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# the BENEDICT REPORT

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## "A COME TO JESUS MEETING"

*"Are we going to be all right?"*

*"I was fairly young during World War II but I remember worrying that the country as we knew it could disappear. Suddenly, I find myself worrying about it again, only this time because of our debt."*

*"I worry that, despite my years of hard work and living well within my means, it will all be wiped out by inflation and currency devaluation."*

In speaking with people over the last couple of months there certainly seems to be a lot of unease among us, which is frequently magnified into sudden movements of the stock market. Over the next few months, maybe years, these stock market gyrations are likely to be fast and furious and I believe they could go in either direction...up or down...maybe both, such as spike upwards and then crash downwards or vice versa. That is why we keep preaching that if you are investing, you have to look at the quality of the asset and not the daily price of that asset.

But let's forget the shorter term and take a few paragraphs to review some of the major things that seem to be on our minds.

Question: Is it true that we are going to see high inflation?

Response: It does seem as though fairly high inflation could be in our future. But, it is also possible that it may be many years in the future. We currently have factories not being used, vacant retail and office space and employees almost begging for that job they used to hate. All this extra "capacity" should hold down price increases unless...

Question: Unless what?

Response: Unless the dollar weakens substantially against other major currencies. Then the cost of our imports is likely to increase rather dramatically. This would definitely include energy and a lot of other things we consume. And, if energy costs increase dramatically, then costs of hauling and delivering goods has to increase, costs to plant and harvest crops has to increase and costs to commute to and from work increase.

Question: You are saying the prices we have to pay for many goods could rise significantly even if buildings are sitting empty and people are sitting at home reading the help wanted section.

Response: Yes.

Question: Is this new action of the Federal Reserve *printing money* helping or hurting the situation?

Response: There is no easy answer. In areas like this almost everything is dependent on everything else. Theoretically, if you create more dollars you make each existing dollar less valuable. Thus, we might expect the dollar to *weaken* against most other major currencies.

Question: You seem unsure; why would this not *weaken* the U.S. Dollar?

Response: If the currency traders of the world feel the other major economies are in even worse shape than ours. It also seems possible to me that, even though the Federal Reserve is *creating* more dollars, they may be just replacing dollars that were lost during the last few years, thus no NEW dollars are really being created.

Question: Who LOST those dollars?

Response: I think it is quite possible that our entire banking system had, probably still has, bad loans that far exceeded their capital (equity). If they had really disclosed the uncollectible loans, most would

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be out of business. The Federal Reserve, by keeping interest rates very low, is making the cost of acquiring new money by banks very low to help them re-build their capital.

Question: I'm not sure I understand.

Response: The banks are still counting as collectable a lot of loans that may never be paid back, but they are slowly *writing off* these loans against new profits. So, instead of putting new money into our economy, they are still paying off past losses. It is somewhat like a family paying off their credit cards when in the past they were adding to them. This results in a big change in the amount of their consumption.

Question: Will this work?

Response: I have no idea. Any time you mess with the laws of nature you risk unintended consequences. It will probably save many banks or it may turn out to be about as fruitful as putting fertilizer on a dead tree.

## COME TO JESUS MEETING...

The American public is desperately yearning for strong leadership. We need leadership that has solid strategies to protect our freedoms and keep our economy strong AND leaders who can articulate these strategies to the masses. Almost every American knows we have some tough choices to make over the next few years and, if properly explained and implemented, most people will follow the lead IF they feel there are solid benefits in the future for enduring pain today and they feel the pain is spread as evenly as possible over all parts of our society. But, we want to be told the truth and we want consistent actions to protect our future.

Over the last several years the federal government and many state governments have been following the playbook of the old General Motors. Borrow to pay current expenses, pretend there are no problems, make promises that can never be kept and count on a miracle to save us. The employees and shareholders of the old GM deserved better. They deserved a management that was honest with them from the start and they deserved union leaders who balanced current needs with long-term success. They got neither.

American citizens deserve better leadership and will, hopefully, demand better leadership so the American dream doesn't go the way of the Oldsmobile.

We need a "Come to Jesus Meeting" between our various governments and the people of this country. Our leaders need to come clean. If organizations like the Pension Benefit Guarantee Corp. are underfunded, then let's get them funded or get out of the business of making promises. If the Federal Deposit Insurance Corporation is underfunded, let's fix it or forget it. Are we making billions of dollars of student loans each and every year that will never be re-paid? If so, let's stop it or fix it. All these things may be GOOD things to do, but we cannot keep adding liabilities to future citizens just so we feel good today.

Fannie Mae and Freddie Mac are still costing taxpayers billions of dollars each year. What for? I guess to subsidize the housing industry and help it heal. Look back over history and see what subsidized agencies went on to be strong and vibrant. AMTRAK? Postal System?

States and cities have promised employees pensions but, in many cases, there is nowhere near enough money in the system to honor those promises. Be honest and tell the employees right now. Tell them that instead of the $2,200 per month pension that you have been promised it looks like you will only get $1,900, or whatever the numbers are. Don't pretend there is no problem.

We have water pipes, sewer systems, roads and bridges that need extensive repair or replacement. We can't just keep pushing this problem on to the next generations because, like mold, problems grow and compound over time. Raise our water bills and our gasoline tax if you must , but do what common sense says needs to be done. Do the right thing. We don't need stimulus, we need common-sense action.

Social security needs to be strengthened and what do we do? We pass a tax act that eliminates part of the premium that each employee pays into the system. Is this not sending very mixed signals to the American people? WE WILL HAVE TO CUT SOCIAL SECURITY BENEFITS IN THE FUTURE BUT, IN THE MEANTIME, LETS CUT THE CONTRIBUTIONS TO THE SYSTEM. Talk about dysfunctional leadership!

We need a social security system that is going to be there as promised. And, forget this talk about not paying benefits to the financially successful. Should a thirty-five year old who works hard to be financially successful and pays a lot of premiums into the system be denied benefits because of his success? Somehow that doesn't sound right to me. Aren't we all in this boat together?

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But the real untalked about elephant in the room is our Medicare/Medicaid/Part D/New Law costs. The last two years showed us how emotionally charged this topic is, but the funding for these costs needs to be addressed.

Our "Come to Jesus Meeting" will be painful for everyone but it HAS to happen! We need a lot of reforms and the American public knows this. But, we have to balance our budget while providing the services and safety-nets Americans have come to need and expect. To make this happen will require strong, forward-thinking strategies by strong leaders who are respected by the American people.

Are those leaders currently at the helm? I guess only time will tell.

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## The Federal Reserve is PRINTING MONEY!

If you follow the business/economic news at all, you are aware that the Federal Reserve is implementing a policy of "buying" about $100 billion of U.S. Treasury bonds each month for the next six months. The press is fond of calling this "printing money."

First, why does the U.S. Treasury need to sell bonds each month? Selling bonds is borrowing money. Currently, almost 40 cents of every dollar the federal government spends is borrowed money, so you can see they need to issue a lot of bonds. China and Japan used to be two of the biggest buyers of Treasury Bonds - but both countries seem to have greatly cut back their bond purchases. If two of your biggest buyers don't buy, what would normally happen? Probably, the remaining buyers could demand higher interest rates. But, we don't have to worry about that right now because the Federal Reserve is now the biggest buyer.

Where does the Federal Reserve get its money? I guess they just make it up.

Is this wise? I don't know. It does feel like a family using one credit card to make the minimum payment on another card.

What will happen? There are certainly a lot of commentators/experts who say this means we will have out-of-control inflation. Their argument is that the U.S. Dollar will lose its status as the currency of the world and, if this happens, our cost of imports will skyrocket along with our interest rates which will cause the economy to go into a severe recession/depression. (Note: IF all these terrible things happen it may be that the money *printing* was just the tip of the iceberg with the real cause being our trillion dollar budget deficits.)

**"We are now spending (and borrowing) 50% more than we take in as income. As a nation we seem unwilling and incapable of controlling this self-destructive behavior."**
**Mike Williams, January 12, 2011**

But, there is another group that thinks this is a brilliant strategy. (The first I read about this was in the *Money Forecast Letter*, November 2010 by David C. Jennett and a lot of my information comes from there. If you want more information, you may contact them at: 800 542-5018 for subscription information.) Here is a quote from that newsletter (I added the underline): "The Chinese understand that the Fed's promised easing has as its primary motive the ending of China's illegal currency manipulation that has allowed it to gain an unfair advantage in world trade. <u>At stake is nothing less than who is to be the dominant world power during the 21st century."</u>

First some background information. (Most of this came from the publication mentioned above, Wikipedia, the St. Louis Federal Reserve, the Peterson Institute for International Economics and the International Monetary Fund website.)

Some of you may remember from your history books that near the end of World War II the world's currencies were in total disarray. In July 1944, upon the urging of President Roosevelt, twenty-nine nations agreed to meet in Bretton Woods, New Hampshire to create an agreement that would guide the currencies of all member countries. The new system was called the International Monetary Fund. The IMF fixed each country's currency to gold and the U.S. Dollar would serve as the world's reserve currency. This basically started the trend of what we now call globalization.

> Being the world's reserve currency means that it is the currency of world trade. If a company in France wants to buy a tanker of oil, it first must exchange its Euros into U.S. Dollars and use the dollars to pay for the oil. If the world loses faith in the U.S. Dollar, there is no world currency and my guess is the world economy would be in serious financial disarray.

At first everything was good, but by the 1960's many countries learned they could gain economic benefits by "cheating" and printing more money than they had gold. This made their currencies *cheaper* than other countries thus making their exports attractive to other countries which boosted the local manufacturing economy. (Think of traveling to Europe during a time when the U.S. Dollar is *strong,* everything seems so cheap in Europe.) By the mid-1960's the United States was also printing more money than we had gold and in 1971 the U.S. abandoned the gold standard and the cycle of floating exchange rates began.

Japan was quick to realize that if they kept their currency, the Yen, undervalued they would gain the advantage of being able to export goods to countries that found their currency *cheap.* This worked for Japan until China joined the game in the early 1990's.

In China, leaders keep their power by keeping their manufacturing economy strong and they are doing this by encouraging exports and discouraging imports. The offshoot of this is that they have accumulated a huge amount of U.S. Dollars. In order to keep their currency from appreciating against the U.S. Dollar they are forced to print massive amounts of *Yuan*. All this extra money is creating a boom in China and huge demand for worldwide natural resources and the extra *Yuans* are/were buying U.S. Treasury Bonds. (If you want to understand this a little better search for currency at www.kahnacademy.org .

The Chinese know that if they allow the *Yuan* to appreciate against the U.S. Dollar they will lose a big part of their manufacturing advantage. Thus, any time they are pressured to let their currency rise to its real fair-market value, they threaten to sell vast quantities of their U.S. Treasury bonds to disrupt our financial markets and economy by forcing our interest rates up. (Note: Here again, if we had a balanced budget and didn't need to borrow trillions annually, the Chinese would not control us with our own bonds.)

The Federal Reserve, by buying Treasuries in big quantities, is making its move to counter the Chinese threat and try to force the *Yuan* to a more fair value, thus greatly reducing their trading advantage.

Will this work? I don't know, but it is likely to increase the cost of our imports from East Asia a great deal. Those in favor of this action claim that, in the long term, world trade will prosper and the world economies would start running smoothly again. Along the way, I assume things will be very messy.

A final quote from *Money Forecast Letter,* "When the "currency wars" are over and the U.S. Dollar is finally trading at fair value to all our major trading partners, world trade will flourish. This is a worthy goal - one worth fighting a currency war over."

So, is this Federal Reserve strategy of *printing* billions of dollars of new money a good or a bad strategy?
I guess only time will tell.

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## Are we doomed?

If what I just wrote makes any sense you are probably thinking something like: "let's see, if things go well we have a multi-year "currency crisis" all over the world, the costs of our imports increase substantially, but in the end, whenever that is, we have smooth economic sailing. Or, it is not pretty at all, the U.S. Dollar tanks, the costs of our imports skyrocket, the economy plummets and interest rates go to the moon.

"I need to find a high bridge."

If either of the above scenarios plays out, you can increase your pain with a lifestyle heavily dependent on imported goods and energy. You can have a lot of debt, especially debt with adjustable interest rates and you will feel plenty of financial pain. Or, to avoid the financial distress maybe you can buy a home in a foreign country and transfer all your assets to foreign accounts..

Or, you can make sure an ample amount of your retirement assets are in investments that are expected to benefit from what is happening. In the previous *Benedict Report*, we exhorted you to "own the company, not the stock," meaning focus on owning high quality assets, not the daily share price. This is the key to your financial success over the next several years, whether we are dealing with low or high inflation.

Let's see how this can benefit from a falling dollar with four real-life examples:

COMPANY #1: This Company is the dominating manufacturer of semi-conductor chips in the world. More than 85% of its revenues are from outside North America. That can be very valuable if our dollar loses value in relation to other currencies. Let's say it earns some profits in Russian *Rubles*. If the *Ruble* has *strengthened* against the U.S. Dollar, it is good. You see this Company earns its profit in *Rubles* and then converts them to U.S. Dollars and then sends you a dividend check. You, as a shareholder, actually benefit from the *weaker* U.S. Dollar.

This world dominating company pays a current dividend equal to about 3.5% of its share value. Over the last five years this company has tripled its dividend. Nothing is certain in the world of investing but IF this company can triple the dividend over the next ten years, at that time your dividend will be over ten percent annually based on today's purchase price. The company also bought back common stock equal to about 3% of shares outstanding. This doesn't translate into immediate returns for the owners (shareholders) but reducing the shares of stock outstanding means each current shareholder owns a little bit more, 3% more, of the asset (the Company).

Shareholders of this Company should benefit nicely from a *weaker* U.S. Dollar.

COMPANY #2: This Company is a global oil and gas producer. It pays a dividend equal to about 3.5%. Over the last five years this dividend has increased 12% per year.

The Company has billions of dollars of oil and natural gas reserves, almost 60% of which are not in the United States. The current market value of this Company is equal to about $9 for each barrel of oil it owns. Last year over 70% of its revenue was generated outside this country. When the U.S. Dollar falls in value, these non-U.S. reserves and revenues become more valuable to U.S. shareholders.

This is a very long-term valuable asset that should be able to provide the owner with a predictable stream of income throughout her or his retirement years. Forget daily share prices, own great assets and you should prosper even if we have a *weak* U.S. Dollar.

COMPANY #3: This Company sells snacks and drinks. Its annual revenues of $52 billion are two and one-half times what they were ten years ago. In 2000 the annual dividend was $0.56 and it is now $1.86. Last year it had over $8 billion left after paying all expenses. For many, many years it has earned over 30% annually on its invested capital. It is a global company, but not as global as many of its competitors, so in October it borrowed $2.25 billion to invest in emerging market expansion. Part of this borrowing does not come due until the year 2040 and the rate of interest is 4.875%. I'm quite certain the lady who heads this company feels very confident it can earn more than 4.875% with this new money.

This Company should do well whether we have inflation or not and whether interest rates rise or fall. Forget market movements, own highly profitable assets.

COMPANY #4: This Company isn't a regular company; it is a rather simple trust. The trust has the right to 16.4% of the daily crude oil production, up to 90,000 barrels per day, from one of the largest oil fields in the country. As a shareholder in this "trust" you are entitled to your share of the daily oil production and you are paid this in a quarterly annually. This "dividend" will rise and fall depending primarily on the market value of a barrel of oil. This asset should benefit if energy costs rise substantially.

Focus on what YOU CAN CONTROL, which in retirement income investing means trying to create a relatively predictable CASH FLOW. High quality assets are expected to help protect your retirement income in any economy.

## RECESSIONS ARE SO TERRIBLE...

So much about our economy, our governments and our systems seems dangerously stressed right now and I don't want to write a newsletter that doesn't address some of the problems because they are real.

But, it really bothers me when I hear people saying things like, "My children will never have as good a life as I have had." Your children may not have as good a life but I believe it will be because of them and not because of lack of opportunities.

Recessions are necessary because they are what keeps our economic world in balance. In fact , some of our actions during the last fifteen years to avoid a recession are partly to blame for the severity of this recession. We have *printed money* and forced interest rates down in an attempt to prop up a weak economy. We repealed the *Glass-Steagall* act in 1999 allowing our big depository banks to enter the world of investment banking. Fannie Mae, under the close supervision of Congress, was literally a sham, approving a mortgage for anyone to buy a home, no matter if they had the ability to repay the loan or not.

Think about it. If you treated your body for fifteen years like we have treated our economy, wouldn't you expect something terrible to happen to your system? In fact, if something doesn't happen to make you change your actions, you will most likely die. Our economy needed a wake-up call and we are getting it. It is a signal that we need to drastically change a lot of things. And, we can and I believe we will make the changes. I don't mean to say that the process will be pretty and painless, no, it most likely will be rather painful and a battle for our economic soul. As a country we can make dramatic changes, however, we seldom make those necessary changes without a crisis. So be prepared. I don't expect the next few years to be a smooth ride for our economy or the stock market or society in general.

However, as I look ahead five to seven years I see a lot of bright skies. This *recession* will force governments to finally utilize their resources much more efficiently. Millions of people all over the world are seeing their standard of living rise significantly. New technologies are near that will dramatically improve our way of life.

*We will continue this in the next <u>Benedict Report</u>...*

## 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 M James, CFP®, Mark A Beaver, CFP® and Ashley A Thompson provide technical assistance. Jean B Wilson handles the layout and editing of the newsletter.



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