DOMINION WEALTH
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April 2012 Newsletter
Consumers are the Staple

From the desk of Matt Brennan

In his Congressional testimony on February 29th of this year, Federal Reserve Board Chairman Ben Bernanke acknowledged that there are limits to how much "the Fed" can do to boost the economy.

"Monetary policy is not a panacea," he said. "It can help offset cyclical fluctuations and financial crises like we've had, but the long-term health of the economy depends mostly on decisions taken by the Congress and the administration." (Ben Bernanke, 2/29/12)

While we here at Dominion Wealth agree with Mr. Bernanke that there are inherent limitations to the effectiveness of creating a trillion dollars from thin air and pumping it into a banking system that refuses to lend, we believe the quote above is not entirely accurate. As we've stated countless times in this space, the long-term health of an economy depends mostly on the decisions of **the consumer!** These decisions are often dictated by the life circumstances of said consumer. To point, the baby boomers are not "upsizing" their homes, and they are not birthing, feeding and educating a family of 2.5 mini-consumers. The baby boomers are aggressively saving for retirement and paying down debt. Neither of these activities is good for the long-term health of the economy…especially when personal domestic consumption represents 70+% of our Gross Domestic Product (GDP).

At the present, our short-term economic health *is* actually very dependent on the Congress and the administration. That is because the Government has stepped into the role of the consumer and has propped up our economy by printing money and spending money it hasn't yet received. As a result, we have historically high debt to GDP ratios and there does not appear to be any end in sight to this fiscal irresponsibility.

While we are observing the European Union dealing with painful austerity measures (higher taxes, reduced entitlements, reduced government spending) in order to address their credit issues, here in the states we have a Congress who continually postpones action on the Debt Ceiling, and a President who is presenting limited solutions like the "Buffett Rule."

Setting political affiliations aside, here is some quick math on the proposed Buffett Rule as it relates to the 2012 Budget.

The Buffet Rule would presumably raise between $47 billion and $171 billion in additional tax revenues over the next 10 years by creating a minimum tax rate of 30% for corporations and families that earn over $1 million annually. By comparison, the President's current budget is adding $6.7 trillion in spending. The $47-171 billion in revenue from the Buffet Rule represents about 0.8% of this amount and just 0.1% of annual government spending.

On paper, facts like these are quite alarming. However, being able to effectively manage investment risk can be difficult when we have rising markets on falling volumes like we have observed throughout the first quarter of 2012. Only in recent weeks, when the markets received word that the Fed might not fire off a third round of stimulus (Quantitative Easing or QE3), did investors step back and rationally evaluate the risks facing the global economy.

Looking abroad, we have the European Union turning its focus to Spain, a faltering economy that happens to be 5x the size of Greece. Our research leads us to believe that no matter the outcome with Spain in the short term, there is a high probability that we will observe sovereign debt crises in Italy, Portugal and Ireland before it is all said and done.

Aside from Europe, there are growing concerns that the Chinese economy is not just cooling off, but that it may be in line for a severe pullback as well. This potential pullback is being termed a "hard landing", which basically means that their economy is rapidly shifting from growth to slow-growth to flat as it approaches a potential recession. This is usually caused by a government's attempts to slow down inflation. In 2011, we witnessed the Chinese Government raise interest rates 5 times in a 9-month span in order to quell inflationary pressures.

"If you look at the Chinese data, you should stop debating a hard landing. China is in a hard landing. Car sales are down, cement production is down, steel production is down, construction stocks are down. It's not a debate anymore, it's a fact." (Adrian Mowat – JP Morgan Chase & Co. 3/15/12)

As Trow has discussed in prior newsletters, much of this is the result of rampant economic expansion in an economy that can produce more than it can sell. Further it should be noted that the Chinese government's 2-year effort to control the property market has led to a 25% drop in home sales for the first two months of 2012 (a 4-year low). As you can see, home sales are not just critical to the US economy.

Regarding our own domestic housing debacle, on April 17th we saw new housing starts figures come in at 645,000 rather than the consensus estimate of 705,000. This represents a drop of 6%. In addition, the recent $26 billion settlement between 5 major US banks in March now paves the way for a glut of foreclosures to begin working their way through the system after sitting in limbo for months (even years in some cases). The phenomenon of people "squatting in their own homes" may soon come to

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a close, and with it, the evaporation of whatever disposable income these individuals were able to direct to consumer spending while they weren't paying their mortgages.

It is estimated that there are 3.1 million home owners in the United States who have been living "rent-free" by not paying their monthly mortgages (Gary Shilling – April 2012 INSIGHT). Early in the last decade, when consumers were driving up home prices, people would do whatever they could to keep their houses. As a result, the highest priority on the monthly budget was the mortgage payment. People were much more likely to delay paying credit cards and other loans since the equity they were rapidly building in their properties was outpacing delinquent interest accrual. Over the last 5 years, the significant decline in home values have made people reticent to pour money into their properties…especially when 23% of mortgagors are under water in their homes (mortgage balances greater than fair market values).

As we close these newsletters each month, I often find myself saying "that's a sufficient amount of doom and gloom for now…until next month." At the same time, I take a tremendous amount of comfort in the confidence behind the investment plan we are currently overseeing. If anything, I hope that we are providing you with that same confidence as well as perspective around the importance of having a risk management process. Each month it becomes more and more clear that the structural weaknesses that triggered the '08-'09 credit crisis have merely been masked by the Fed creating money out of thin air. At some point the road ends, and the proverbial "tin can" can be kicked no further. The goal for your portfolio is for short-term patience to yield long-term gain.

Best Regards,

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