J.J. BURNS & COMPANY, LLC

2nd Quarter Newsletter, July 2011

Risking Recovery

U.S. Debt Ceiling Issue

With job creation showing signs of anemic growth, unemployment at 9.2% and housing still in a slump, Japanese disasters, and countries like Greece on the heels of bankruptcy what else could risk the recovery to the US economy? Answer: our own political system. This reminds me of an old saying from our forefathers, "Mother Nature gives us the earth, and we humans will find a way to mess it up." Politics and party positioning have become more important than the credit worthiness of The Unites States of America.

How did the world's largest economy get to the edge of default?

Why is America facing a debt crisis?

The simple answer here is, America is not allowed to borrow any more money. The US national debt cannot legally exceed a debt ceiling of $14.29 trillion (tn) – a seemingly huge amount, but one which was reached in May.

So what happens next?

Either the US raises the debt ceiling (and can then issue more debt), or it does not (and is then barred from borrowing to pay its bills – such as social security and Medicare). With a 2011 deficit of at least $1trillion, the stakes are high.

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Why doesn't President Obama just raise the ceiling?

Because the leader of the world's largest economy does not have the authority. Any change to the debt ceiling needs to be approved by Congress, and this has led to a protracted stalemate between Republicans and Democrats.

Why can't the two sides agree?

Both sides realize that the US debt needs to be brought under control, but have rather different ideas about how to do it. Obama is proposing a 10-year, $4 trillion package of spending cuts and tax rises – including higher income taxes. The Republican party supports a $2.4 trillion package of spending cuts, but is not backing the tax rises.

How has America been keeping afloat since May, when the debt ceiling was reached?

By stopping payments to certain federal pension accounts, and by liquidating some of the account's assets. Treasury secretary Tim Geithner has pledged that the shortfall will be repaid once the ceiling is raised. Furthermore, the Treasury may have the discretion and authority to determine which obligations will be paid, should Congress fail to raise the debt limit and funds are inadequate to pay outstanding debts. Basically, if Congress fails to authorize an increase in the federal debt ceiling it appears the US Treasury may have the authority to prioritize the order in which debts are paid.

Who Holds US Debt?

Looking at who holds US Treasury debt, the most recent ranking shows that approximately 41% of the public debt is now held by the Federal Reserve and other intergovernmental agencies. Next is China at 14% and now ranks second behind the Federal Reserve. So, as a first cut, the Treasury could decide simply not to pay interest or principal due to the intergovernmental holders of debt. This buys some time, but is merely "kicking the can down the road."

How urgent is the situation?

The US treasury estimates that funds will dry up on 2 August. However, the deadline is actually July 22 – to give time for legislation to be written and approved.

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Has the debt ceiling often been raised?

Many, many times! More than 70 times since the mid-1960s, and 10 times in the last decade. It's not been entirely one-way traffic, though, since Congress did vote to lower the limit twice in the 1950s, during America's postwar economic boom.

Without a deal, will the US immediately default on August 2nd?

Not according to Ben Bernanke. The Federal Reserve's chairman told Congress on Wednesday that the first response would probably be to cut social security payments, Medicare and military pay.

How are the markets reacting to the deadlock?

Until very recently, the view on Wall Street was that a deal would be reached in time. However, investors are starting to get edgy. Moody's has warned that a US default is unlikely, but no longer unthinkable, and put America's credit rating on negative watch. On the bond markets, however, US 10-year bonds are trading with a yield, or interest rate, of just 2.9%. The suspicion is that neither side wants to take the blame for pushing the US into a new financial crisis.

What impact would a default have?

Some experts have predicted a major panic. Standard & Poor's has made it clear that it would cut the US rating from AAA (the top) to D (the bottom). That would mean banks would technically be barred from using US debt as collateral with central banks (although these rules could be changed). Even Bernanke has conceded that failure to lift the US debt ceiling would throw the financial system into tremendous disarray.

Why doesn't the president have unfettered powers to set the debt ceiling himself?

Article 1, section 8 of the United States constitution says only the US Congress has the power to allow America to borrow. Originally, this meant that every loan had to be signed off individually. But in 1917, Congress agreed on a limit for the first time. This legislation, called The Second Liberty Bond Act, funded America's entry into the First World War. The modern debt ceiling – the limit on all public debt – was created in 1939, set at $45 Billion.

Despite what the rating agencies say, the US is unlikely to default on its own currency. The markets are sending a message to us as wealth advisors, in that this current market is paying closer attention to the "default" risk. In discussion with our bond managers it appears our asset allocation is representative of this increased risk.

The Tables Have Turned – Debt Ceiling 2006

It was not long ago that President Bush was requesting an increase in the debt ceiling in 2006. I came across the testimony of what then Senator Obama had to say on this:

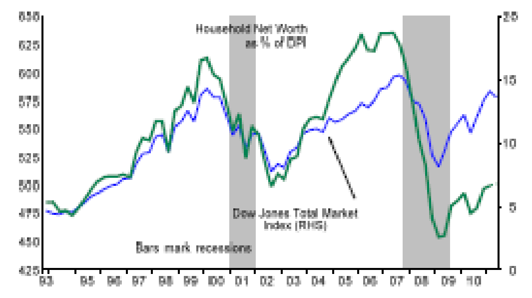
"The fact that we are here today to debate raising America's debt limit is a sign of leadership failure. It is a sign that the US Government can't pay its own bills. It is a sign that we now depend on ongoing financial assistance from foreign countries to finance out Government's reckless fiscal policies… Increasing America's debt weakens us domestically and internationally. Leadership means that 'the buck stops here.' Instead, Washington is shifting the burden of bad choices today onto the backs of our children and grandchildren. America has a debt problem and a failure of leadership. Americans deserve better."

Ultimately, action to raise the debt ceiling will likely happen. Volatility may increase, thus uncovering opportunities to rebalance portfolios to find additional value.

US Household Finances

The financial crisis crushed household balance sheets. Households lost 25% of their net worth between mid 2007 and early 2009. They have recouped about half of those losses in the past two years, but that still leaves their net worth only at mid-2005 levels; adjusted for inflation and population growth at just mid-2003 levels. By comparison, the bursting of the equity bubble at the turn of the century was a mere hiccup; then, net worth fell 9% and took just a year to regain its former peak. The loss of wealth has been much greater and more enduring this time because the fall in asset prices was so much steeper and broad-based, affecting not only equities but housing as well. An average US household took on significant debt during the bubble years, however, their own net worth increased substantially (more than 60% from mid-2003 through mid-2007); because their assets appreciated so much. In fact, it was this appreciation that encouraged households to take on more debt and lenders to make it available to them.

Today we have nearly one in four households with "upside down mortgages" meaning their home is worth less than their outstanding mortgage. De-leveraging continues but still has a ways to go. Mortgage applications are heading lower once again. The one positive is, banks are no longer lending imprudently as they were before.



Source: Reuters EcoWin Pro, BNP Paribas

Household wealth is recovering but only gradually as equity market gains have been partially offset by house price declines. Wealth looks to be basically flat year to date.

Jobs, Jobs, Jobs, Where, Where, Where?

Employment data showed we are at a very low level of hiring announcements. Layoffs rose 12% on the month. Firings have now exceeded hiring's in each of the past two months by over 25,000 and in three of the past four months. Recently the WSJ (Wall Street Journal) ran with the headline "For Small Businesses, Recession Isn't Over." – 70% have no plans to add to staff loads in the next 12 months. Only half see any revenue growth and 78% of small businesses don't believe the National Bureau Of Economic Research that the recession ever ended in mid-2009. This is the huge disconnect between the large corporations (S&P 500 businesses) and the rest of the corporate world which include small family businesses. Small businesses have little to no access to the capital markets especially for lending. A recent survey indicated many credit unions would rather borrow money from the Federal Reserve and invest the proceeds into US Treasury bonds and pocket the spread as profit.

US Municipal Bond Market

Six months ago the US Municipal Bond market was getting thrown out like the "baby in the bath water." The talk of widespread defaults and the potential loss of principal for investors was daunting. Interestingly the Municipal Bond market enjoyed its best quarter in 2 years with a 4.5% net return in the 2nd quarter.

Revenues at the state level are still below pre-recession levels but are climbing nonetheless, and most states are cutting program expenditures to protect their credit ratings in the process. State government employment is down to 1999 levels. Finally, demand for tax free bonds continues to grow.

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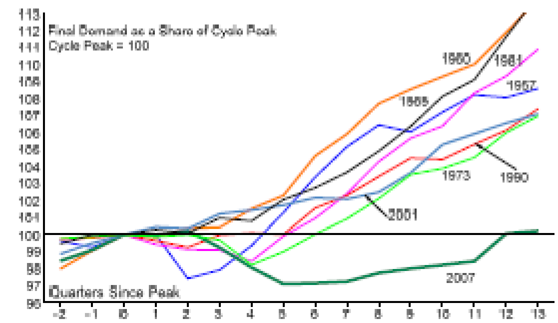
Pictures Speak A Thousand Words

With the help of BNP Paribas, the old adage, "A Picture Speaks a Thousand Words", the graphical charts below help to give clarity to the issues we face as a country, furthermore as a global economy.

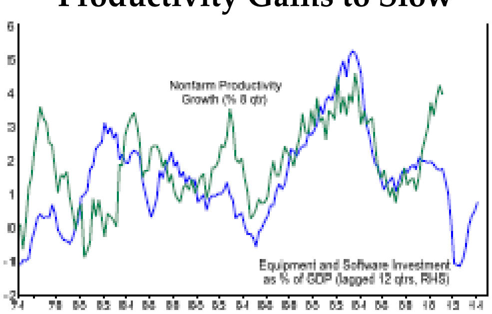
The New Era Of Slow Growth



Source: Reuters EcoWin Pro, BNP Paribas

After a solid Q4, the US economy returned to a slower pace of growth in H1 2011, reflecting a lower pace of potential growth, the lack of pent-up demand in the current cycle and a number of temporary headwinds.

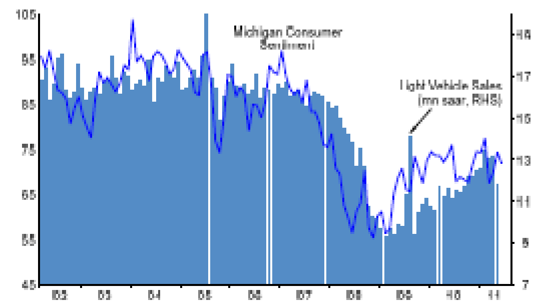
Productivity Gains to Slow



Source: Reuters EcoWin Pro, BNP Paribas

The tilt toward public sector borrowing does not bode well for capital investment and future productivity growth trends. The recent burst in productivity may be short-lived, highlighting the transition to a new era of lower potential growth.

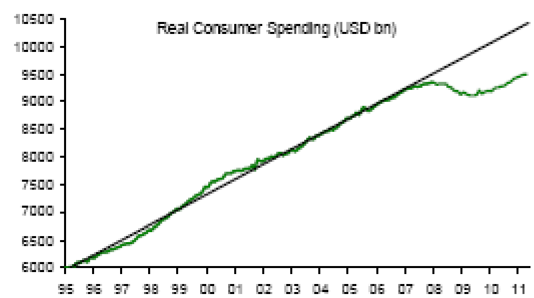
Auto Sales Disrupt



Source: Reuters EcoWin Pro, BNP Paribas

Rising gasoline prices curtailed consumer purchasing power, and supply chain disruptions related to events in Japan produced a plunge in auto sales that has weighed heavily on GDP growth in Q2; we look for growth of 1.5% q/q saar.

No Pent-Up Demand



Source: Reuters EcoWin Pro, BNP Paribas

There has been no indication in consumer spending that households are trying to make up for lost time or get back to the pre-2008 trend. Notions of pent-up demand are misguided.

Conclusion

Martin Wolf, Editor of the Financial Times sums up JJ Burns and Company's investment advisory team conclusion accurately: "These times require wisdom and courage among those in charge of our affairs. In the US, utopians of the right are seeking to smash the state that emerged from the 1930's and the Second World War. In Europe, politicians are dealing with the legacy of a utopian project which requires a degree of solidarity that their peoples do not feel. How will these clashes between utopia and reality end? In August we may know at least some of these answers." Ultimately, the risks are rising against a sustainable recovery.

Our wealth management team continues to monitor and rebalance your portfolio accordingly to your style specific objectives. Please feel free to contact anyone on our team to discuss your concerns and questions you may have.

On behalf of our entire team at JJ Burns and Co. we wish you all the pleasures this warm summer brings to you and your loved ones.

James J Burns, CFP
President and CIO

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