The Big Squeeze on Middle Class America

By: Craig Van Hulzen

You may have already noticed that prices are rising in many everyday areas of life. The prices of food, gasoline and clothing are likely to continue to rise in the second quarter of 2011. The impacts of actions to pull the world out of recession are beginning to have some uncomfortable side effects. Commodity prices are moving substantially higher and will accelerate the rise in prices of milk, beef, cotton clothing, gasoline, corn, coffee and other household items.

As we have detailed in previous commentaries, the Federal Reserve (the Fed) is in the middle of a second quantitative easing program designed to stimulate the economy and keep interest rates low. Low interest rates are essential to the overall debt burden of the United States (see our insert on the U.S. financials form last quarter) and to the resumption of economic borrowing activity by the private sector. However, it is also a stealthy "tax" on savers, as the interest earned on savings are below the cost of living increases. In order to keep up with costs, investors are being forced to invest in asset classes that can produce higher income or growth, and concurrently risk savings to losses should the economy stumble.

Wages are stagnant in most sectors of the market and unemployment remains at abnormally high levels. Despite the pressures on the average household, many corporations and equity markets appear to be quite healthy. Corporations have high levels of cash and are growing revenues through higher prices of goods, while stocks have a tailwind from the government's stimulating actions. The biggest rise in earnings is coming from the financial sector, where banks are enjoying essentially free margins with unlimited low cost borrowing from the government and safe investment back into government guaranteed products. The result is essentially a no risk profit margin earned using government funds to buy government guaranteed investments. This is helping big banks to stabilize and increase reserves.

The implications

With $14 trillion in Treasury debt and $75 trillion (the official government figure; includes social security, Medicare, Medicaid and other social programs) in total obligations, the math strongly suggests that the debts cannot be paid off via tax receipts and economic growth alone.

Unless entitlements are substantially reformed, the U.S. will likely default on its debt; not in conventional ways, but via inflation, currency devaluation and low to negative real interest rates.

Bill Gross, PIMCo Funds (the world's largest bond fund manager)

Possible government actions to "solve" the debt burden:

- Higher tax rates
- Lower and/or delayed social security payments
- Less Medicare and Medicaid support
- Less spending power of dollars
- Higher costs of food and energy

Remember, the government must take some combination of these actions, and they are most likely to use the means that are most clandestine and stealthy. An outright default is unthinkable. There are other ways in which the debt burden may be reduced or mitigated. The bad news is that the middle class of America is likely to pay the bill on any path taken.

Perhaps the easiest method is to devalue the dollar. The inserting of newly printed dollars into the system makes each existing dollar a little less valuable. When you lay a dollar on your nightstand before you go to sleep, it would still be there in the next morning and it would appear exactly as you left it. But overnight, the price of everything a dollar can buy went up a fraction of a percent. In reality, the dollar's purchasing value is going down, but our senses tell us everything else is going up.

Social security is seen as an untouchable program, but the calculation of how much your social security check rises each year can be controlled by the Consumer Price Index (ex food and energy). Over time, your social security check may rise by 1-2% per year but the actual living costs rise by much more. Over the course of 20 years, your social security check would cover one-third less than it does today.

Through 1) low rates of interest on savings, 2) by "inflating" assets and prices for goods, and 3) by devaluing or pressuring the currency, the American middle class is getting squeezed. Much of the middle class has already lost substantial equity value in their homes, and is also likely to be taxed more in future years. The burden is will be heavy for many households, with more government support required for struggling Americans, and a shift in consumption, where more of the monthly budget will be necessary for food and energy, clothing and health care.

No one is saying Mr. Bernanke has an easy job, and his choices may literally be of the "lesser evil" variety with no single good choice available. I am convinced that he looked at the choices available to him in 2009 and decided that inflation was far better than the enormous debt burden, a housing bust, and a languishing stock market. Now, dealing with the side effects will be the challenge for everyone.

The opportunities, challenges, and what to do about it

The potential problems facing consumers and the middle class of America, ironically represent upside and opportunities for some sectors of the economy. Energy companies, food companies, health companies can all benefit <u>as long as they can pass costs along</u> to consumers and end users. Also, financial companies are being supported by extraordinary government measures (but remain a risky area for most investors).

<u>Current investment themes:</u>

- Own shares of U.S. companies that benefit from the current economic situation.
- Own a higher percentage of companies doing business outside the U.S. and in growing economies.
- In fixed income investments, mitigate rising interest rate risk and add exposure toward bond investments that can rise if rates move higher (TIPs; floating rate bonds)
- Own some investments that are in other currencies, reduce US dollar dependency
- Review personal debts, pay down high rates, adjustable rates.
- Review personal budgets and habits. It is more common to review a budget each year, but perhaps less common to review habits, hobbies, and standard of living.

Owning Equities
We prefer equity investments in areas that provide a good reward-to-risk ratio. The current worldwide economic recovery remains dependent on government intervention, the use of debt leverage and on earnings driven, in part, by inflationary cost increases. Risks remain elevated. We prefer many established companies with dividends, positive cash flows, good management teams as well as companies that are currently experiencing a tailwind from commodity price increases and other economic factors. The reward in some of these names may be smaller than if we were investing solely in some of the high growth areas, but the risk of decline is far smaller for our investments and we still participate in higher stock prices.

More Equity Ownership Overseas
Some regions of the world have a positive outlook. Developing countries including Brazil, Russia, India and China are the most apparent. Japan may represent opportunity during the rebuilding of the country and following the large scale decline in the Nikkei index. It is still very uncertain, and we may look for US-based companies that will help to replace energy needs and also benefit from rebuilding activities.

Mitigating Interest Rate Risks
The Fed is between a rock and a hard place. Raise rates to fight inflationary pressures? Rates rising despite Fed actions due to large debt load? China moving away from US debt? Upward pressure on rates are likely to remain unless or until a double dip occurs. Maintain short duration in the bond portfolios, with inflation protection, and some global sovereign debt to diversify both currency and country risk.

A Basket Approach to Currency Exposure
In equities, bonds and cash, begin a process to have a more diverse basket of underlying currencies. Move from a wholly dollar denominated lifestyle and portfolio to a diversified exposure of paper monies and hard currencies. Use countries with strong sovereign balance sheets and a wealth of commodity resources. Silver remains far below historic ratios relative to gold prices.

A Personal Review: Debts and Budgets
Reduce or eliminate adjustable rate debts, high interest debts. If you have a 7%+ loan and also have 3-4% bond investments, it is worth reviewing why you are paying a lender more than you are receiving to be a lender.

Is it time to review the type of car you own, whether public transportation would work, how you shop for groceries, where and when you buy gasoline, how much dairy and meat you will need and when to buy clothes? This may be too much detail for many, and wholly unnecessary for some, but price increases will change the way some people choose to live their day-to-day lives.

950 Iron Point Rd, Suite 290 ♦ Folsom, CA 95630 ♦ Tel 916.608.4284 ♦ www.vanhulzen161.com

Closing Remarks
For many in the world, food inflation is both damaging and dangerous. In many countries, food will require more than half of wages to feed a single person. There is nothing quite like hunger to cause social unrest. And now, social media brings it to the attention of the world in real time.

The recovery is still vulnerable, and despite historically low interest rates and low taxes, the US consumer is struggling mightily against a stubborn unemployment rate, low wage growth and a disappointing (non-existent) bounce back in real estate prices. Foreclosures now take over 18 months on average. Whether due to banks unwillingness to act or a lack of knowing who actually owns the loan, it hangs as a millstone around the neck of residential property owners.

Investments should be made on a case-by-case basis and person by person. Banks are using mortgages and loans to gather brokerage assets, and insurance companies are selling annuities as guaranteed income. One will sell their products to investors and assign inexperienced brokers to the accounts, the other will sell products promising a “6% guarantee” when 4% of that is coming from principal and only 2% from interest earned.

Financial advice should be personal and specific, offered by knowledgeable professionals who have no conflicts of interest. Be wary of the large corporation who wish to use your assets as their collateral base. If something sounds too good to be true, investigate! If it feels like a deal, it may very well be, but look into it closely. Use your financial advisor to run the math, to investigate the details and to offer suggestions. A good financial advisor will want you to succeed and prosper in any investment, whether it is managed by them or not.

950 Iron Point Rd, Suite 290 ♦ Folsom, CA 95630 ♦ Tel 916.608.4284 ♦ www.vanhulzen161.com