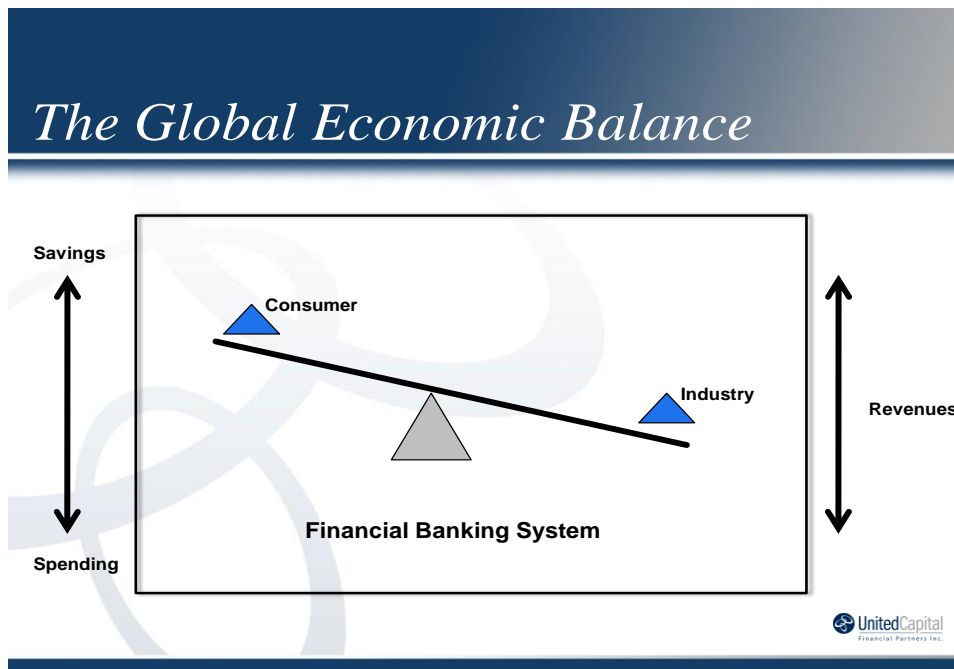


## Bailout Nation

With the nation having spent half of the approved \$700 billion bailout, the line of applicants constantly expanding and the Federal Reserve taking the unprecedented step of driving interest rates down to 0%, it seems appropriate to ask: How we are doing on the project of stabilizing our economy and what we should expect as a consequence?

For several months we have been writing about the implications of the global delevering (overall reduction in debt level) and what it means for our economy. As has been reported extensively, Corporate America and the U.S. consumer are finding debt harder to obtain and, when available, it is increasingly expensive. Our research team created the chart below to help illustrate the challenges we are facing, how we should think about what we are doing as a country and how it might affect us as U.S. taxpayers and investors.



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We can see how consumer spending, the banking system and U.S. corporations are interlinked. Think of it like a seesaw. As consumers save more (and spend less), the less revenues accumulate for industry, and vice-versa. Removing debt is akin to increasing savings. Decreasing debt slows spending as well as our overall economy.

The banking system is the pivot that supports the flow of money throughout the

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economy. Initially, the banking and credit crisis that caused the market turmoil in the early fall created panic because the whole seesaw collapses without the support of a healthy banking system. The purpose of the approved plan to stabilize our financial system (called the Troubled Assets Relief Program or TARP) was to buy toxic and hard to value debt from the banks, so that they could continue to operate in a healthy manner. Instead of buying this debt, we have decided to invest directly in the banks. These banks have now kept the TARP money on their balance sheets to support these toxic assets instead of lending the money to consumers.

Now we are considering using the TARP funds to support industry, other finance companies, state and local governments and consumers (by having the government drive down mortgage rates for all homeowners, buying this debt directly from banks). Furthermore, the incoming administration is considering stimulating the economy by implementing an additional stimulus package that could cost over \$500 billion.

Instead of simply focusing on the fulcrum of the seesaw, Congress and the Administration is now going down the road of supporting all participants on the seesaw and that will only complicate matters, prolong resolution and take a lot more money. We are now sliding down the moral hazard slippery slope many economists have been concerned about: Where do we stop and just who is worthy of government and taxpayer support? How does it get decided?

### **What are the implications of this amended plan?**

The amount of money we are pumping into the financial system to offset the loss in debt circulating in the system is staggering. We are by many estimates going to add over a trillion dollars to our deficit this year alone! It has taken our whole history as a country to get to roughly ten trillion in debt and we are increasing that number by ten percent this year, and probably the same amount next year again.

It is not our place to make political statements about our actions; however, there will be some very clear implications for all of us over the next few years:

1. **A weaker dollar:** You cannot issue this much in new debt and not drive down the value of your currency unless every other country does the same thing. Of course a weaker dollar will reduce the amount we owe the rest of the world but invariably it will lead to higher interest rates.
2. **Higher interest rates:** Today there is still a flight to safety in our currency but in order to keep the flow of money into US treasury securities, we will have to offer higher rates on a comparative basis.
3. **Reflation and inflation:** It appears that our Federal Reserve has decided to flood the system with money, which invariably leads to asset bubbles. It happened during the cash flood prior to Y2K, which led to the Internet bubble; and again post-9/11, we saw a liquidity flood which led to the real estate bubble. We do not know today when it will occur but don't be

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surprised if we see commodities become a lot more expensive again (oil, food and everything else we use every day).

### **So What Should You Expect?**

Often during a deflation, you will see an increase in the value of many assets (including stocks) and a real cost to owning cash. In essence, in an inflating environment holding cash doesn't work well because your cash is worth less, which leads people sitting on cash to invest their money. By driving interest rates down as low as 0%, the Fed has decided to make holding cash unattractive for everyone (presuming we are not in a deflationary environment) and they hope people will start spending and investing again.

While we are clearly in the midst of recovering from a very cash focused investment environment, over time that money will be redeployed and, frankly relative to other assets the stock market looks very attractive. Don't be surprised if we see stronger stock markets, not just in the US but around the world. This does not mean that the economy will recover any time soon. We will likely see at least six more months of very weak economic data. As we have mentioned many times before, the market is anticipatory in nature and typically acts many months in advance of economic recovery.

Please know we will be working with your adviser to take advantage of the myriad of opportunities over the coming year.

### **A Final Word**

You might have read about the collapse of a \$50 billion hedge fund, that was in essence a Ponzi Scheme, built over the course of many years by well known New York financier, Bernie Madoff. Many well heeled individuals and institutions were bilked by a very sophisticated financial scheme. Rest assured that our firm has no exposure to his funds. The best way for any investor to protect themselves from a situation like this is to have their investments held in their name with complete transparency, and to assure that their investment adviser can only manage assets but never have access to them.

At our firm, we have no custody and no proprietary products, so all of your assets are accounted for by an independent custodian every single day.

We will as always provide a full quarter-end report in January, but let us take the time to wish you and your loved ones the very best for the holiday season. If there is any solace to this current turbulence we have all experienced this year, it is a better appreciation of the things that really matter in our lives and for that we can be grateful.

Thank you for your trust and confidence,

Joe Duran, CFA®

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