www.firestonecapital.com

QtrNotes

Qtr 4 October 2011

FIRESTONE CAPITAL MANAGEMENT

Volume 19 No. 4

In this Issue

Finance 101: Help Us Help Your Kids

More often than not, young adults venture into the working world with very little experience in or knowledge of finance. Whether it's defining a stock versus a bond, or learning the best way to manage 401k choices at a new job, a basic introduction can go a long way.

Over the past few months, we've had the pleasure of meeting with several of our clients' adult children to get them started on some of the elements of financial planning and wealth management. We welcome the opportunity to do the same with your children, or any of your relatives and friends who you think might find it helpful. We can start from the very top or dive deep into the details. Give us a call and we'll gladly set something up.

The Economy: Reducing Debt at Home, Headwinds Overseas

Economic growth continues at a muted pace, as concerns over a renewed recession mount. Whether or not we technically return to recession, most American consumers believe we are already there. Businesses aren't hiring, consumer spending is tepid, and construction is stagnant. In previous recessions, the economy contracts after an unsustainable "sugar high." This time, instead of feasting on candy, we've had four years of cardboard diet food. With several leading economic indicators forecasting renewed contraction, we are cautious.

Consumers are pessimistic and fearful, with faith in our political leadership at all-time lows. The latest polls found only 11% of Americans approve of Congress. Standard & Poors voiced its disapproval by downgrading US debt. We interpret the downgrade as a response to US political ineptitude, rather than inability to pay. Bond markets agreed and Treasuries rallied.

The root of the economic trouble lies in the process of *deleveraging*: reducing and paying off debt to improve net worth. When individuals deleverage, they improve their personal financial condition. When a nation deleverages, consumption falls and everyone is affected. Debt reduction is a drag on a nation's potential growth trajectory, but necessary to its long-term economic health.

According to financial crisis scholar Carmen Reinhart, the process of deleveraging takes seven years on average. The US is likely to follow a similar multi-year path of lower than average GDP growth as it rebuilds its balance sheets. Current household debt-to-income levels suggest consumers have paid off approximately a third of the debt they need to reduce. Having extended itself to prop up the world's financial systems, the US government is only just beginning to institute austerity measures and will likely take longer than the private sector to unwind.

Index	9/30/2011	% YTD
Dow Industrials	10,913.38	-5.7%
S&P 500 Index	1131.42	-10.0%
Nasdaq Composite	2415.40	-9.0%
Russell 2000	644.16	-17.8%
MSCI EAFE	1373.33	-17.2%
10 Year Treasury	1.93%	

Corporations are in good health and can continue to profit even during a weaker economy, although earnings expectations may have to come down from current lofty levels. Trepidation about the future as a whole has discouraged firms from reinvesting heavily in new hiring or capital investment. Instead, they continue to keep record levels of cash on their balance sheets as insurance against unstable markets.

The European debt saga continues. An August uptick in fear caused bonds to fall and yields on Spanish and Italian debt to rise. The European Central Bank stepped in with plans to purchase bonds in an attempt to bring rates back down. We fear that much of the policy to date has been reactive and will not resolve the underlying debt issues, but we are encouraged by the discussions currently taking place.

While the credit crisis continues to unfold, central banks, governments, and private institutions are in constant communication and have enacted measures to support the Euro Zone and its member nations. Greece can't afford to pay its debt in full and Portugal is likely in the same boat. We believe lenders will be forced to accept renegotiated terms to restructure and write down past loans.

Overall, economic conditions in Europe are much more difficult than in the US. Prospects for economic growth are weaker and unemployment in several nations, including Greece and Spain, is close to 20%. Europeans

(continued next page)

1500 San Remo Ave., Suite 176
Coral Gables, Florida 33146
305.669.2119
www.firestonecapital.com

jack@firestonecapital.com
carolk@firestonecapital.com
carlos@firestonecapital.com

FIRESTONE CAPITAL MANAGEMENT

Operation Twist:

The Federal Reserve is selling short-term US bonds and buying longer-term treasuries, causing bond prices to increase. As bond prices rise, yields fall.

'Operation Twist' is designed to drive down long-term interest rates to benefit borrowers. We suspect the true goal is to increase asset prices for all investments whose value is tied to interest rates, including stocks.

Volatility:

Since August, the S&P 500 has changed by 1% or more approximately 2 out of every 3 days.

In September, the S&P 500 fell 6.6%, gold was down 10%, and silver dropped 26%.

Unemployment:

August unemployment rates were lower in 262 out of 372 metropolitan areas than they were in August 2010.

Another View:

"Of course it's a Ponzi scheme. So what? It's also the most vital, humane and fixable of all social programs. The question for the candidates is: Forget Ponzi - are you going to fix Social Security?"
- Charles Krauthammer

Social Security in the Crosshairs

With Social Security in the political crosshairs during election season, let's examine what Social Security is and isn't. Social Security was designed during the 1930s as a national insurance program to protect against the specific risk of being unable to work and provide for oneself or one's family.

For those who allege that Social Security is a Ponzi scheme: it is not. The program was designed as a 'pay-as-you-go' system, with current taxes (premiums) used to fund benefits for retirees. Benefits are funded first from premiums and second from the interest earned on the program's assets. Only after these first two sources are exhausted does the program draw on principal.

Since inception, premiums paid in have been much larger than total benefits paid out, allowing Social Security to accumulate substantial reserves. These reserves are held in the Social Security Trust Fund and currently total $2.6 trillion. A tipping point was reached last year: with life expectancy increasing and unemployment high (reducing the amount of payroll taxes collected), more benefits are being paid out than taxes collected. As this trend continues, benefits will soon be paid in part by drawing on the Fund's reserves. Today, without making any changes to the system, Social Security is funded to meet 100% of its obligations for 25 years. Beyond the year 2036, Social Security could sustain paying 77% of all future obligations.

The challenge is to close that 23% gap. The process has been a work in progress for decades: Congress has modified the program more than sixty times since 1937. Major changes have included increasing tax rates and the amount of wages subject to taxation, as well as raising retirement ages to account for changing demographics.

The most politically sensitive fix is to raise taxes on all wage earners, or at minimum on high-income earners by increasing the wage limit (currently $106,900) against which payroll taxes are assessed. Other options include raising the early retirement date from 62 to 65, reducing the annual Cost of Living Adjustments, or reducing benefits for top wage earners. A judicious combination of these measures is capable of addressing the current shortfall. Washington will figure it out, but we don't expect any legislation to pass until after the election.

Beyond addressing funding concerns, we should examine questions about the legitimacy of the Social Security Trust Fund. All assets held in reserves are also liabilities of the US government. These are real govern-ment obligations, just like any US Treasury bond, backed by the full faith and credit of the United States.

The bottom line is that the Social Security program is not going to vanish. As financial planners, we must take into account the uncertainty surrounding the details of future benefits. Planning as though our clients won't get any Social Security benefits at all would be unrealistic, forcing them to save more, invest more aggressively, and even live at a lower standard of living than necessary. We can and will plan for the possibility of higher taxes, later onset of benefits, lower benefits, and lower cost-of-living adjustments. Social Security will go through changes, as it has before, and part of our job will be to prepare for those changes, so our clients are not taken by surprise.

European Headwinds

(continued from page 1)

are undertaking much stronger austerity measures (tax increases and spending cuts) than we have agreed to here in the US. These measures will help sow the seeds for long-term financial stability, but will impede growth in the short term.

Europeans have the tools to support their financial institutions and allow debt forgiveness. Once coordinated action is taken, we expect valuations to improve quickly. Until that time, markets may remain volatile. European financial markets are down 17% year-to-date and are priced for recession. We see considerable value at these levels.

In this environment we continue to seek out investments that can weather a fresh economic downturn.