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PIIGS Get Slaughtered

A sad paradox of lending and borrowing is that the borrowers who need money the most are the ones who must pay the highest rate of interest. Those who need it the least can borrow at extremely low rates of interest. High interest rates make it difficult to repay one's debts, frequently causing one to borrow more....and the endless, relentless cycle of excessive debt and high interest rates perpetuates itself, sometimes indefinitely. Many American consumers have found themselves in the lifelong trap of high credit card balances that they will never be able to repay because of 18% – 24% interest rates.

Countries can be a lot like people sometimes. When countries have plenty of money, they can borrow at low rates of interest... or should I say, when countries are perceived to have plenty of money, they can borrow at low rates of interest. Although the U.S. has a large debt, we are still perceived as having the ability to repay. If lenders (other countries) begin to perceive that we might NOT be able to repay our debt, the price of borrowing (interest rates) will increase.

I have written about the **PIIGS** before. I did not invent this acronym which stands for Portugal, Italy, Ireland, Greece and Spain. Those five letters were arranged in that fashion because it is the least attractive order in which to arrange them. These are countries that have gone from being "good borrowers" (those perceived as being able to repay) to being "bad borrowers" (the opposite).

Earlier this year, Greece was slapped with economic reality when the populace was informed that retirement at age 60 may not be a realistic expectation. The rioting that ensued illustrated just how distant they were from economic reality before being slapped with it.

The graph below shows what it can take for a country to realize that the rest of the world (the lenders) will not continue to subsidize the country's desire to retire at a young age.



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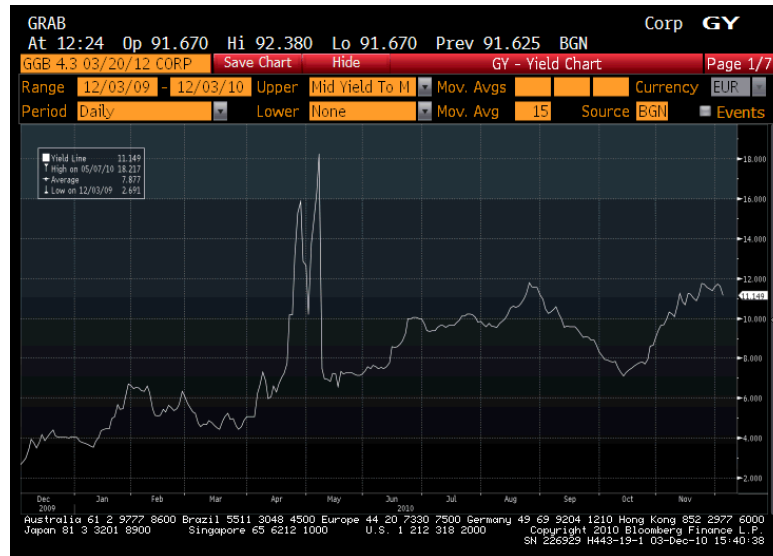
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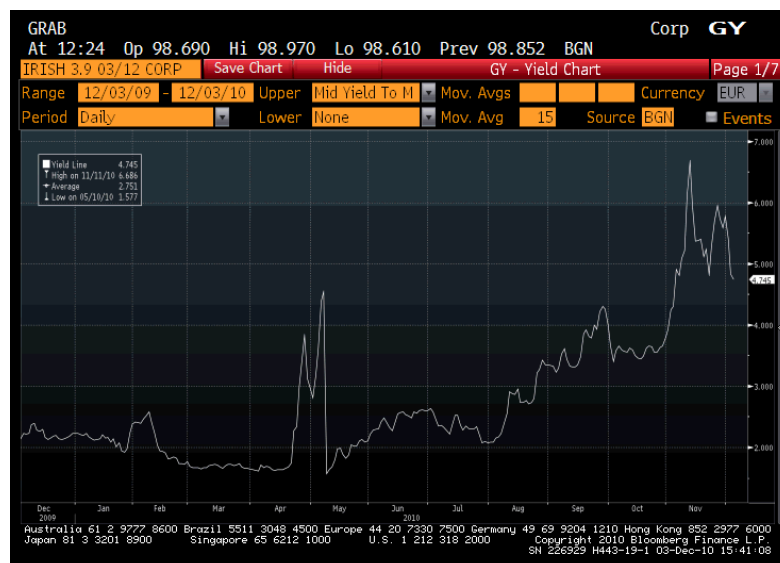
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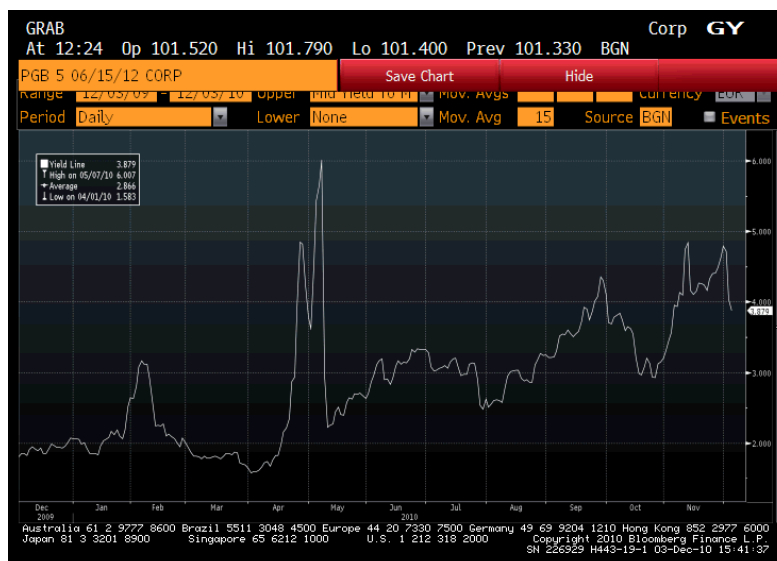
The graph shows the interest rate on the Greek government 2-year bond for the past 12 months. You can see that in December, Greece could borrow money at just above 2% interest. A few months later, as lenders began to doubt Greece's commitment to austerity, the interest rate on Greek bonds soared to over 18% (just like credit card interest!). A bailout of €110 billion (\$146 billion) by Euro-region governments brought interest rates back down to almost 6%. But confidence in Greece's financial stability was short-lived and their cost of borrowing has climbed up to almost 12% as of today.

The economic problems of Ireland and Portugal are not far behind.



The graph above shows the interest rate on the Irish 2-year government bond for the past year. Both exhibited a sharp spike in interest rates during the Greek crisis. After returning to below 2% post-crisis, the interest rate on the Irish 2-year bond quadrupled through the end of November. Ireland made the well-intentioned mistake of guaranteeing ALL bank deposits during the financial crisis two years ago....not just deposits up to €100,000 or €250,000 (like the U.S. did with dollar denominated deposits) but ALL deposits. Not long after that decision, they realized that perhaps they bit off more than they could chew. Portugal's 2-year bond graph is strikingly similar.





Contrast the bonds of these countries with U.S. 2-year Treasury Bonds which have an interest rate less than ½ of 1%. That's right. The U.S. can borrow for almost NOTHING. Apparently the rest of the world is not nearly as concerned about U.S. debt and governmental spending as we seem to be. However, as you can see in the three graphs above, if the world DOES wake up someday and thinks "ya know, maybe the United States is spending a little too much", we might find ourselves applying for a new global credit card that will be happy to lend us money... for 10%... or 14%... or 18%.

Maybe our inability to deal with entitlements (Social Security and Medicare) will become an obstacle to paying our debts. Maybe Congress will continue to have difficulty making those tough choices about where NOT to spend because it is more important to get re-elected. Maybe we end up with so much debt that our annual revenues (taxes) can only pay the interest on our debt without reducing the amount owed.

Maybe the world starts looking at us someday the way they have been looking at the PIIGS this year. As these graphs show, if that happens, the cost of borrowing can increase rather quickly.

It is unlikely we will face a spike in interest rates that the PIIGS faced earlier this year. Why? Because we ALWAYS have the money to pay our debts. We simply print more dollars and pay our debts. The PIIGS cannot print more Euros because they don't have access to the printing press. Printing more dollars to pay our debts, however, will undoubtedly have a negative effect on the value of the dollar.

The good news is that America can smell this one coming. They threw out Congressman during the mid-term elections who they perceived to be spending culprits. The Tea-Party movement had a more significant impact on this election than most would have predicted six months ago. America said, "we're tired of you guys spending too much. We're going to put people in office who promise NOT to spend as much," Whether reduced spending actually comes to pass remains to be seen.

The Bush Administration and the Obama Administration have overseen one of the biggest increases in government debt we have ever seen. The Republicans now have a chance to actually prove they are in favor of smaller government and reduced spending.



The stock market continues to be range bound. After an eighteen year secular bull market from 1982 to 2000, global stock markets have been trading sideways. Since the end of 1999, the Dow Jones Industrial Average is up approximately 2% per year and the S&P 500 is actually still in negative territory. For the calendar year 2010, the DJIA is up 9.13% and the S&P is up 8.64%.

There are a few positive economic signs. Consumer spending is up. Manufacturing is expanding. Inflation remains low. General Motors had a very successful Initial Public Offering... so successful the underwriters increased the size of the offering.

Consumer spending, however, may struggle when 1.36 million unemployed lose their jobless benefits this month. A bill to extend the benefits for another three months was defeated in the House. Unless a bill is passed to extend these benefits, even more unemployed workers will lose this safety net.

Unemployment remains high at 9.6% and housing is showing scant signs of improvement. There were 332,172 new foreclosure filings in October, the 20th consecutive month in excess of 300,000.

At Boyer & Corporon Wealth Management, we continue to see many economic headwinds. Financial tremors from Ireland and Portugal as well as Italy and Spain would be felt globally. Consumer spending will suffer if jobless benefits are cut off. And the housing market continues to point toward decreasing home values.

We expect to reduce our equity exposure during significant market rallies and increase our equity exposure after significant sell-offs. In addition, we see keeping relatively short-term security durations as a critical portfolio strategy.

