

# PLANMARK<sup>SM</sup>

Weekly Commentary  
July 25, 2011

## The Markets

How did our federal budget deficit become so large that we find ourselves in this political quagmire over raising the debt ceiling?

In testimony before Congress last month, Congressional Budget Office Director Douglas Elmendorf laid out a few key points that we should all keep in mind:

- In recent years, the federal government has been recording budget deficits that are the largest as a share of the economy since 1945.
- At the end of 2008, federal debt equaled 40 percent of the nation's annual economic output (a little above the 40-year average of 37 percent).
- By the end of this year, CBO projects the federal debt will reach roughly 70 percent of gross domestic product (GDP) -- the highest percentage since shortly after World War II.
- Looking forward, the CBO projects the federal debt will exceed its historical peak of 109 percent of GDP by 2023 and would approach 190 percent in 2035, based on its most realistic estimate.
- The sharp rise in debt stems partly from lower tax revenues and higher federal spending related to the recent severe recession. However, the growing debt also reflects an imbalance between spending and revenues that predated the recession.

Elmendorf went on to say, "The budget outlook, for both the coming decade and beyond, is daunting."

Other factors that play into our growing budget deficit include the increase in entitlement benefits related to the retirement of the baby-boom generation and a likely increase in per capita spending for health care as our population ages.

Without boring you with more numbers, any way you slice it, our country has to get a handle on its budget. We can do that by cutting spending, raising revenue (that's code for raising taxes), or a combination of both.

Democrats and Republicans are arguing over the right split between cutting spending and raising revenue. The bottom line is, they better get something done very soon or we will all pay a very heavy price for their failure!

Data as of 7/22/11	1-Week	Y-T-D	1-Year	3-Year	5-Year	10-Year
Standard & Poor's 500 (Domestic Stocks)	2.2%	7.0%	22.0%	1.7%	1.3%	1.2%
DJ Global ex US (Foreign Stocks)	2.8	2.8	20.2	-0.8	2.2	6.2
10-year Treasury Note (Yield Only)	3.0	N/A	2.9	4.1	5.0	5.1

DJ-UBS Commodity Index	0.4	1.8	26.8	-7.7	-0.9	5.0
DJ Equity All REIT TR Index	2.9	15.3	31.3	5.3	3.2	11.4

Notes: S&P 500, DJ Global ex US, DJ-UBS Commodity Index returns exclude reinvested dividends (gold does not pay a dividend) and the three-, five-, and 10-year returns are annualized; the DJ Equity All REIT TR Index does include reinvested dividends and the three-, five-, and 10-year returns are annualized; and the 10-year Treasury Note is simply the yield at the close of the day on each of the historical time periods.

Sources: Yahoo! Finance, Barron's, djindexes.com, London Bullion Market Association.

Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly. N/A means not applicable or not available.

## SPECIAL REPORT ON CHINA

Before China, there was Japan.

From the 1960s to the 1980s, Japan was on a roll. They had one of the highest economic growth rates in the world, according to PBS. Their manufacturing prowess grew to be the envy of the world. Their stock market soared 373 percent between 1980 and its peak in 1989, according to *Knowledge@Emory*. And, like China today, there were predictions that Japan would overtake the United States as the largest economy in the world.

Oh, but times change.

Japan's economic miracle came crashing down in the 1990s along with its stock market. By the end of 2010, the Japanese stock market, as measured by the Nikkei 225 index, was down an astounding 73 percent from its 21-year old 1989 high, according to data from *Yahoo! Finance*.

As happened in Japan, extrapolating past performance could be hazardous to your wealth. Will China suffer a similar fate? If it does, what will that do to the financial markets?

### MANAGING THE ECONOMY

China has deftly managed its economy over the past three decades to produce spectacular growth and improved living standards for its people. In fact, economic growth has contributed to more than 500 million Chinese people rising out of poverty since 1981, according to *The World Bank*. But, growth has its price.

Strong economic growth can lead to problems such as inflation, social and economic inequality, and a growing pile of foreign exchange reserves.

#### Inflation

Inflation is a major threat to China's future success because if it gets out of control, the population may revolt. In June, inflation rose by 6.4 percent from a year earlier, the highest rate in three years. Worse yet, food prices rose 14.4 percent while pork prices, a Chinese staple, rose 57 percent in June from a year earlier, according to *The New York Times*.

Rising food prices is particularly difficult for China to stomach (pardon the pun) because the average Chinese household spends about a third of its disposable income on basic food, according to the *Financial Times*.

If you want to know why inflation is a threat, go back to 1989. The *Financial Times* said, “Inflation of nearly 20 percent is considered a key contributing factor to the 1989 student protests that culminated in the bloody military crackdown in and around Beijing’s Tiananmen Square.”

## Social and Economic Inequality

While China’s economy has grown more than 90-fold in the past 30 years, the gains have left a widening gap between the “Haves” and “Have-Nots.” Chinese Premier Wen Jiabao said back in February that rising inequality is threatening social stability, according to a *Bloomberg* article.

Can you imagine what would happen if even a small percentage of China’s 1.3 billion people turned against the government?

Well, unrest has been on the rise in recent years. As *Bloomberg* reported in citing data from Sun Liping, a professor of sociology at Beijing’s Tsinghua University, “‘Mass incidents,’ everything from strikes to riots and demonstrations, doubled from 2006, rising to at least 180,000 cases in 2010.”

So, how do you keep 1.3 billion people “in check?” According to Nicholas Bequelin, a China researcher for Human Rights Watch in Hong Kong, China’s been doing it “through a combination of economic growth, social reforms, and political repression.” Time will tell how long that lasts.

## Foreign Exchange Reserves

At \$3.2 trillion, China has -- by far -- the largest foreign exchange reserves in the world, according to *The Wall Street Journal*.

These trillions were built over the years through China’s trade surplus, foreign direct investment, and capital inflows betting on yuan appreciation (The yuan is China’s currency.) On the surface, large foreign exchange reserves sound like a good thing, and in some ways it is. The downside is that it exacerbates inflationary pressure, according to *Bloomberg*.

In an ironic twist, the U.S. has been a beneficiary of this massive reserves buildup. China had to park their cash somewhere, so, where did they turn? To the U.S. treasury market! At the end of May, China was the largest foreign holder of U.S. Treasuries with more than \$1.1 trillion filling their balance sheet, according to *Bloomberg*.

Viewed another way, China has been a big reason why the U.S. has been able to run up trillion dollar budget deficits while keeping interest rates low -- we have China as a willing buyer of our paper.

With China needing a large liquid market to park its reserves and the U.S. needing a big buyer of its paper, these countries have the ultimate “too big to fail” global relationship, said Andy Rothman, an analyst in Shanghai for the investment bank CLSA as quoted in *The New York Times*.

## Conclusion

China is so large and growing so fast, that it will impact the world in major ways for the foreseeable future. Its success or failure, its twists and turns will reverberate throughout the financial markets and affect everything from the level of interest rates to the price of soybeans to the volatility of the S&P 500 index.

Will it stumble at some point? Probably. Yet, no matter what happens, we will continue doing our research. We will continue monitoring your investments. We will continue doing what is in your best interests.

We truly live in a globally interconnected world that is getting smaller and smaller by the day. One thing that does not get smaller is our commitment to you.

## Weekly Focus – Think About It

"When it is obvious that the goals cannot be reached, don't adjust the goals, adjust the action steps." --Confucius, *Chinese Philosopher*

Best regards,



**Fredrick J. Livingston, CFP, AIF**



**Mark H. Winston**

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P.S. Please forward this to your friends or colleagues that you'd like to introduce to our firm and send us their email address. We'll ask for their permission and then we'd be happy to add them to this weekly email.

\* These views are those of **PEAK**, and not the presenting Representative or the Representative's Broker/Dealer, and should not be construed as investment advice.

\* The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.

\* The DJ Global ex US is an unmanaged group of non-U.S. securities designed to reflect the performance of the global equity securities that have readily available prices.

\* The 10-year Treasury Note represents debt owed by the United States Treasury to the public. Since the U.S. Government is seen as a risk-free borrower, investors use the 10-year Treasury Note as a benchmark for the long-term bond market.

\* Gold represents the London afternoon gold price fix as reported by the London Bullion Market Association.

\* The DJ Commodity Index is designed to be a highly liquid and diversified benchmark for the commodity futures market. The Index is composed of futures contracts on 19 physical commodities and was launched on July 14, 1998.

\* The DJ Equity All REIT TR Index measures the total return performance of the equity subcategory of the Real Estate Investment Trust (REIT) industry as calculated by Dow Jones.

\* Yahoo! Finance is the source for any reference to the performance of an index between two specific periods.

\* Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.

\* Past performance does not guarantee future results.

\* You cannot invest directly in an index.

\* Consult your financial professional before making any investment decision.