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Storm Clouds and Silver Linings

Officially, the recession in the U.S. ended more than a year ago. Apparently not everyone got the memo. This past summer has seen a parade of disappointing numbers: ragged retail performance, saging home sales, and paltry progress on the employment front.

Past recoveries from major downturns suggest that gross domestic product should have risen by between 6% and 8% for the year ended June 30th. Despite large fiscal and monetary stimulus, growth was more like 3%, and even that momentum has seemed to be slipping.

However there is *some* improvement. According to the Bureau of Labor Statistics (BLS), about three million more Americans held jobs in July and August than back in January. Markets continue to obsess over the monthly reports of net jobs lost or gained. But that "net" number is the difference between two much larger numbers: total jobs added minus those eliminated. Both of those figures run in the hundreds of thousands monthly, portraying an economy hard about the task of resizing work forces, reaching for productivity gains, and redefining the kind of talent required by its myriad enterprises.

The crises of 2008-09 revealed a U.S. economy over-invested in financial services, home building, and the nexus of those sectors, expansive mortgage lending. The extraordinary monetary measures intended to help cure the 2001-02 recession helped sow the seeds of the 2008-09 bust.

Over-investment usually involves over-employment. Redeploying that human capital sounds neat and easy in an economics textbook, and it is key to revitalization. But for millions of people the process is deeply unsettling. As shown in the accompanying table, unemployment was elevated well into the recovery from the 2001-02 recession, but had dropped below 5% by mid-2006.

This time the labor force adjustment looks more daunting. According to the BLS, five million *more* folks are jobless today than at the peak of the unemployment curve in 2003. And more of them are a little farther out on the *age* curve as well.

One relative bright spot has been the manufacturing sector. U.S. factories have been at the vanguard of the productivity revolution (producing more with fewer people) for years. Still, the Institute for Supply Management's employment index for August hit its highest level since 1983. Are we returning to an economy in which more people actually make things? That would be an adjustment. ■

Tracking Americans at Work - or Not

Key Components of Labor Statistics	August 2000	August 2003	August 2006	August 2009	August 2010
Civ. Labor Force (16+)	143.2mm	147.0mm	152.5mm	154.9mm	154.7mm
Labor Force Participation	67.2%	66.3%	66.5%	65.6%	65.0%
Number Employed	137.3mm	138.1mm	145.4mm	140.1mm	139.9mm
Employment/Population	64.5%	62.4%	63.4%	59.3%	58.8%
Number Unemployed	5.86mm	8.83mm	7.09mm	14.82mm	14.76mm
Unemployment Rate	4.1%	6.0%	4.6%	9.6%	9.5%

* Source: ***Bureau of Labor Statistics - U.S. Department of Labor***

Keeping an Eye on State and Local Finances

A few weeks ago the Securities & Exchange Commission (SEC) broke some new ground when it sued the state of New Jersey. It was the federal agency's first securities fraud case against a state, claiming that New Jersey had misled investors about the health of its two largest employee pension funds while issuing billions of dollars worth of bonds from 2001 through 2007. We won't parse those issues other than to note that the SEC is looking into financial disclosures that accompanied other states' bond offerings.

The market seemed to take the SEC action in stride. New Jersey has made all scheduled principal and interest payments, and it successfully sold $2.25 billion of bonds a few days after the SEC's announcement. But many states are in the midst of their most challenging fiscal stretch in decades. The average projected budget gap for the 50 states is 20% for 2011. Longer term there's a combined trillion-dollar gap between future benefits promised to retirees and funds actually set aside, according to a report by the Pew Center on the States.

Compared to many developed nations, most states and municipalities carry modest levels of debt, in the low single digits as a percentage of their economic base. Debt service for all states ranges from 0% to 13% of expenditures. The first quarter of 2010 saw an overall rise in all three key components of states' revenue: sales, personal income, and corporate income taxes. But revenue is still running about 12% behind the peak levels of 2008.

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One of These Approaches Will Be Wrong

The federal government and many American families share a challenge: managing lots of debt. Families are responding by refinancing their mortgages at some of the lowest rates ever. Most are locking in for 15 to 30 years rather than grabbing even lower rates on adjustable loans that could reset in the next few years.

Given the long-run fiscal challenges facing the U.S. Treasury, one might assume it would be doing the same. The average maturity of U.S. debt held by the public has edged back up to 58 months from a 26-year low of 49 months a couple years ago. Treasury's Borrowing Advisory Committee sees that trend continuing but at "a slower pace."

Staying relatively short makes the government's life a little easier today. Two-year Treasury yields are around 0.5% versus about 2.5% for the 10-year and 3.6% for 30-year bonds. With new borrowing running well over $1 trillion annually, refinancing at the short end saves the feds billions of dollars per year, for now. But the fiscal time bombs of Social Security, Medicare, and Medicaid are not going way, and federal spending has surged in other categories as well.

In 2012 the new debt required to finance that year's deficit spending will have to be floated along with about $1.2 trillion of maturing issues. That's nearly double the amount refinanced last year. Missing the chance to issue more long-term debt at today's rates may mean a bigger jump in the government's interest costs in the near future.

So far those bond market "vigilantes" have not imposed the discipline of higher yields. And some other governments such as Japan continue to borrow at very low rates despite debt-to-GDP levels much higher than the U.S. But 95% of Japan's debt is held domestically while 50% of U.S. debt is held by foreigners. The U.K. pays a bit more to finance its debt, but an average maturity of over 13 years may provide greater financing flexibility in the years ahead.

Eighteen months ago the *Quarterly* noted the government's emergence as "the last of the big subprime borrowers." Credit markets continue to treat old Uncle Sam gently, while homeowners are more circumspect about a future reckoning with those bond vigilantes. ■

Investment Performance Review	**TOTAL RETURN *** (dividends and capital gains reinvested)			
Major Mutual Fund Categories *	**--- Annualized thru Sept. 7, 2010 ---**			
	1 yr.	*3 yr.*	*5 yr.*	*10 yr.*
Large-Cap Stocks (Core)	7.0%	– 7.2%	– 0.7%	– 1.0%
Mid-cap Stocks (Core)	13.7	– 5.4	0.5	2.0
Small-cap Stocks (Core) †	12.1	– 5.5	0.0	4.7
Foreign Stocks (multi-cap) †	5.3	– 8.0	1.9	3.4
Emerging Market Stocks †	19.2	– 2.6	10.2	11.1
Flexible Portfolio	8.6	– 1.3	2.3	2.5
General Bond	10.3	4.9	4.2	6.4
Int'l Fixed Income †	6.4	6.9	5.2	7.0
High-Yield Taxable Bond †	19.6	5.3	5.4	5.6
General Municipal Debt	9.1	4.3	3.6	4.5

* Source: Lipper, as reported in the *Wall Street Journal*, Sept. 8, 2010. **Past performance is NOT indicative of future results.**

† Small-cap stocks and high-yield (lower rated) bonds pose more risk and price volatility than those of larger, 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.

Middle Kingdom Moves Up a Notch

Last month brought the news that China will likely take Japan's place this year as the world's second-largest economy. Official estimates of China's second quarter gross domestic product (GDP) came in at $1.34 trillion versus $1.29 trillion for Japan. The big gap between their respective growth rates would seem to make China's ascension to number two for the full year a virtual certainty.

That's a heady accomplishment for a still-developing nation and a milestone for the world economy. China and its southeast Asia neighbors first appeared on the *Client Quarterly* radar screen in early 1992, and their long-term prospects have been a recurring theme ever since. As recently as a decade ago, China was still just the seventh largest economy, measured at prevailing exchange rates. In 2007 it took over the number three spot from Germany.

If China is indeed now in second place it may roost there a while. At $15 trillion, U.S. GDP is about triple China's output. China's growth rate may continue to outpace the U.S., but perhaps not as dramatically as it has the past few years.

Of course there are different yardsticks for comparing nations' economies. China's output *per capita* is still only about a tenth that of Japan's. On the other hand, China has held the number two spot for some time on the basis of purchasing power parity, a measure of the goods and services a country's currency buys in its home market.

Challenges abound for a nation that sees robust growth as critical to social comity. Economic inequality is surging, the social safety net is still weak, and foreign companies invested in China are increasingly vocal about shortcomings in such areas as intellectual property protection and fair administration of business and labor regulation. There is little question of China's economic prominence and the world's stake in the path it pursues from here. ■

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Thinking About a Roth Conversion Can Get You... Thinking

As outlined in recent issues, converting assets from a traditional IRA to a Roth is now an option for upper-income taxpayers. But just because more people can convert does not mean they should. In most cases conversion triggers significant tax on the funds converted. The benefit is the prospect of tax-free future distributions from the Roth IRA. But is that up-front tax bill the best use of those dollars?

One alternative is to keep the traditional IRA in place and consider buying some life insurance, especially if most of that IRA is likely to pass to one's beneficiaries. If you're considering sending 35-40% of that conversion amount off to Uncle Sam, it makes sense to first find out how much life insurance you might put in place instead.

If one's beneficiaries inherit a traditional IRA, they may well incur taxes over time as they withdraw the assets. But a beneficiary IRA structured correctly can perpetuate substantial tax deferral for a number of years. Or the beneficiary can do a Roth conversion if his or her tax situation makes that attractive.

Life insurance proceeds pass to beneficiaries *income*-tax-free. If *estate* tax is apt to be an issue (who knows, at this juncture) one might purchase the policy in an irrevocable life insurance trust (ILIT). Death benefits from a policy held in an ILIT are excluded from the gross estate of the insured for federal estate tax purposes.

Remember, the premiums paid represent money that, under the Roth conversion scenario, would have been sent off to the U.S. Treasury. There are many variations on such a strategy, depending on one's age, health, financial situation, etc.

This reinforces a key point: a Roth conversion represents a current use of money to secure an uncertain future benefit. Whether it's the best way to do that is a complex question requiring a thorough, personalized analysis. But life insurance is one alternative to consider *whenever* the objective is to leverage identifiable current dollars against an unpredictable future. ■

Speaking of Life Insurance

From time to time these pages have chronicled the multi-decade decline in the cost of basic life insurance protection. Yet the percentage of U.S. households carrying *no* life insurance is at a four-decade high, according to a recent survey by the Life Insurance Marketing & Research Association (Limra).

Yes, times are tough, and folks have cut back. But few things would seem more essential than some layer of protection against the loss of a household's breadwinner(s). Some employers also have scaled back on the coverage they provide, but workplace coverage is rarely sufficient in any event.

Half of the Limra survey's respondents acknowledged a need for more coverage. Forty percent of those with children under 18 said they would experience fairly immediate financial hardship if a primary wage earner were to die. Appropriate, cost-effective life insurance is a cornerstone of financial planning. And for most individuals, it's more affordable than ever. ■

The More Things Change...

You know the rest of that saying. But it's still striking to glance back 20 years to the ***Client Quarterly* of October 1990**. Much has changed, or has it? Here's a rundown of the articles from that long-ago issue of the *CQ* along with a little context.

Time for a Little Courage and Discipline... in Small Doses

Iraq's August-1990 invasion of Kuwait had sent stocks into a nose-dive that lopped about 25% off the major averages in just six weeks. And the 1987 market crash was still pretty fresh in investors' minds. Venturing back into the market on a systematic, disciplined basis proved rewarding; stocks didn't see another meaningful correction for a decade.

Portfolio Diversification with Income from Around the World

Back then there were not a lot of avenues to broad or targeted exposure to non-U.S. bonds. The sector was not a big winner in the 1990s, but the past decade has shown it to be a source of higher yields and a constructive hedge against bouts of weakness in the U. S. dollar.

Despite Market Risks, Mutual Funds Feature Many Protections for Investors

With all the financial innovation and manipulation of the past two decades, funds still comprise a nearly $10 trillion nucleus of mainstream investing. Funds didn't dodge all the slings and arrows the markets fired, but they have sustained a record for shielding investors from significant fraud and malfeasance.

Debate Over How to Buy Insurance Really Comes Down to You

This remains a key element of financial planning and risk protection. Those who seek coverage on behalf of their families and businesses have benefited from a long run of competitive reductions in its underlying cost.

Budget Compromise Calls on Taxpayers to Ante Up

The big *news* in that 1990 compromise was the tax hikes, but the big *change* turned out to be much slower growth of federal spending through the '90s. Sustained economic growth boosted tax revenues, and the federal fisc achieved rare surplus for a few years. Today, deficits "as far as the eye can see" are a hot issue once again. ■

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Keeping an Eye on State and Local Finances

Municipalities, which depend more on property taxes, are generally doing a bit better. In many locales, assessments had not kept pace with market values during the boom in home prices, so they haven't had to be set back that much if at all.

Debt service generally holds a high priority position under state laws and constitutions. Many mandate spending cuts when revenues fail to materialize. Obviously the U.S. Congress suffers no such restraints. Some states are already taking action on retiree benefits, curtailing benefit levels for newer employees, raising the retirement age, and boosting employee contributions. Nevertheless, the SEC's action against New Jersey is prompting a fresh look at the extent of fiscal finagling by other states that are now known to be especially strapped.

Meanwhile, with U.S. Treasury yields at rock bottom, and with the possibility of higher marginal tax rates next year, investors have driven yields on short to intermediate term tax-exempt municipal securities to record low levels as well. When it comes to parsing the risk-reward equation with munis, diversification and professional security selection will play an important role. ■

Raising "Spirits" with a Highly "Liquid" Pension Contribution

As the *Quarterly* has reported in recent issues, many companies and governments face significant pension funding challenges. Some companies are getting creative. Diageo PLC, the maker of Johnnie Walker blended whisky and Talisker single-malt scotch, announced recently that it would transfer 2.5 million barrels of aging whisky to its U. K. pension fund. It's part of a 10-year plan to address a funding deficit of approximately £862 million ($1.3 billion).

It's enough booze to fill about 180 Olympic-size swimming pools, and it represents about 30% of Diageo's total whisky stock. Barring a big resurgence of the temperance movement, it represents a highly marketable asset that will produce annual income to the fund.

Diageo is not alone. British Airways PLC has pledged used airplanes as security for its pension obligations. Other companies have placed corporate real estate holdings and enterprises such as hotels, restaurants, or stores into their pension funds. They're simply using the stuff they have as an alternative to tying up operating cash.

By the way, there is no suggestion that Diageo plans to make *in-kind* distributions from those whisky barrels. Pensioners should continue to receive their checks in the currency of the realm. But in the face of volatile valuations for traditional pension assets, booze in the barrel may help *smooth* out those pension funding obligations – just another facet of the "new normal." ■

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