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Global Growth Leaning on China For Now

With so much of the global economy on tenterhooks, can China continue to be an engine of growth? Amidst the global financial crisis in the fall of 2008, China announced a stimulus program pegged at four trillion yuan, nearly \$600 billion and about 7% of China's gross domestic product. As the *Quarterly* suggested at the time, "the transformative potential [of such stimulus] is clearly more profound" for a developing economy like China's.

China appears to have had no shortage of "shovel-ready" projects, including roads, railways, buildings, and especially housing. Chinese consumers also continued to boost their buying of cars, computers, and a widening spectrum of the trappings of middle class life. But there are concerns about the cost of it all, rising inflation, higher debt levels, and a possible property bubble.

Housing is a key topic of current debate, but the demand for more, higher quality housing is huge. Over the next 15 years China's urban population is expected to *rise* by some 280 million people – nearly the total U.S. population. A large portion of its current housing is of poor quality, built in an era when the country was much poorer. Officials indicate that much of the urban housing built before 1999 will be dismantled to make way for new development over the next two decades.

China's property market may be overheated, but housing is financed relatively conservatively there. A price pullback may not imply nearly the hit to consumer liquidity that it has in the U.S. In fact, Chinese consumers have been more inclined to reduce household spending on other goods in order to boost their investment in homes.

As for the overall level of debt in China, official numbers have often come under question. Best estimates for total credit in the economy are around 175% of gross domestic product and headed higher. There was a notable surge in credit in 2009-10, and there's almost certainly a layer of bad loans in that mix. But the government has taken steps to cool housing prices and broad inflation. Credit growth appears to have moderated this year.

Measuring China's total economy may be even trickier than gauging outstanding credit. Yukon Huang, with the Carnegie Endowment and formerly with the World Bank, notes that official household consumption statistics are based on obsolete sample survey procedures that do not fully account for cash transactions which are prevalent in China, or the non-cash provision of education and health care. Nor have they been updated for current values of owner-occupied housing.

With all land and major industrial enterprises still owned by the state, returns from those assets accrue to local authorities and the state enterprises themselves. The International Monetary Fund estimates Chinese households' income from investments and government transfers at under 10% of disposable income, about one-third to one-half the share in other countries.

Both GDP and consumption may be understated, while investment as a share of GDP may be overstated. We often hear that China needs more consumer spending verses investment to help alleviate "global imbalances." One way or another, the global economy appears to have a vested interest in the China growth story continuing apace. ■

Working On That Budget Thing

Three months ago the *Quarterly* offered a primer on the federal government's debt ceiling. Some weeks later the need to raise that ceiling prompted a battle royal among D.C.'s competing political powers. At the eleventh hour they reached agreement to raise the ceiling, accompanied by commitments to address our swollen federal deficits and ballooning debt.

These pages have parsed the federal budget from time to time, but the last occasion was nearly three years ago. Things have changed a bit since then. For most of the past 40 years the annual *deficit* hovered around 2% of the nation's output (gross domestic product or GDP). That average gap opened a bit during the 2001-2010 decade as spending edged higher and tax receipts slumped under the weight of two recessions.

Federal Revenue and Spending

Fiscal Years	Revenue (avg. % of GDP)	Spending
1971-80	17.9%	20.3%
1981-90	18.2%	22.2%
1991-00	18.8%	20.3%
2001-10	17.1%	20.6%
Most Recent Years		
2009	14.9%	25.0%
2010	14.9%	23.8%
2011 (est.)	15.5%	23.8%
Source: Congressional Budget Office		

That last decade's averages mask a bigger shift in the last few years. As recently as fiscal 2008 revenues came in at 17.5% of GDP with spending at 20.7%. But the recent recession knocked tax receipts down to just

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Revisiting the “Gold Bubble” Debate

Almost two years ago the *Quarterly* examined the debate over whether the surging price of gold represented a “bubble.” Gold had just re-crossed the \$1,000/oz. line, and we cited the key drivers of both consumer and investor demand. That case proved out, as gold recently topped \$1,900. But a short, sharp pullback from those highs rekindled the “gold bubble” debate

One of those drivers we noted was the new ease with which investors could gain portfolio exposure through exchange-traded funds (ETFs) designed to track the metal’s price. A few weeks ago it was reported that the leading gold ETF had surpassed the asset size of the largest stock ETF which tracks the Standard & Poor’s 500 Index.

Meanwhile the “pure” gold play has left the stocks of gold mining companies in the dust. The average gold-oriented mutual fund is about flat this year, and BMO Capital Markets recently noted that over the past 20 years a representative group of global gold stocks has never been cheaper *relative to the current price of the metal* itself.

These developments are not absolute indicators, but they are emblematic of the rush to gold from other investment staples. Nobody really knows where gold will top out or whether the mining stocks will get their turn to shine. In some measure gold’s run reflects a lack of confidence in the world’s major currencies. It is not clear that policymakers are laying sufficient groundwork to rebuild that confidence.

That leaves us with this admonition from our comments of two years ago: “We *do* know the historic tendency for investors to pour into gold near the top of major price swings and bail out nearer the lows. The better approach may be to strive for a little more consistent exposure with the discipline to take some gains when they materialize, then add back to the position in response to those inevitable corrections.” ■

Speaking of Bubbles, How About College Tuition?

One of the investment world’s best known managers, William Gross of PIMCO, raised hackles recently when he described undergraduate education as “primarily a four-year vacation interrupted by periodic bouts of cramming or Google plagiarizing.” Mr. Gross’ remarks called further attention to tech entrepreneur Peter Thiel who is awarding lucrative fellowships to a few bright youngsters willing to forgo college to pursue their scientific and technical innovations with a cadre of high-profile mentors.

It’s a bit discomfiting to parents bracing for another year’s tuition tab. There are also signs of disillusionment among direct consumers of higher education. Two lawsuits seeking class action status were filed recently against a pair of law schools claiming misrepresentation of their graduate employment rates. Recent surveys indicate that fewer companies are recruiting on college campuses, and many of those that do are seeking more interns than permanent employees.

A study by Rutgers University indicated that only 56% of spring 2010 graduates had a job in hand at graduation. Of those lucky grads, only 52% report that their first job required a college degree. Meanwhile, as the academic year kicks off, outstanding student loans are approaching \$1 trillion, more than Americans owe on credit cards.

In a tough job market, these perspectives have real financial implications. Thirty-five years of escalating tuition costs and profound changes in the U.S. labor market are highlighting a question posed in these pages seven years ago: “What’s the Value of that College Degree?”

Of course the college experience is what a given student makes of it, and value is difficult to gauge. But price certainly has been on a long-term tear. According to the College Board, the average full tuition at private four-year institutions is up 11-fold since the 1976-77 school year. For in-state students at public colleges the increase has been

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Investment Performance Review	TOTAL RETURN * (dividends and capital gains reinvested)			
	--- Annualized thru Sept. 2, 2011 ---			
Selected Mutual Fund Categories *	1 yr.	3 yr.	5 yr.	10 yr.
Large-Cap Stocks (Core)	7.8 %	- 01.5 %	- 0.6 %	1.9 %
Mid-cap Stocks (Core)	9.0	0.5	1.4	5.0
Small-cap Stocks (Core) †	10.1	0.0	0.6	5.7
Foreign Stocks (multi-cap) †	3.9	- 1.8	- 1.2	5.7
Emerging Market Stocks †	2.9	3.1	5.9	14.9
Natural Resources	17.1	- 4.3	2.5	9.1
Real Estate related	8.3	0.5	- 0.9	9.0
Flexible Portfolio	8.3	2.8	2.5	4.5
General Bond	6.4	6.5	5.7	7.1
Int’l Fixed Income †	9.4	8.7	7.1	7.1
High-Yield Taxable Bond †	6.9	8.4	5.7	6.9
General Municipal Debt	1.9	4.8	3.4	3.8

* Source: Lipper, as reported in the *Wall Street Journal*, Sept. 3, 2011. **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.

Planning to Work Past “Retirement Age”? What’s Your Back-up Plan?

In a recent survey by the Transamerica Center for Retirement Studies, more than half the respondents said they plan to keep working in retirement. About 40% expect to extend just a few years while 39% plan to work past 70 and perhaps never truly retire. In 2010 the labor participation rate among 55-65-year-olds was its highest since 1975.

There’s much to be said for satisfying, remunerative work at any age. Delaying retirement until or beyond Social Security’s Normal Retirement Age (currently 66) can meaningfully boost one’s lifetime benefits, and each year of earned income allows for more contributions to 401(k) plans and IRAs.

However, relying on working indefinitely entails some risk. The Employee Benefits Research Institute’s annual Retirement Confidence Survey consistently reports that most retirees actually leave the work force *earlier* than planned. Common reasons include health problems or disability, changes at one’s employer, and the need to care for a spouse or other family member.

Joblessness is lower than the nation’s average for older Americans, but data indicate that it’s tougher for older workers to find new jobs if they do become unemployed. Ac-

ording to the Urban Institute, those who find a new job will experience a 20% wage reduction on average.

On the other hand, older workers may have advantages in some industries. Experienced scientists and engineers are highly valued and may benefit from flexible work arrangements designed to keep them on the job. Older workers tend to be viewed as more loyal, reliable, and even more productive. The long-run trend away from physical work also facilitates older employees continuing to make a contribution.

The American Association of Retired Persons lists education, engineering and technology, financial services, government, health insurance, manufacturing, nonprofit, and services as industries most hospitable to older workers. The 55-64-year-old cohort also accounted for 23% of *new* enterprises in 2010, according to the Kauffman Index of Entrepreneurial Activity.

But risks abound. About half of all business start-ups fail within their first year, and a third of the survivors fail in year two. Those who find it rewarding to work into their golden years surely serve themselves and society well. But a back-up plan is essential, so let’s keep funding those retirement accounts. ■

► *continued from page 2 ... College Tuition?*

roughly 12-fold. Even adjusting for 35 years of inflation, the respective *real* increases are 3-to-3.5-fold.

The mid-1970s are an interesting reference point, because that is when the federal government really stepped into the business of student aid. The program establishing what would become known as “Pell Grants” was enacted in 1972. By the 1976-77 academic year the incipient program was providing \$1.5 billion in annual grants.

A significant increase in Pell Grants was pushed by the Obama administration, and annual awards

currently total about \$30 billion, a 20-fold increase (5.4-fold in real terms) over 35 years. But Pell Grants are just one pillar of federal support. Subsidized Stafford Loans total nearly \$40 billion per year, up from \$1.2 billion 35 years ago.

One might see *some* parallel to the recent boom-and-bust phenomenon in housing. More than three decades of expanding tax and mortgage subsidies for home ownership culminated in a period of rapid increases in home prices in the middle of the last decade. Many came to see ever-higher home prices as a

Social Security Suspends Projected Benefits Statements

Three years ago these pages highlighted the Social Security Administration’s new online Retirement Estimator at www.SSA.gov. That tool took on added importance with Social Security’s recent decision to stop mailing us those projected benefits statements. The agency expects to save about \$30 million this year and \$60 million next year by cutting out those mailings.

Every little bit helps since nothing has yet been done toward reforming Social Security’s basic entitlement and the future strain imposed by the burgeoning ranks of boomer beneficiaries. In fact the payroll tax dedicated to Social Security was trimmed 16% at the beginning of 2011 – a \$120 billion cut in revenue that President Obama would like to extend for another year.

According to a 2010 Gallup poll, 60% of Americans do not believe Social Security benefits will be there for them when they retire. Expectations are even lower among younger workers. But in the government’s longer term budget projections it’s Medicare and Medicaid that really run riot. Most discussions on Social Security reform involve modest increases in the “full retirement” age for today’s younger workers and adjustments in how benefits are calculated, taxed, and adjusted for increases in the cost-of-living.

In any event, if you are closing in on retirement, or you just like to think long-term, check out the Retirement Estimator tool at www.SSA.gov. They’re not trying to hide the ball; they just want to save a little paper and postage. ■

foregone conclusion and leveraged to the hilt to be in that game. It would be unfortunate to see a comparably broad discounting of higher education, unless that’s what it takes to spur that delivery system to meet the real needs of each generation’s best and brightest. ■

► *continued from page 1 ... That Budget Thing*

14.9% of GDP in 2009 and 2010 while spending surged to 25.0% and 23.8% respectively.

At the end of fiscal 2008 federal *debt* held by the public was 40.3% of GDP, just above the 40-year average. It will approach 70% of GDP by this fiscal year-end, so a certain amount of hand wringing is in order. But is the picture *all* gloom and doom?

Renewed gridlock appears to have capped spending growth for now. Fiscal 2010 outlays actually fell slightly from 2009, and they're about flat for 2011. An eventual surge in Social Security, Medicare, and Medicaid costs may be inevitable, but the current-year's rise in those programs will only run about 4%. Defense spending is about flat year-over-year and a likely target for selective cuts.

With the surge in debt, net interest costs are up even as the government enjoys record low borrowing rates. Net interest is still modest at 2% of GDP for fiscal 2011, up from 1.3% as recently as 2009.

On the revenue side individual income tax receipts are running 24% ahead of last year. Total revenue may be up 8-9% despite this year's cut in Social Security payroll taxes. History suggests the existing tax structure can generate better than 18% of GDP if the economy gets back on track. Meanwhile, tax reform discussions are revolving around reducing mar-

ginal rates while curtailing tax exclusions and deductions to broaden the tax base. Three years ago we noted that the share of income taxes drawn from higher-income households had risen, making federal revenues "more susceptible to swings in income and asset performance for these households." That effect has played out in spades since then.

There also seems to be political momentum for entitlement reform. Social Security, Medicare, Medicaid, and Unemployment Benefits account for about half of all federal spending. Trimming or rationalizing benefits is politically difficult, but the impact is spread over tens of millions of beneficiaries. It should be possible to effect real savings without ruinous effects on those most vulnerable.

Of course there is one big wrinkle: 2012 is an election year. ■

The Bipartisan View: S&P Goofed

Given the partisan acrimony over raising the debt ceiling, you might be surprised that lawmakers of *both* parties seemed to agree on one thing: Standard & Poor's was wrong to downgrade U.S. sovereign debt from AAA to AA+.

S&P is one of the major credit rating agencies that Congress had legislated into a preferred position as the arbiters of credit worthiness for all manner of debt issues. That gave the downgrade the look of a dog biting the hand that feeds it.

Immediate reaction across global markets was a rush out of most "risk" assets and *into* U.S. Treasury securities. In fairly short order the other major rating agencies reaffirmed their top ratings on U.S. sovereign debt. We'll see who has the last laugh. ■

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