

Published by KMS Financial Services, Inc. * December 2008
2001 Sixth Ave., Suite 2801 • Seattle, WA 98121 • <http://www.KMSfinancial.com>
* Member: Financial Industry Regulatory Authority • Securities Investor Protection Corporation

Gauging the Storm in the Middle of the Storm

After a quarter century of mostly strong performance, the U.S. economy is in a swoon with much of the rest of the world also feeling faint. Different regions will be affected differently, but they clearly have not “decoupled” from the U.S. Nor has the business cycle been repealed by the machinations of Congress, the Federal Reserve, or other central bankers. These pages have often stressed the propensity of economic and market cycles to overshoot. Have we reached one of those overshoots yet?

The “Real” Economy: Suspense over whether we’re in a recession ended the other day when the National Bureau of Economic Research announced that we actually entered one a year ago. They define recession as “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in production, employment, real income, and other indicators.” Sound familiar?

Although we haven’t recorded consecutive quarters of negative real growth, most economists believe the fourth quarter *will* show a sharp drop. In the 1973-74 recession gross domestic product fell more than 9% in real terms. And to kick off the Great Depression GDP sank over 26% from 1929’s peak to the 1932 low.

Housing, the epicenter of the financial crisis, has seen a decline reminiscent of 1974 with new housing starts off 65% from the 2006 peak. The Mortgage Bankers Association reports that only about 6% of *prime* mortgage holders are a month or more overdue on their loans. But for subprime borrowers that rate is 33%. Business bankruptcies and default rates on commercial property have been more contained so far.

Counting Jobs: Employment numbers are a touchstone of economic stress. Unemployment has popped to 6.7%, still a ways from the 10% level that was breached in the 1973-74 and 1981-82 recessions. Comparable employment statistics are not available for the 1930s, but it is estimated that 20-30% unemployment was endemic through much of that decade.

A lot of the headline jobs data come at us in absolute numbers, and we forget that the economy and the workforce have grown quite a bit over the years. For example, the four-week average of weekly new unemployment claims recently topped 500,000, a level not seen since 1983. But back then there were fewer than 100 million Americans employed compared to more

So Now It’s China’s Turn

You might think an economic growth rate of 8% would be just dandy, but it doesn’t quite ring the bell for China. Each year millions of Chinese migrate from the nation’s relatively impoverished countryside into the cities seeking higher wages. It is estimated that China must create a million jobs a *month* to avoid severe social unrest. That implies an 8-9% growth rate, a level China has topped handily for several years running.

But now a global slowdown is calling the tune. China’s growth rate is believed to have slowed to around 6% in the current quarter. Alarmed, Beijing has announced a stimulus program pegged at 4 trillion yuan (\$586 billion), or about 7% of the country’s gross domestic product. This is a major policy shift for China after three years of efforts directed at cooling the economy to dampen a perceived inflation problem.

Much of the stimulus effort will come in the form of infrastructure spending, and the “bang for the yuan” could be substantial. After all, while infrastructure spending in the U.S. might typically involve resurfacing or widening a highway from point A to point B, in China it’s likelier to involve *creating* a highway from point A to point B. The transformative potential of the latter is clearly more profound.

World leaders and markets welcomed Beijing’s announcement like a cold beer on an August afternoon. After decades of looking first to U.S. consumers as the locomotive of global growth, it may be China’s turn to pull the train. §

than 145 million holding jobs today.

Similarly, the number of *unemployed* recently hit the 10 million threshold. The Bureau of Labor Statistics pegs today’s U.S. civilian labor force at more than 155 million. When that 10-million-unemployed threshold was hit in the 1992-93 period the civilian work force totaled just 126 million. And in early 1983 the number of unemployed Americans topped 12 million in a labor force of only 110 million. All that said, the jobs picture appears likely to worsen before it gets better.

Equity Markets: At this writing the decline across nearly all sectors of the equity markets rivals the 1973-74 bear market and is the broadest and deepest downturn most investors have ever experienced. It’s still not nearly as severe as the 1929-32 slide, a sicken-

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ing 86% collapse for a basket of that period's stocks comparable to the Standard & Poor's 500, according to the Ibbotson-Singfield study. More investors today are diversified internationally, but that tended to *worsen* the pain this year as the dollar strengthened.

Today stocks of major companies across a host of industries and regions of the world hover at fundamental valuations that historically have presaged rewarding long-term returns. But with employment worsening and consumers retrenching, many companies will struggle to maintain the profits that underpin those valuations. And market volatility remains daunting.

Fixed Income: Other than U.S. Treasury debt, bonds haven't provided much cushion. The stampede to quality widened the yield gap between Treasuries and so-called "junk" bonds (below investment grade) to as much as 12 percentage points. Even municipal bond yields soared (and prices declined) as nearly all issuers became suspect absent the full faith and credit of Uncle Sam. That panic appears to have subsided, but premium yields are still available across many fixed-income instruments that were considered comparatively low-risk holdings not long ago.

Safeguards and Policy Responses: In the 1930s Americans could not look to basic safeguards such as deposit insurance and unemployment benefits. Officials were more inclined to *tighten* fiscal and monetary policy in the face of financial stress, so deflation was a signal feature of that era. The dollar rose by a third against the pound sterling, the leading currency at that time.

This contrasts sharply with the 1973-1975 period when the price of gold tripled. The dollar *lost* 11% against the ascendant deutschmark, and inflation became a dominant motif of the 1970s. This year government and monetary officials have moved to flood banks with liquidity. The inflation worry that appeared earlier in the year has been turned on its head.

The rolling financial crisis has only made global economic linkage more apparent. Trying to go it alone probably is not an option for any significant country. Economists often cite the Smoot-Hawley tariff of the early 1930s as exacerbating the economic difficulties that evolved into a sustained global depression. But *pledges* of international coordination will face challenges as tough times intensify pressure for protectionist policies; witness the debate over propping up Detroit automakers. Those who allocate capital around the world will be watching closely. §

Treasury Extends Program to Insure Money Market Funds

One of this fall's dicier few days revolved around a prominent money market mutual fund. Carrying a dose of commercial paper issued by Lehman Brothers, the fund posted a three-cent drop in its net asset value, to 97 cents a share, in the wake of Lehman's bankruptcy filing. Money market funds generally hold high-quality, short-term debt obligations, and maintaining a constant \$1.00 share price is their hallmark.

Money market funds are *not* covered by the Federal Deposit Insurance Corp (FDIC) like bank deposits, and the commercial paper market has struggled since mid-2007. This fall, with some money market funds facing heavy shareholder redemptions, the U.S. Treasury took the extraordinary step of offering a *temporary* insurance program for assets held in participating funds as of September 19, 2008. More specifically, the coverage is for the *lesser* of that amount or the fund shares held at the point the insurance is called into play.

The Treasury's program appears to have revived investor confidence; money market funds' total assets have hit records in recent weeks. The money market industry does have a long history as a productive alternative for investors' ready assets. And there are money funds that hold only U.S. Treasury bills, with commensurately lower yield, as well as deposit programs that provide a conduit to FDIC-insured institutions.

As shown in the accompanying performance summary for major fund categories, investors haven't had many stable hiding places this past year. Your KMS Representative can help review your options for holding ready reserves. Information on the Treasury Department's program is available at <http://www.treas.gov/press/releases/hp1163.htm>. §

Performance Summary: Major Mutual Fund Categories*

Mutual Fund Category	Total Return w/ Dividends and Capital Gains Reinvested			
	--- 1 yr. ---	--- 3 yr. ---	--- Annualized through Dec. 5, 2008 ---	--- 5 yr. ---
Large-Cap Stocks (Core)	- 40.2%	- 10.5%	- 2.9%	- 1.6%
Mid-Cap Stocks (Core)	- 43.1	- 12.0	- 2.2	3.8
Small-Cap Stocks (Core) †	- 41.2	- 12.9	- 2.5	4.0
Foreign Stocks †	- 49.9	- 9.5	0.4	1.6
Emerging Market Stocks †	- 60.5	- 8.9	5.2	8.3
Flexible Portfolio	- 29.3	- 5.5	0.5	2.8
General Bond	- 6.8	1.2	3.0	4.5
Int'l Income (non-U. S.) †	- 4.5	3.1	3.4	4.6
High-Yield Taxable Bond †	- 30.8	- 8.3	- 2.8	0.4
General Municipal Debt	- 10.9	- 1.6	0.4	2.3

* Source: Lipper, as reported in the *Wall Street Journal*, December 6, 2008.

Past performance is NOT indicative of future results.

† Small-cap stocks and high-yield (lower rated) bonds pose greater risk and price volatility than securities of larger, well-established companies. Securities of companies based outside the U.S. may be affected by currency fluctuations and political or social instability to a greater extent than U.S.-based companies.

Oil's Down for the Moment

A year ago the *Quarterly* noted the high risks of investing in hot sectors, a case in point being energy. That call was a few months early as crude soared to \$148 per barrel by late July. Since then it has staged a stunning reversal, flirting with \$40-per-barrel at this writing. Oil investments are quite unloved at the moment, but moments pass.

A slowing global economy has cut oil demand, but the International Energy Agency recently issued a sobering study with its annual World Energy Outlook. According to the IEA, oil production across the world's existing fields is on an accelerating decline curve. The Agency looked at 800 fields accounting for more than two-thirds of 2007's global crude production. They found decline rates averaging 6.7% per year and likely to rise to 8.6% over the next couple decades.

Notwithstanding the current economic retrenchment, the IEA projects *demand* growth at an average of 1.6% per year, or a cumulative 45%, between now and 2030. Finding and developing additional resources will require massive investment: \$26.3 trillion, the IEA says. And even if demand does *not* grow, declining production from existing fields will likely necessitate replacing some 45 million barrels per day of capacity.

The plunge in oil prices is bound to curtail some exploration and development plans. Major private oil companies are increasingly cut off from opportunities in regions where national governments control the resource and its development. Many of the remaining opportunities – deep-water drilling projects, tar sands, and shale deposits – involve technical challenges and risks that are only warranted if future prices rebound substantially and sustainably.

Oil Around the World

Top 10 Producers	Top 10 Consumers	Top 10 Proved Reserves
Saudi Arabia	United States	Saudi Arabia
Russia	China	Canada
United States	Japan	Iran
Iran	Russia	Iraq
China	India	Kuwait
Mexico	Germany	UAE
Canada	Brazil	Venezuela
UAE	Canada	Russia
Venezuela	Saudi Arabia	Libya
Kuwait	South Korea	Nigeria

* Source: U. S. Energy Information Administration

As suggested by the accompanying table, foreign governments that control much of the world's more accessible oil also may be constrained from making the requisite investments and marshalling effective long-term management to optimize those resources.

Political Urge to Boost Tax Rates Meets Economic and Budget Realities

The political stars appeared to be aligned for higher marginal tax rates. But economic conditions and a few realities of the federal budget itself are clouding that particular constellation.

A generation ago the landmark Tax Reform Act of 1986 dropped the top marginal rate to 28% and curtailed many aggressive tax-shelter strategies. In the ensuing two decades the drift back toward greater complexity has been persistent, making it tougher to gauge the effect of a simple boost in marginal rates.

Meanwhile, the share of income taxes drawn from higher-income households has been rising, making the federal tax take more susceptible to swings in income and asset performance for these households. Ratcheting up marginal rates on a relatively small number of high earners has a dubious record for actually boosting overall revenue. In the current environment it risks dampening the economy at the margin and failing to help the budget situation.

For the past five fiscal years, federal revenues as a percent of gross domestic product (GDP) grew from 16.3% in 2004 to 18.8% in 2007 before slipping back to 18% in 2008. The 40-year average is 18.3% of GDP, and the tax system has had a hard time extracting much more than that on a sustained basis. Federal revenues look more likely to fall than rise until the economy gets rolling again.

On the other hand, federal *spending* grew from 19.9% of GDP in 2004 to 20.8% in 2008. The 40-year average is 20.7%, so there's nothing too unusual on this side of the ledger either. But in fiscal 2008 Social Security and Medicare/Medicaid represented 44% of federal spending (not including net interest). Demographic factors suggest that growth in these entitlements is more likely to quicken than slow down.

Defense spending may be due to flatten out, but it represents a much smaller share of the federal budget than it did a few decades ago. It would take a 30% cut in Defense just to offset this past year's *increase* in Social Security, Medicare, and other program spending. What would budgeters do the following year?

Whatever tax philosophy one favors, tax-wise *investing* remains a key to building a financial cushion against an uncertain future. Your KMS Representative can help you adjust your strategies if the changing political landscape redefines the tax calculus. But it may be premature to *assume* that higher marginal rates will be part of that new equation. §

At some juncture the distinct challenges in meeting the supply needs forecast by the IEA may well drive another round of dynamic pricing response. §

Tax Break Reinstated for Charitable IRA Distributions

As part of the Emergency Economic Stabilization Act of 2008 (the “bailout” bill) Congress has reinstated the ability for those over 70½ to direct IRA distributions to charity and avoid tax on those dollars. The provision had expired at the end of 2007, but now it’s back for 2008 and 2009.

A popular use of this provision is to shelter some or all of a required minimum distribution. One simply instructs the custodian to make the distribution payable to a qualifying charity. It must be an operating nonprofit

rather than a donor-advised fund or private foundation. Of course this is most useful to those who usually don’t itemize their deductions and would not otherwise get a tax break for charitable gifts.

Congress left precious little time to apply this strategy in 2008 and no real recourse for those who have already taken their required distributions for this year. The provision *is* retroactive to the beginning of 2008, so if an IRA holder ordered a direct-to-charity distribution earlier in the year *hoping* that the tax break would be reinstated, that wish has been granted. If you think it might be a useful strategy, check in with your KMS Representative or tax advisor. §

A Club for the Upper Crust Runs Short of Bread

You’d think an exclusive enclave for the *very* rich might be immune to a punk economy. But just last month the Yellowstone Club filed for Chapter 11 bankruptcy protection. The golf and ski community near Big Sky, Montana, boasts about 350 members, reportedly including Bill and Melinda Gates.

The Club had borrowed heavily to fund an overseas expansion that didn’t pan out. A tough real estate market has crimped sales of Club assets, including a castle in Paris. Chapter 11 protection should allow members to enjoy the ski season, but a recent bankruptcy hearing showed how tenuous that prospect had become. The Club’s operating funds had shrunk to \$40,000.

Nevertheless, there’s no talk of the Yellowstone Club seeking a federal bailout. If you think the Big Three auto executives make unsympathetic supplicants, imagine these folks lined up before some Congressional committee. It looks like they’ll just have to tough it out with the rest of us. §

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