

THE BIG PICTURE

Coming into year-end I thought it would benefit all readers of my articles to comprehend “the big picture” as I see it to assist with their thoughts and strategies going into calendar year 2012 and beyond. While no one knows what might happen over the coming days, weeks, or months, history has shown that eventually the rooster comes home to roost and I am sure this time will be no exception. So with that said allow me to share some thoughts and concerns that abound in my head as I consider investment strategy for portfolios and look for opportunities to exploit should they materialize in the coming years.

As I see it the big picture consists of three primary issues which include: (1) exploding deficits; (2) unlimited fiat money creation; and (3) negative compounding. Let’s discuss each one individually.

By now it is common knowledge that the U.S. Government borrows 40% of every dollar it spends and with no end in sight to this unsustainable path. Earlier this year the projected budget deficit was approximately \$1.5 Trillion for fiscal 2011. As I read earlier this week for the first two months of fiscal year 2012 the deficit is on an annualized track to be a staggering \$1.9 Trillion or 26.7% more this year than the prior year. Considering the public national debt is over \$15 Trillion at present the nation will be over the \$20 Trillion mark within the next three years at the current pace. Also bear in mind that 70% of the national debt is held in short-term maturities that will mature within five years and yield less than 2% interest. This will be important to keep that in mind when we discuss the third issue of negative compounding.

Since the government is borrowing money to pay for entitlements, promises, and true obligations, it is important to comprehend that the overall economy is *not likely to recover* as long as this borrowing continues. The reason is that the significant “owners” of U.S. Government debt are the Federal Reserve, China, and Japan, of which the Federal Reserve is now the largest holder of U.S. Government debt of all. The Federal Reserve creates fiat money through accounting entries (i.e. quantitative easing) and loans it to the U.S.

Government. BUT the U.S. Government pays back principal AND interest on these loans so as the interest continues to accumulate so do the payments owed by the U.S. Government. This is like someone who uses a credit card and only pays the minimum payment – as interest accrues on interest it becomes near impossible to ever pay off the principal. When those interest payments are made, and currently they are at record historically low interest rates, the money that could normally be reinvested into the economy through new productive opportunities is *exported* out of the country to the Federal Reserve, China, and Japan. Even if interest rates never change the nation is only paying the minimum payment, so how can the economy improve when the capital needed for improvement is going to private interests? (Please recall the Federal Reserve is a *private, for-profit, entity*).

All of this leads us to the final overriding concern of negative compounding. I am sure you are familiar with compounding in general. For instance, if you make a \$10,000 investment which yields 7% per year after ten years you would double your money and have \$20,000 (excluding taxes, etc. for simplicity of the illustration). While this is considered “good” compounding negative compounding is the opposite. The national debt is currently compounding at low interest rates but at some point in the future investors are not likely to continue to buy 10 year U.S. Treasury Notes yielding 2% or 30 year bonds yielding 3%. At some point all the money creation from the Federal Reserve’s quantitative easing programs is likely to result in a mountain of inflation washing onto our shores. And when this does investors are not going to accept 2% yields for a 10 year Note, but might want 5% instead, or 8%, or 12%. Just assuming a 5% yield on the current national debt means the nation would be spending \$750 Billion on interest payments instead of \$300 Billion at an interest rate of 2%. And *none* of the principal is being paid off to boot. Some may say, “It doesn’t matter – debts don’t matter.” That may be true, but the same thing was said about exponential rising home prices. They also didn’t matter...until they did.

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So what is an investor to do? Personally, I believe history is the best teacher and guide. While the future will not exactly repeat the past I do believe it will rhyme. My objective is to learn from past lessons and apply similar logic and strategy to the present environment. While I do not believe general investing strategies of the past couple decades like “buy and hold” will prove profitable for the foreseeable future I do believe opportunities will present themselves in unlikely places. The trick will be to take advantage of

them when they occur while being mindful to protect your capital.



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