflation. There is certainly the risk that the foreign governments that are big buyers of our debt suddenly quit buying or demand much higher interest rates to help compensate for the depreciating purchasing power of the dollar. However, it is also quite possible the situation will drag on for years and years.

If our leaders start showing some signs of fiscal sobriety, it will help a great deal.

I actually think the entire world is looking to us saying something like, "please get your financial house in order because we have nothing else we can count on." Of course they are saying this while still competing with us head-to-head economically and politically and, in many cases, laughing at a group of people who have almost everything but want more and more...paid for by someone else.

QUESTION: I still don't know if you are saying we should be totally frightened or not?

RESPONSE: I believe our current leaders have agendas that are much more important to them than getting our economy under control. They certainly don't show any spending restraint. But, that could turn quite quickly if the American people rise to the occasion.

We do believe there will be economic consequences to our current economic actions. But, how those consequences play out and when are very big unknowns. The country of Iceland did some very stupid economic things and literally went bankrupt in a couple of years, while Japan has spent more than two decades adding to their deficit with make-work jobs created by government spending.

I guess you could say that we know what we know, but we don't know what we don't know. I'm quite certain the future will be different from what we think it will be, thus we are trying to manage our investment accounts with a strong focus on common sense and a faith the American voters will demand more economic sobriety. We believe in this economic environment every investment account should provide a solid income. We also believe the bedrock of any longer-term investment account should be globally dominating, dividend paying common stocks. We try to focus on years and not weeks or months. We have had a depreciating dollar for decades and we do not expect that to change. We have had what much of the population considered inept elected officials for decades and we do not expect that to change.

QUESTION: It feels like a very risky time to own stocks, is it?

RESPONSE: If you focus on the daily or even monthly volatility of the share prices, it is almost always a risky time to own stocks. We suggest you learn to focus on the "company" and not the company's "stock price." We will cover this in a future *REPORT,* but here's a quick look at how this focus works. During the 1970's we had a lousy performing stock market. However, there were a lot of companies that doubled or even tripled their profit during that decade and companies that doubled or tripled their dividends. Many companies were performing well but their share price was not. Focus on the *company* and not the *stock.*

Many of today's giant corporations are lean-and-mean. They have no debt or have refinanced their debt at historically low rates. Many have a lot of cash on hand. These companies are primed to expand and conquer. Owning shares of globally dominating companies should help us weather any financial storm.

QUESTION: The article on *The Deleveraging of America* said we are "headed in an unsustainable direction." Doesn't that imply bad things are about to happen?

RESPONSE: We will suffer the consequences of our over-borrowing. However, how that will play out is unknown. Something may happen in the near future or we may stumble along for years. My real fear is that economically things start looking much better and the American voter loses his or her appetite for financial sobriety. We don't know the future, but we need to be aware and have a plan.

Do remember that the riskiest time to be in the stock market is when the future looks perfect. And, the easiest time to make money in the stock market is when a situation goes from bad to less bad. Get it? The easiest time to make money in the investment markets, and many other areas also, is not when things seem perfect, but when they seem LESS BAD. **My crystal ball sees a lot *less bad* over the next several months.** We could easily have a down market cycle first, but don't spend all your time looking in the rear-view mirror and miss things getting better.

Life will never be perfect. We are watching high-drama play out on a very global scene. You may as well enjoy the theatre because we are all part of the experience!

WHAT WE DO...

We prepare financial plans, which are essentially blueprints for what our clients are trying to achieve in the future. Much of our planning involves creating a Retirement Income Plan for our clients.
We manage our clients' investment accounts on a fee basis with discretionary authority focusing on meeting their objectives rather than focusing on what the financial markets may be doing.

The primary author of The Benedict Report is Philip C. Benedict, CFP®, an Investment Advisor Representative and Registered Principal with **LPL Financial**, a registered investment advisory firm and member of FINRA/SIPC. Travis James, CFP®, Mark Beaver, CFP® and Ashley Thompson provide technical assistance. Jean Wilson handles the layout and editing of the newsletter.

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