From: Arthur McKee <art@mckeeinvestments.com>
Subject: Update: US Deficit, European Debt, Lack of Logic
Date: November 22, 2011 3:59:54 PM EST
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Dear Clients,

I can't keep quiet about this any longer. Nonsense has to be called to the carpet and I find myself wondering if there is ANYONE in the news media that has a brain. And for those of you who love Fox news, they aren't any better.

We often get too caught up in the details that we forget the bigger picture. That is not by accident, because the details of today's environment make for great TV and media coverage. It is like we are watching a train wreck in slow motion and are taking our cues for whether things will get better or worse based upon the details of what happens with each car and passenger on the train. This transpires each day with the continuing coverage on both the US deficit issue and the European debt problem, the media giving us play by play coverage of a very BASIC problem. Let's look at the big pictures:

Debt, Government, Incentives, and Stimulus (in any country on this planet)

The debt issues in the US and Europe display that practicing Keynesian economics will fail in the long run. In the short run, there is no doubt that government spending boosts economic activity; win for John Maynard Keynes. However, the dissociation of incentives and consequences provides the fatal flaw that no amount of spending can surmount. While Keynesian economics will win many a battle, it cannot win the war.

Keynes is the author of the economic playbook that Western European countries and the US subscribe to in this modern economy. The governments are in many cases, the largest employers in a country and take on the authoritative role of steering the economy by stimulating it with low interest rates and a "borrow & spend" program or slowing the economy with higher interest rates. However, the removal of stimulus generally does not include a contraction in spending, but governments utilize solely an increase in interest rates. That happens because the spending is directed by politicians who gain the most when they are re-elected. Politicians get re-elected by getting the most for their constituents. Constituents don't like their favorite government programs to be cut. So, over time, the system builds up a large debt balance, like we are seeing today. We get hooked on the spending like its a drug and can't give it up.

We call the US or any country's economic situation it's economy, or "macro economy", meaning the whole thing. By contrast, a "micro-economy" refers to the specific situation of small parts of the whole; small parts like your household, your business, your job, your income, your incentives, and the rules that govern those parts. Keynesian style economics deals with the macro and adjusts aggregate supply and demand through government spending. What Keynesianism fails to recognize is that the MACRO is just a bunch of MICRO, just a bunch of "us." It is impossible for a person or group of people to manage ALL of us, and grossly overreaching to believe otherwise.

For each one of us to decide what to do on any given day, actions have to lead to consequences and the consequences have to be predictable. "Boosting Aggregate Demand" means that the government is spending money and with that much money to be spent, the new competition becomes "who can get a government contract." When the system is set up to reward the few at the expense of the many, it then becomes a game of "becoming one of the few". The government is taking future taxpayer's money and distributing it today, as it sees fit.

The banking and finance industry of today becomes the governing body of tomorrow and the governing body of today was the banking and finance industry of yesterday. (Bernie Madoff, John Corzine, Hank Paulson, etc.) This creates a self perpetuating system of crony-ism and when the stimulus need to be "applied", it only takes a few phone calls to some old buddies. Their reward is in keeping the current system intact, so nothing they say or promote can be taken earnestly. They are in line for the next round of "Quantitative Easing".

The minutes of the latest meeting of the Federal Reserve (the handful of people charged with herding cats) was just released today and it showed that several members of the committee thought that we needed more quantitative easing; this time in the form of printing money and buying mortgages from Fannie Mae, Freddie Mac, and the too-big-to-fail banks. You know, I have heard that the definition of insanity is doing the same thing over and over again while expecting different results.

The Ben Bernanke Fed appears to be ready to pull out all the stops to apply more and more Keynesian stimulus to our system and this WILL lead to an oversupply of US dollars and the devaluation of the dollar. Right now, the dollar has strengthened, but that is only because European banks have decided to hoard some US dollars as opposed to Euros. That preference will ebb with each rotation of the printing press drums at the US Mint. With that, I still expect the value of the dollar to decline over time.

US Deficit Crisis: (data from CBO - Congressional Budget Office - www.cbo.gov)

First, let's look at some quick facts:

- In 2011 our (the USA) budget deficit will be $1.3 trillion dollars. Deficit means that our government is spending more than our government currently takes from us in taxes. First, here's what $1.3 trillion looks like with all the zeros:

$1,300,000,000,000

- The tax revenues taken in 2011 are expected to total about $2.1 trillion and spending will come in at around $3.4 trillion, hence leaving the aforementioned deficit of $1.3 trillion.

- The "Budget Control Act" passed earlier this year provided for $133 billion in budget cuts per year over the next 9 years. They called it a $1.2 trillion cut, but that is just the cumulative total of all the future cuts over the next 9 years. $133 billion looks like this:

$133,000,000,000 (in trillions, it would be $0.133 trillion)

Now for the narrative:
The so-called SuperCommittee doomed itself to failure upon inception. What were the consequences for their failure to agree which programs to cut? Answer: Nothing. The SuperCommittee was just window dressing and completely inconsequential.

If we said we were cutting a dollar from our budget, we would be talking about now. Not so in congress. This $1.2 trillion is the cumulative budget cut over nine years, so an average of about $133 billion a year for the next 9 years. That would be like us counting a $1 budget cut as $9 in cuts. Make sure you don't miss this point. The budget deficit is expected to be $1.3 trillion in 2011. That means that we will spend $1.3 trillion dollars more than we take in taxes during this year. That means we will have to borrow $1.3 trillion dollars more than we owe right now. With the $1.2 trillion in mandatory cuts included, we would STILL have a deficit of $1.167 trillion and STILL have to borrow $1.167 trillion. Only Congress.......

Think of it this way: (numbers rounded) Let's say you make $100,000 per year in income. An equivalent personal budget would be for you to spent $162,000 while making $100,000. That is the same ratio of spending to revenue as practiced by our government. The $1.2 trillion in budget cuts would equate to cutting your $162,000 spending budget by $5,000 per year for the next 9 years. Therefore, our new spending budget would be $157,000. Now, if we were congress, we would call that $5,000 budget cut a "$45,000 budget cut" because it would total that over the next 9 years. We would still have to borrow $57,000 per year, while making $100,000. Oh yes, and we would have to come up with some triumphant name for our $5,000 budget cut as congress did with their "Budget Control Act". What a distraction!!!

If, and that is a big "if", the $1.2 trillion in cuts were going to be implemented in each year going forward, then we would have something. As it stands now, our government appears content to steer us toward a Greece-like situation. Our national debt is at 63% of GDP and increasing by 10% per year on its current track. So, unless we get our act together, we will owe more than our annual GDP within 4 years. Not good.

<u>European Debt Crisis</u>

Some countries in Europe have a bonafide debt problem. You don't solve a debt problem with additional debt. This is so basic, I ask your forgiveness in advance if I have insulted your intelligence. However, the media and markets are cheering every time there is news that the European Union may be issuing more debt to finance a failing country or that Germany will swoop in and lend money to a bankrupt country. That makes no sense whatsoever.

What does make sense is the other countries withholding support to an ailing country UNLESS that country balances their budget with an allowance to pay down the principal of the debt. If I were Germany, I wouldn't lend any money to Greece either, UNLESS the Greeks got their budget balanced.

Balanced budgets.....Sound familiar? They are quite important.

At a Spanish Bond auction this morning (Spanish government was borrowing money), Spain saw their borrowing rates hit 5% for a 2 year Spanish government bond. This is the highest rate that Spain has had to pay since joining the European Union. Interestingly, Spain's debt-to-GDP ratio is 60% while the debt-to-GDP ratio for the USA is 63% and growing at a rate of 10% per year. Dangerous? I think so. (Table below in case you are interested.)

I believe that the end result in Europe will be a group of countries that realize how important it is to keep the budget right and the countries like Greece, Portugal, Belgium, and Italy will fight with their debt dragons for at least a decade. During that time, those specific countries should expect lower than normal growth. The void will be filled by other, stronger countries in Europe and Asia. The world will not come to an end.

<u>Going Forward</u>

I believe that Europe will provide enough of a crisis to bring down the stock prices and asset prices to the point that opportunities for great investments will present themselves. Already, I am seeing significant downward moves in the stocks of very good companies that have done quite well in this economic environment and I expect a batch of further selling "just because". When that happens, we will be buying. I don't have an estimate on exactly when that will happen, but we are prepared to move when everyone else throws logic out the window.

The volatility will create opportunity. We have to recognize that the media will create the environment that we need to make great investments. So, for that, among many other things, I am thankful.

Have a Happy Thanksgiving!

Rank (high rank is bad)	Country	Central Government Debt as a % of GDP
2	Japan	199.70
4	Greece	142.70
6	Iceland	126.30
8	Italy	119.10
11	Belgium	100.70
12	Ireland	94.90
13	Portugal	93.00
16	Germany	83.40
18	France	82.40
21	Hungary	80.20
23	United Kingdom	76.10
25	Austria	72.30
26	Malta	67.80
29	United States	62.90
30	Netherlands	62.70
33	Cyprus	60.80
35	Spain	60.10
47	Poland	52.80

52	Norway	49.70
53	Finland	48.40
62	Denmark	43.70
70	Sweden	39.70
72	Czech Republic	38.90
74	Switzerland	38.40
84	Romania	33.80
94	Australia	28.80
96	New Zealand	27.50
99	Indonesia	25.70
104	Korea, South	22.60
112	Paraguay	19.30
114	Hong Kong	17.80
116	China	16.30
122	Chile	9.20
Source: CIA World FactBook www.cia.gov		

Best Regards,

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