The Advisory Group

20955 Pathfinder Road, Suite 110
Diamond Bar CA 91765
Phone: 909.869.7880 Email: mail@tagfinancial.com
Website: www.TAGFinancial.com

Credit Hurricane Approaching!

We are concerned about the astonishing levels of debt, in many cases government debt, around the world. You have probably heard us describe this as a "huge dark cloud on the horizon of hurricane proportions." Let us share why we think you need to be cautious.

Living on Credit Cards

Let's start with an example to illustrate our point. John and Jane Consumer are normal people who have nice incomes and a reasonable life style. They get their initial credit cards, which they pay off each month and are doing fine. But living is expensive, we all know that, so when something comes up, they use their credit cards and just let the balance ride for a while. As something else comes up, they just borrow some additional money on their cards, knowing that they can make the monthly payments – it is not a problem. It is so much more fun to spend money than it is to save your money and balance your budget.

As they maintain their lifestyle, John and Jane take out additional credit cards. The credit card companies are happy to lend more money – John and Jane have nice incomes and have been maintaining their debt. Like most people, John and Jane want to buy a new home, and like most new home buyers, they purchase a home that is "just a bit more" than what they can probably afford. To buy their new home, John and Jane get an adjustable rate mortgage on which they pay interest only for the first several years. They figure it's no problem – their cash flow can handle it. By the time the mortgage adjusts, they expect that both be making more money and the home will have appreciated in value – doesn't real estate always go up?

Things seem to stay on track, but their expenses keep getting higher. To maintain the style of living that they enjoy, John and Jane continue to run up their credit cards. Their nice income mean that they can easily make the minimum credit card payments and to help things out, they get additional credit cards to make sure they have funds to spend. Maybe some of the credit cards offer zero or low interest rates on transferred balances, so they add those credit cards as well. This cycle of additional borrowing and maintaining balances goes on for an extended time and everything seems just dandy.

At some point, the credit card companies decide that they are not going to lend John and Jane any additional money. In fact, they are concerned and decide not to renew their existing credit cards. The adjustable mortgage comes to the end of its fixed period and interest rates may have risen – certainly now that they are paying both principal and interest, their payments have increased. Money gets even tighter. They are deep in debt, their home may be "underwater" and not worth what they owe on their mortgage. Heaven forbid one of them lose their job and the family income drops. Their "house of cards" collapses.

John and Jane face difficult choices. What can they cut from their budget? Can they drastically cut back on their lifestyle to begin paying down their debts? They are going to have to. This may even mean they go through bankruptcy to get some of their obligations relieved. The longer they wait, the more difficult the final unwinding becomes.

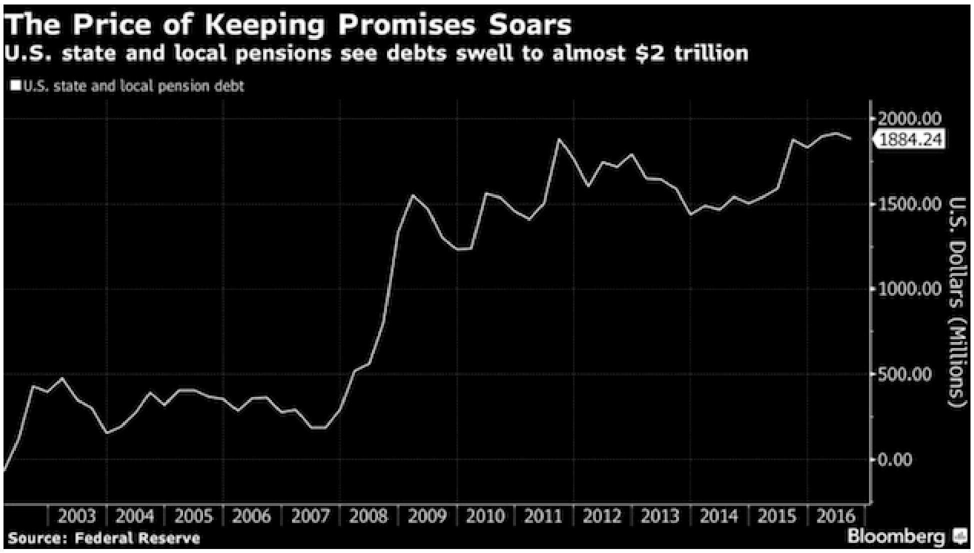
The Government "Credit Cards"

As responsible individuals, most of us know that John and Jane's scenario is not what we want to have happen to us and our families. We watch our budgets and make sure we pay our debts on time and have a plan to pay off any long-term debt. Yet governments around the world seem to be doing the same thing as John and Jane. They have been borrowing money to pay expenses and now have built up their "credit cards" to huge amounts.

And governments just keep borrowing. Interest rates are low, so it seems easy to maintain the levels of debt that they are carrying. We even have central banks (e.g. in the U.S. the Federal Reserve, known as "the Fed," or in Europe the European Central Bank or ECB) who take on huge amounts of that debt at zero interest rates. (The Federal Reserve pays back any interest it earns on government debt.)

The "interest only adjustable rate mortgage" that the governments have taken on is represented by the huge and increasing retirement benefits that the governments have promised. One example that we addressed in an earlier communication involves Social Security. In their 2016 annual report, the Board of Trustees of Social Security have let us all know that according to their projections, if nothing is done by 2034, they will need to cut benefits approximately 23%. There are also many reports that numerous local and state government retirement plans are seriously underfunded and unsustainable.

. .Further complicating the problem, these figures are based on the investment assumptions used by the government pension administrators. We find many economists believe the long-term rates of return these administrators use to calculate being able to pay pensions may be unrealistic.



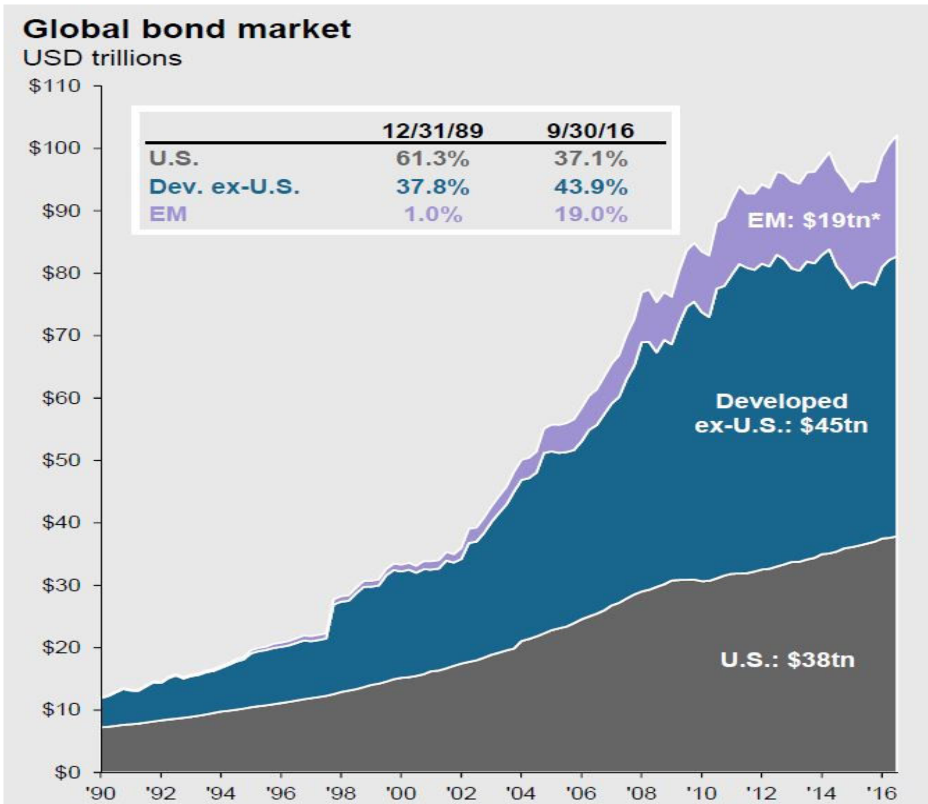
Bad as this chart seems, by some estimates, unfunded liabilities would triple to upwards of $6 trillion if the current interest rates on Treasuries were used.

Want to see an immediate example of this in action? Simply look at what is happening in Illinois. Illinois already has the dubious distinction of having the lowest credit rating of any state. They are on the verge of being rated as "junk" bonds. According to CNN, Illinois already faces $15 Billion in unpaid bills. They owe a quarter-Trillion dollars to public employees and don't have enough cash to pay lottery winners. If they can't find a solution, cuts are being made to schools, counselling, and other services. Union leaders are very concerned that the state may seek to reduce pension benefits for their public service members. And Illinois is not alone. New Jersey, and Connecticut are also under scrutiny.

Huge International Debt

U.S. Government debt is fast approaching the $20 TRILLION ($20,000,000,000,000) mark. According to www.USDebtClock.org, U.S. debt was over $19.9 Trillion when this was written, over $61,000 for every man, woman, and child in this country. The entire U.S. economy, as measured by our Gross Domestic Product (GDP) is "only" a bit under $21 Trillion, so the U.S. Government debt almost equal to the whole U.S. economy.

The U.S. is not the only country increasing its debt. In fact, the U.S. is in better shape than many of the countries around the world. Japan's debt of over $11.4 Trillion is almost 2½ times their GDP. On May 23, 2017, Moody's Investors Service downgraded China's debt rating saying the steady buildup of debt would erode China's financial strength. Other countries are jumping on the debt bandwagon. The global bond market has soared to almost 10 TIMES as much debt since 1990.



Source: J.P. Morgan Asset Management; BIS.

So what happens if (should we say when?) interest rates rise? We think it will hasten or exacerbate the debt crisis. If the U.S. Government is already spending more than it brings in, what happens when the government's interest expense gets even larger? What programs do you think will be cut? The government's payments for interest are already growing just because the size of the debt is increasing. It will get even worse if interest rates increase. Currently much of the U.S. Government's debt is in mostly in short term instruments, which have the lowest interest rates. Locking in current low interest rates using long-term debt would probably be smart in the long run, but doing so increases the current interest rates being paid now. Keeping the current debt short-term means that rising interest rates could add quickly increasing outflows to the already excessive government deficit.

What Happens Next?

John and Jane were able to continue their borrowing and live a nicer lifestyle – until they weren't. Once the moment to truth arrived and lenders were no longer willing to extend additional debt, their lifestyle had to change dramatically – and the good life stopped.

Governments have the same problem. That moment of truth is known as the "Minsky moment." Named after the late Hyman Minsky, an economist who studied financial crises and their causes, the Minsky Moment is the point at which excess debt sparks a financial crisis. When will our current debt boom reach its Minsky Moment?

Bottom line is, we just don't know – no one does. We just know that unless there is a program put into action to begin reducing debt, at some point the increasing debt will become unsustainable. At that time, the financial downturn seems likely to be far greater and more widespread than the debt crisis we saw in 2007-09. We know how horrible that downturn was for most people.

Will governments be able to make any changes in their budgets without affecting the services they provide? Can governments "drastically cut back on their "lifestyle" spending to begin paying their debts" or go through "bankruptcy" to get some of their obligations relieved like private individuals can? Short answer is NO!

What happens if there is another downturn of a 2007-09 magnitude? Part of the reason government debt is so high now is that governments spent extra funds to help their citizens through the crisis. In another crisis, governments will want to spend more to help their citizens again, but how are they going to do that, especially if they can no longer borrow more money?

Likely to occur in such a crisis could be a credit "freeze" with governments, companies, and individuals finding it hard to borrow money. If businesses cannot borrow money to grow, they are likely to slow down or even contract. GM had this problem in the last downturn and needed the U.S. government to step in. If individuals find it hard to get car or home loans, won't those markets be affected as well? The governments could find themselves squeezed between the need to help companies and individuals and much lower tax revenues as economic activity slows down.

What should you do?

You can see why we are concerned. No one has a "crystal ball" able to predict the future. This whole crisis may pass us by and never take effect. We are seeing markets shrugging off this debt crisis scenario, with stock market indexes recently hitting new highs. Just as we saw in 2005-2007, it seems the markets can go up forever.

Still, at The Advisory Group, we believe it is prudent to remain cautious and to have a plan of action should another 2008 level debt crisis "hurricane" hit. We believe prudent investors should set up their investments to dampen the effects of a downturn, even though this may mean not getting all of the upside of more aggressive market based returns. Decide with your advisor what the appropriate risk profile fits YOUR needs and then design a portfolio that helps you achieve what you need.

Reach out to us any time you feel the need. If you have any questions or would like to discuss this further, please contact us.

Our role as your advisor is:

- **NOT make panicky decisions;**
- **Maintain a non-emotional objective;**
- **Avoid knee-jerk reactions;**
- **Assist you in making decisions that are always in your best interest; and**
- **Be here for you – good markets or bad markets.**

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