

Malaise vs. Morning in America

April 2010

I am reminded of a time, 30 years ago, when we faced a “crisis of confidence” and America had to ask itself if this was the end of life as we knew it. It really has been that long since we faced anything like this. In the late 70’s we had the misery index (inflation plus unemployment) over 20%, its peak. OPEC seemed to control oil prices, and we were powerless to do anything about it.

Cars were of poor quality – remember “planned obsolescence”? New Chevys were nowhere near as good as the 60’s models, which were still running strong as 70’s models went to the junkyard. GM owned the market and had to work hard at:

1. not increasing market share by being good – anti trust worries
2. instead, making more money by cutting every possible corner on quality.
 - And now we own GM, isn’t that lovely?
 - They (excuse me, we) lost \$4.3 billion in the second half of 2009.

As some of us recall, President Carter gave a speech in 1979 for which he will always be remembered. Funny, although he never used the word “malaise,” it is remembered as the “Carter Malaise” speech. Even funnier, I just read it again and it sounds pretty conservative, at least in parts. Times change...

Back to the 70’s

But he was pretty negative. Offering “toil, sweat and tears” worked for Churchill in the throes of the London Blitzkrieg, but Carter didn’t pull it off. The energy crisis didn’t quite rise to that level of desperation, and his ill-received speech may have finished his chances for re-election (unless it was the Iran crisis – does that sound familiar?). Hard to say, I suppose.

So what does all this mean to us now? Why is this Stone Age example of any interest? Recall that phones had wires and dials and computers were huge boxes in special cold rooms attended by people in white jackets with boxes of punch cards. Why is this relevant now?

**From here
you can see
everything.**

Well, the misery index recently hit 11.84, its highest level since the mid 80's, when it was diving, as the economy was growing strongly. Now it is going higher, unemployment is very high, and, while we can't be certain it will persist, it is hard to envision a sharp recovery as from past recessions. Inflation is a big worry, although we don't see it happening yet. We do see a revised estimate from the CBO (the non-partisan Congressional Budget Office) projecting a \$10+ trillion deficit over the next ten years from the new Health Care plan, much larger than projected during the debate of the bill. Everyone asks, can inflation be far behind? I wish I had the answer.

The bigger question, then and now, is about us, about America. Are we special, are we exceptional? Is America a great nation, and do we have a great future? Or is all that in the past? Are we to be superseded by others, relegated to a secondary role? And what is the role of government in all this? President Carter painted a grim picture and offered higher taxes and a tough road, with a leadership role for government. His opponent, Edward Kennedy, offered Universal Health Care controlled by the government (sound familiar?) but failed to unseat the incumbent. In the general election, however, a different path was chosen. Let's not discuss the politics of all this, but recognize instead the fundamental question we faced then and we face now: is America finished as world leader, as the exceptional nation blazing new trails and showing the way, or not? Is there another Morning in America in our future?

I don't pretend to know the answer. I am hoping for better than massive deficits and the New Normal, but we have to be realistic and see what comes--hope for the best, prepare for the worst.

The New Normal

Let's return to our good friends in Newport Beach, CA, PIMCO. Bill Gross and Mohamed El-Erian are co-CEO's of a truly remarkable firm, one of the best money management firms on the planet. They do bonds, mostly, and very well indeed. Funny, a classmate of mine from Harvard Business School (class of '83) recently reminded me that he had interviewed with this guy from Southern California, Bill Gross, who had a little bond management firm. He passed. Oh, well. PIMCO passed \$1 trillion in assets under management last year. That is real money even for the U.S. Government.

The co-CEO's of PIMCO were Obama supporters. But they are also excellent analysts and money managers. What they publish is their "best thinking," not anyone's talking points, and it is useful to look at their views; they are not easily dismissed. Let's be clear, this discussion, this letter, and in fact, our whole outlook, is not about politics, not about party, not about wishful thinking. This is serious, it is specifically about our financial futures, and

how what we see, what we hear, what we experience, and what we may well fear, ought to affect our thinking about what to do in terms of investing for the future. Mohamed and Bill set their politics aside to invest wisely, and so should we.

Just for the record:

1. I will be attending the PIMCO Institute for Wealth Managers Conference later this month. (Martha Post, our CIO, attended last year.) They manage a lot of our clients' money and are very smart people; we learn a lot from them. That being said, we pay our own expenses; this is not a "perk." This is business, and we pay our own way.¹
2. I disagree with important aspects of their fundamental view of the world, the "New Normal." Hopefully they will still welcome me to Newport Beach.

Bill's latest letter included the obvious observation that our government's plans for spending do not work. The deficits are terrifying, the required increase in taxes death-defying, the projected debt levels comparable to those of Greece. This is not a partisan issue. The solutions you prefer may have a partisan tinge, but the issues are clear. Our spending commitments are way past anything we can fund, and big changes are coming.

PIMCO concludes that we are in for an new era of The New Normal: reregulation, deleveraging, and deglobalization, bad economies, higher taxes, weak returns on equity, just no fun at all. They don't really have a solution other than being "nimble" and "opportunistic." Whatever that might mean - they don't really say. They do have some global asset allocation funds to offer... 😊

All kidding aside, there is a lot of reason for pessimism, but let's not overlook the other side, the reasons known and unknown why the future will not be what we expect or predict; it will be something else again. And speaking of fleeing the United States for better opportunities...

One of my favorite Churchill quotes of all time is:

"It has been said that democracy is the worst form of government except all the others that have been tried."

I think we may well think of the U.S. economy, equity markets and dollar this way. You may search around the globe in vain for a spot devoid of serious trouble. Yes, our problems are serious, but that does not lead to any easy answers like "buy the Euro."

¹ Full disclosure – I might let them buy me dinner!

Have a good look at Greece, or Spain. Or Japan. Or even China. If you find an easy answer please call me! I am looking for one, always have been...

Speaking of the New Normal:

Callan CMEs

The 2010 Callan Capital Market Expectations are out – and they are lower! But not for “New Normal” reasons; it is simply the case that interest rates and inflation are about as low as they’ve been in our memory, and the overall environment for returns on assets at varying levels of risk is such that *nominal* returns are expected to be modest, as opposed to *real* or *inflation-adjusted* returns, which appear normal because inflation is so low, while risk is actually somewhat elevated. You can expect roughly 0.8% lower long-term annualized returns on a 60/40 portfolio than you expected last year, with the “worst case” downside a bit worse. But a lot better than the New Normal forecast by the pessimists. Why?

Well, we believe the history of markets and economies is one of surprises. It is never easy to guess at future results. Think about how many things can change (the things you know about that can change). Now think about the X factors, the things you do not know and can’t even guess at. They are coming, they always come. Back to the 70’s:

1. One could have guessed that Reagan would be elected, tax cuts would be passed, and the economy would respond positively. That was one of the outcomes everyone had to consider.
2. Who knew microprocessors and personal computers would change the world? And who knew a quick and dirty operating system (DOS) that couldn’t be sold for peanuts would come to dominate the world? And that we were on the cusp of a new age of increased productivity and creativity?
3. Who knew the world-conquering Japanese economy had the seeds of disaster sown inside of it?
4. Etc, etc – do you really think you know what is coming next?

We will be meeting with you to review your portfolios, your asset allocations and the revised expectations for outcomes, and hope to do some Visual Interactive Planning with the new numbers to assess your personal “New Normal.” We are managing in a highly uncertain environment, as always, as we try to control greed and fear and steer a middle course to long-term success.

Look forward to seeing you soon. And please call anytime.

Sincerely,

Handwritten signature of Roger C. Hewins III in black ink.

Roger C. Hewins III
President

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Please contact your consultant if there are any changes in your personal/financial situation or investment objectives.