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ECONOMIC AND MARKET OUTLOOK **July-September 2009**

“Welfare's purpose should be to eliminate, as far as possible, the need for its own existence.”

Ronald Reagan

The U.S. Economy

In the late 1990s, and the years leading up to the subprime mortgage crisis, high consumption and low savings rates in the U.S. contributed to significant amounts of foreign money flowing in from fast-growing economies in Asia and other oil-producing countries. This inflow of funds, combined with low U.S. interest rates from 2002-2004, resulted in easy credit conditions, which fueled both housing and credit bubbles, triggering a dramatic rise in mortgage delinquencies and foreclosures in the U.S.

The extent of the subprime mortgage crisis became apparent by mid-2007, and exposed pervasive weakness in financial industry regulation and the global financial system in general. Between June of 2007 and November of 2008, Americans lost more than a quarter of their net worth. By early November of 2008, the S&P 500 Index was down 45% from its 2007 high; housing prices had dropped 20% from their 2006 peak, with another 10% decline still in the cards; total home equity in the United States, which was valued at \$13 trillion at its peak in 2006, had dropped to \$8.8 trillion by mid-2008, and was still falling in late 2008.

Until the collapse of Lehman Brothers and American International Group in September of 2008, it was unthinkable to most people, including conventional economists and the growing roster of financial pundits, that an event as devastating as the Great Depression could occur in the U.S. The panic following Lehman's demise essentially shut down the credit markets, as investors fled assets carrying any amount of risk, even historically safe money-market funds, for the guaranteed safety and liquidity of Treasury bonds and cash.

By November of 2008, America was mired in a financial crisis like nothing we've seen in two generations. Now, two-years after the crisis began, there is a lingering sense of fear and anxiety among investors, especially retirees. Many are waiting for the proverbial “other shoe to drop” as the memories of the crisis, and the devastating economic effects from it, are still apparent. On top of that, the new administration in Washington is pushing massive, frame-breaking change that involves the spending and printing of trillions of dollars on new programs.

Bad Timing

New government programs always result in bureaucracy and spending, never higher quality products or services, or lower costs. As an example, whether you agree with nationalized health-care or not, the real concern is that nationalized health-care is moving forward before we come to grips with the wastefulness at the root of the system. Why are malpractice costs so high? Why are insurance deductibles so low? Should we be insuring against paper cuts and the common cold?

We're seeing the same kind of rush with reforms in the financial and auto industries too. The government is moving to oversee and regulate a wide swath of territory in order to "save the system." But is this "this is an emergency" approach just a way to silence debate over long-term consequences?

The government's snub at bankruptcy law and the rights of stock and bond owners in the GM and Chrysler bailouts could set back capital investment for years, not only in the automobile industry, but in ancillary industries as well. Cap and trade is another harmful business tax U.S. industries will be forced to pay, while their increasingly fierce global competitors will have no such burden. In this rush-and-hush environment, private enterprise is being squeezed and businesses are scared.

And the scariest part of the lack of debate is that there's no real plan to pay for all the change ahead. Instead, the President is doing what leaders do when they want to overspend on programs: He's inflating, if not outright creating, revenue projections.

In nationally televised infomercials, President Obama is projecting that individual income tax revenue will jump by 32% and corporate income taxes by 30% in 2011, from current levels, even while the unemployment rate continues to climb to a 26-year high of 9.5% (it's a good bet the rate will reach 10%-plus by year-end).

The continuing rise in unemployment is an indication that the situation is perhaps more dire than the statistics suggest. Consider that the average number of hours worked per week has dropped to 33, the lowest in 40 years. If the working week had been maintained the official unemployment rate would probably exceed 12%, meaning that underemployment is keeping the official unemployment figures down.

That things are still deteriorating was rammed home by the fact that not only were 467,000 jobs lost in June, but business investment plummeted by 37.3% in the first quarter. When asked his opinion on the job losses, president Obama said; "If we're weatherizing every building and home in America, if we are creating windmills and solar panels and bio-fuel facilities, that is a huge promising area not only for jobs here in the United States, but also for export growth."

And how can the largest tax increase in history lead to his projected 4.7% GDP growth in 2011 and 6.0% GDP growth in 2012? How will the Cap and Trade tax and the additional \$1 or \$2 trillion for the government takeover of the healthcare system lead to a boom in our economy?

It doesn't matter which side of the policy debate you are on. It's the timing of the policies, and it's simple math. The Fed and the Treasury can't just continue to print more money until it becomes worthless. The Weimar Republic of 1930's Germany tried it, and in the end "money" was used as fuel for heating and cooking in the fireplace and stove.

In 1929 personal and corporate debt had risen to 365% of Gross Domestic Product (GDP) before the Crash. We are now at 375% of GDP. Like the Roaring Twenties, excessive credit and consumption got us into this mess in the first place. And the government's short-term solution to print trillions of dollars, give it to the banks, and say "lend away" makes no long-term economic sense, especially in the face of higher taxes and unemployment.

Our globalized world is more competitive than ever, and debt-laden companies and consumers are deleveraging, which means lower spending *no matter how you slice it*. The results can only be slower GDP growth and a deficit Americans can't afford, even with the tax hikes ahead, which will further hamper GDP growth and thus revenue. In business, budgets with revenue projections built on hope rarely bring happy endings.

Is it that bad?

Do we believe that consumers and producers in the aggregate will collectively go into a long-term cocoon and refuse to do any significant spending for production or personal consumption? That the aggregate economic activity of the average American household will mainly center on paying down debt and shoring up savings? Do we further believe that in a commerce- and consumption-driven nation like ours that the impulse toward creativity, ingenuity and innovation could be so quickly replaced by the paralyzing fear caused by the credit crisis? That the American instinct towards economic expansion, which has been ingrained for over a century, could be halted in its tracks by a two-year financial reversal?

Not entirely, but throw in literally trillions of dollars in spending designed to transfer wealth, and this recession is going to be deeper, and more prolonged than originally hoped. Although stocks rallied strongly from March to early May, major indexes have been stuck in a narrow trading range for the past two months. It's going to be hard for the stock market to make another nice upside move without some pretty clear evidence of economic improvement. In many ways, the next six months of 2009 look as cloudy and confusing as the first six months looked to be as the year began.

The Federal Reserve

The Fed is showing no signs of either continuing their bond purchase program to try to keep yields on treasury bonds down, or withdrawing some of the "emergency" stimulus in the form of higher interest rates, as economic data has started to show slight improvement. No doubt inflation will become a concern in the future, for now though, with weak spending, high unemployment, excess global capacity and low wage pressures, it seems that monetary tightening (higher rates) is not yet necessary to fight probable inflation down the road.

It's a tricky balancing act for the Fed though; trying to support the tentative housing stabilization we *may* be seeing, while trying to appease inflation fears. If anything could sabotage an economic recovery, apart from increased corporate and individual tax rates, it would be another collapse in housing. Additional declines in home demand would put further pressure on home prices, leading to more bank write-downs, and more erosion of bank resources. Clearly, that's not something the Fed would like to see, which is why the recent rise in long-term interest rates has raised concerns.

Long-term rates are rising partly because improving prospects for economic recovery are focusing attention on when the Fed will begin to tighten monetary policy. Investors are getting uneasy about the potential inflation consequences of Fed programs that already have pumped more than \$1 trillion into the economy. Cranking out even more funds could intensify those concerns and end up lifting rates.

Should rates continue to move higher, the Fed may be forced to move more aggressively to lower rates again. Yet any effort to push long rates lower by continuing their purchases of Treasury securities could backfire, as inflation expectations get out of hand.

It's a catch-22 for the increasingly-more-political Fed that for now, is trying to finesse the economy with words of appeasement. The fear of future inflation and the timing of Fed tightening are key issues for investors right now. Eventually, the Fed must convince us that inflation and interest rates will stay low enough to support a lasting recovery. Until then, investors will remain jumpy.

Bonds

Bond markets seem to be entering a consolidation period, as the steady rise in Treasury yields we've seen since the beginning of this year has settled down. Investors have continued to move out of "safer" investments, like Treasuries, but the flow has slowed somewhat as markets stabilize..

Much of the movement, we believe, represents a reversion back toward more "normal" market conditions. The Fed, though, will be struggling with a bunch of issues that impact bonds, including short-term rates, Treasury purchases, and inflation. For now, the Fed indicated that it will keep things "status quo" which, as Ronald Reagan once said; "*Status quo, you know, is Latin for "the mess we're in."*

We have taken advantage of this market-healing process by continuing to rebalance bond portfolios, taking the opportunity to *methodically* seek higher returns outside of treasury bonds or money markets.

We think investment-grade corporate bonds are still attractive, especially compared to Treasuries, despite the tightening of spreads as credit markets improve. But diversification is essential. So, we continue to add to a diverse basket of corporate bond issuers across sectors, via the American Century Diversified Bond Fund.

We are more cautious about heavy exposure to short-term municipal bonds, sold by state and local governments for cash-flow borrowing needs. Yields may be higher for some short-term debt issues ("notes"), but extra yield comes with additional risk as well.

The relative value of Treasury Inflation Protected Securities (TIPS) compared to Treasuries has narrowed since the peak of deflation worries at the end of 2008. Still, TIPS offer protection against inflation if it's higher than markets expect. Right now, TIPS are priced for just over a 2% annual inflation rate during the next several years. If it's higher, which we believe is a good bet, investors holding TIPS should do better than those holding regular Treasury bonds.

Year-to-Date U.S. Market Index Results
As of 6/30/09

<u>INDEX</u>	<u>Y-T-D Return</u>
S&P 500 Index	1.78%
Dow Jones Industrial Average	-3.75%
NYSE Composite	2.58%
NASDAQ Composite	16.36%
Russell 2000 Index	1.79%
Barclay's U.S. Aggregate Bond Index	1.90%

WFA Notes

Thanks to our clients and staff, Nicholas Enea and Timothy M. Piasecki were recently recognized as Five Star Wealth Managers in the July issue of *Milwaukee Magazine*. In an independent research survey, *Milwaukee Magazine* searched out wealth managers that successfully satisfied key client satisfaction criteria, based on customer service, integrity, knowledge/expertise, communication, value for fee charged, meeting of financial objectives, quality of recommendations, and overall satisfaction.

Additional Notes

Double Whammy For U.S. Businesses and Consumers

By: Peter Schiff - Author of "*Crash Proof: How to Profit from the Coming Economic Collapse.*"

Misguided government policies have already dealt vicious body blows to our economy, but that hasn't stopped politicians this week from launching two new kicks to the groin: a national health insurance plan and a carbon emissions regulation system called "cap and trade." Even if these plans could achieve their desired ends, which is highly unlikely, I would have hoped Washington would refrain from throwing more monkey wrenches into the economy until it shows some signs of resurgence. The last thing we need right now is to further encumber our economy with higher taxes and additional regulations.

The meteoric rise in health care costs, which has become an unending nightmare for U.S. businesses and consumers, is not an accident. This painful condition has arisen from excess government involvement in the system, tax provisions that encourage the over-utilization of health insurance, and government support of an out-of-control malpractice industry. Rather than allowing more bad policy to drive health care costs further upward, we should be looking at ways to allow market forces to rein them back in.

If left alone, the free market drives quality up and costs down. Government programs produce the opposite result. Despite the president's claim that a federal plan will bring costs down, there is no historical precedent for such faith.

Simply providing more widespread health insurance, as the Obama plan offers, is not a solution. In fact, it will aggravate the problem. Since consumers no longer pay for routine medical expenses out of pocket, comprehensive health insurance creates a moral hazard for both patients and doctors. To maximize the value of the health insurance “benefit,” most workers opt for low deductibles and co-pays. Therefore, doctors learn that their patients are not concerned with the cost of care, and so they are free to bill insurance companies at the maximum allowable rates.

Given our current tax code, the simplest way to bring down medical costs would be to fully tax health care benefits as wages and simultaneously increase the personal deduction by an amount significant enough to neutralize the effect of the tax increase. This would do two things. First, the uninsured would get a huge pay increase, enabling them to buy reasonably priced catastrophic policies. Second, those currently insured could opt out of expensive employer-provided plans, trading premiums for extra wages, then buy a more economical plan. The savings would go right into their pockets.

The bottom line is that aggregate medical costs will never come down unless services are rationed more wisely. Rather than being used as a pre-payment plan for routine care, insurance should only cover unpredictable, catastrophic costs.

As a comparison, homeowners often carry fire insurance, but seldom maintenance insurance. You buy fire insurance to guard against a catastrophic loss, which is a low probability but high cost event. As a result, fire insurance is relatively affordable, since premiums paid by all those homeowners whose houses do not burn down more than pay for the losses on those few whose houses do.

On the other hand, no one carries home maintenance insurance to pay for a clogged drain or broken garage door. If insurance paid for the plumber visit every time a toilet overflowed, we would now have a plumbing crisis, and Congress would be looking to reign in runaway plumbing bills with “national plumbing insurance.”

In his press conference, President Obama claimed that government insurance would not drive private providers out of business. This is absurd. As the government provider will not have to produce a profit or accurately account for its contingent liabilities, it will provide insurance on an actuarially unsound basis. With taxpayer subsidies, the government provider can run losses indefinitely. If private insurers did this, they would either be shut down or go bankrupt. Therefore, the cost of government provided health insurance will not be confined to the premiums paid, but will include the taxpayers' bill to continually bail out the government provider.

When Medicare was first proposed back in 1966, it cost \$3 billion per year, and the projection was for inflation-adjusted annual costs to rise to \$12 billion by 1990. The actual cost in 1990 was \$107 billion, and the 2009 estimate is a staggering \$408 billion! So much for government estimates on health care.

As if this were not bad enough, today the House votes on “cap and trade” legislation. Disguised as an environmental bill, this proposal would merely be another gigantic tax. The lion's share of the new revenue is already committed to politically connected special interests that will reap windfalls at everyone else's expense. To make matters worse, the bill before Congress amounts to a blank slate, with the EPA empowered to draft the details in any manner they see fit. If Congress is going to shoot the economy in the knee, they should at least be required to pull the trigger themselves.

“Cap and trade” will do nothing to reduce pollution, yet it will drive up production costs throughout the economy – rendering us even less globally competitive than we are today. In addition to the huge cost of paying the tax, its enforcement involves the creation of an entire new bureaucracy, the costs of which will be borne by American consumers in the form of higher prices.

Years of reckless borrowing and spending have left us in a gigantic hole. Getting out of it requires that we make the most effective use of all available resources. We need labor and capital to operate as efficiently as possible so we can save and produce our way back to prosperity. Unfortunately, national health insurance and “cap and trade” are two steps in the wrong direction. Rather than getting us out of this hole, they will merely cave in the walls around us.