

## Horizon Notes

Owen Murray just returned from a due diligence trip to New York. He met with fund representatives from Davis Advisors (Selected American Fund) and the senior management group of Royce Funds. In addition, he stayed for the weekend with wife, Suzanne, in celebration of their 10th anniversary.

Larry Maddox attended the Fidelity Executive Forum in Orlando, a gathering of top advisors from around the country. In addition to educational sessions, keynote speakers included Fareed Zakaria, Tom Brokaw, Madeleine Albright, and former President Bill Clinton.

After being in our current location for 17 years, Horizon Advisors and Maddox Thomson & Associates are relocating our office to 510 Bering this summer. We will send more information as our timing becomes clearer.

## Fiscal Responsibility in the U.S.

We have had a number of clients ask us about the widely held pessimism surrounding the U.S. fiscal situation. This is a matter of constant media attention and spotlight with little meaningful talk of how it can be resolved. Much has been written about how we got here, but fundamentally, we have to figure out how to pay for the government we have or change the government to make it more affordable—at all levels. We think that there are signs of meaningful change occurring at the local and federal levels. To explain:

### The Problem/Issues

There has been a great deal of scholarly and interesting work on U.S. borrowing and budget problems. This includes the creation of a faux annual report by Mary Meeker, titled "[USA, Inc.](#)" This work has been endorsed by Paul Volcker and Michael Bloomberg among others. Fundamental to this report is the theme that entitlement (social security for example) and medical spending in its various forms must be reformed in order to keep costs

from spiraling further out of control.

Bill Gross, the "king of bonds" at PIMCO, has substantially reduced his U.S. government bond holdings and recently outlined his concerns in a report titled "Skunked." In his report Gross compares our spend-happy legislators with Pepe Le Pew, the cartoon skunk – whispering sweet nothings and promising, but never delivering on their promises.

*"Unless entitlements are substantially reformed, I am confident that this country will default on its debt; not in conventional ways, but by picking the pocket of savers via a combination of less observable, yet historically verifiable policies – inflation, currency devaluation and low to negative real interest rates." - Bill Gross*

Fundamentally, the solution to our fiscal problems is within our control; only our willingness to change is suspect. Solving the problems will involve difficult decisions. The conventional wisdom is that our politicians are not willing to make these difficult choices, preferring instead to kick the problems down the road. This is the premise underlying rating agency Standard and Poors recent unprecedented decision to place the U.S. government debt on negative credit watch.

Certainly, the consequences of non-action are not pretty, as Reinhart and Rogoff have chronicled in their book, "This Time Is Different," which we reviewed in our Summer newsletter last year. So, it is not a small concern that some action be taken and soon.

### Seeds of the Crisis

When the world is seemingly swimming in cash, the economy is booming, and tax revenues show no sign of abating, politicians are not required to make difficult decisions; so they do not. Decisions that might require complex negotiations because of conflicting ideology are deferred. There is plenty of money to satisfy everyone's desires and both sides get what they want. It is also diffi-

cult to get the voters' attention when things are going great. It is hard to get worked up about things when you are living on easy street.

But after our recent recession, falling tax revenues and ever expanding costs have given rise to budgetary constraints at local levels affecting local services, such as fire, police, road maintenance, and schools. These local problems began to focus voter attention and led voters to ask questions that are not easy to answer. The prospect of widespread layoffs and limits on basic services in our home towns and states may have created a tipping point.

Ultimately, this sort of necessary and difficult decision-making may require a different kind of representation. When pain hits close to home, affecting our city, county, and state services, we begin to take notice and take action. "We the people," the citizens and voters, have a much larger stake in the outcome of elections and we expect our representatives to actually represent us and do things that improve the situation.

*"It is to me a new and consolatory proof that wherever the people are well-informed they can be trusted with their own government; that whenever things get so far wrong as to attract their notice, they may be relied on to set them to rights." - Thomas Jefferson*

We think that voters are beginning to notice, and elected officials are beginning to respond.

### Evidence of change

Recent census information indicates that many are voting with their feet and moving to other more tax or business-friendly locales. This doesn't happen overnight, so it is difficult to discern until after the fact. It is incremental, but clearly there has been migration from states with more difficult financial situations and into states with more jobs, less expensive housing, or lower taxes.

As further evidence of change, New York State recently passed a budget which closed a projected \$10 Billion deficit, including a 2% reduction in spending, and with no new taxes. In New Jersey, Governor Chris Christie seems to constantly be in the headlines with his austerity agenda. Wisconsin had a dramatic legislative fight over

stripping unions of collective bargaining rights. And, in a huge political event, the Massachusetts House of Representatives passed a bill in late April, which takes away collective bargaining for health care benefits for municipal employees. This is not a done deal, yet, but it is certainly a new way of looking at things and a possible game changer in the transition to fiscal responsibility. Nearby, Louisiana is tightening up its tax compliance rules in order to collect more tax revenues with simple, but effective steps.

One thing all of these events have in common is that they are happening at the local or near-local government level. Since local governments and even states have a limited ability to issue more debt, "local" is where the rubber meets the road in terms of fiscal issues.

On the other hand, we have the U.S. government, which has had a habit of "buy now pay later" for a long time. In March, in a decided reversal of form, Congress actually passed a bill that cuts spending. (This is real headline news and perhaps we should set aside our cynicism and pay closer attention). In addition, Rep. Paul Ryan of Wisconsin has put forth a budget proposal which appears to have changed the debate in Washington from "How much shall we spend," to "How much spending shall we cut?" This is a decided change in thinking and we hope that this change in focus and thinking will continue to inform fiscal issues as time goes by. These are certainly the seeds of much needed change.

### Observations

So, it is our view that fiscal responsibility is a force of nature, eventually. The only question is when? With ordinary consumers, the answer to "when?" is pretty easy – it's when they run out of money or cannot borrow any more. For political entities in general, the answer is more complicated as the power to tax its citizens provides the ability to borrow more money. Finally, when you add in the federal government's ability to literally print money, it is more complex still.

But, as we describe above, there is clear evidence that fiscal responsibility is coming to government finances. We think that belt tightening and informed, long-term decision making which has occurred at the local level will begin to "filter up" to the federal government. It has been

said that in politics, “everything is local” and hopefully we are beginning to see the seeds of Federal changes in our state and local governments. Perhaps we are also seeing the beginning of the end for Federal fiscal irresponsibility. Tom Brokaw spoke in early May at the Fidelity Executive Forum and as part of a truly inspirational address, urged that Americans need to “re-enlist as citizens,” and we think that is beginning to occur.

Now, we cannot turn all of this on a dime and we have miles to go; but as they say, the longest journey begins with a single step and the road to fiscal responsibility begins at home. We are hopeful that we are seeing the beginning.

## Market Review

The following table shows market index returns through April 30<sup>th</sup>, trailing 3-mos., 12-mos., and 3 years.

Index (Through 4/30/11)	YTD	1-Year	3-Year
S&P 500 TR (Large Stocks)	9.06%	17.22%	1.73%
EAFE TR (Int'l Stocks)	9.54%	19.18%	2.75%
Barclay's Bond Aggregate	1.70%	5.36%	5.82%

In the first four months of 2011, global equity markets have rewarded investors with impressive gains. Through April 30<sup>th</sup>, the S&P 500 has gained 9.1% and the MSCI EAFE, which measures the performance of international stocks, has returned an even more notable 9.5%. And this in spite of widespread civil unrest in the Middle East, a military conflict in Libya, and skyrocketing oil prices. Not to mention the catastrophic earthquake and tsunami in Japan that killed more than 14,000 and resulted in the worst nuclear disaster since the meltdown at Chernobyl in 1986. The bond market, however, did not fare as well. The Barclay's Aggregate Bond Index has returned only 1.7% so far this year, and has returned 0.0% for the past 6 months.

Real GDP continues to grow, albeit at a slower rate. It was reported last month that GDP grew at an annualized rate of 1.8% for the first quarter of the year. This was a good bit slower than 3.1% which was reported in the fourth quarter of 2010. The slowdown is thought to be a

result of severe winter storms in the northeast and rising gasoline prices. Federal government (-7.9%) and commercial construction (-21.1%) were the largest negative contributors to growth, but equipment purchases (+11.6%), exports (+4.1%), and consumer spending (+2.7%) all improved.

The employment picture continues to recover with the April unemployment report confirming a continuation of the improving labor market. An impressive 244,000 jobs were added for the month with the unemployment rate now standing at 9.0% and expected to drop through at least the end of the year. While hiring appears to be picking up, many believe that it could take as long as three to four years for the unemployment rate to reach levels last seen before the recent recession.

Many businesses are enjoying a steep rise in profits and profitability. Operating earnings, as reported by Standard and Poors, are estimated to have grown by 3.2% in the first quarter and are expected to grow by as much as 18.5% by the end of the year. These improving results are anticipated to serve as a catalyst to fuel hiring and further stimulate the economy. In addition, business balance sheets are very strong, with many companies reporting record amounts of cash. This could fuel a pickup in capital spending as well as merger & acquisition activity.

The first four months of the year have seen a sharp rise in prices for commodities with the S&P Goldman Sachs Commodity Index (S&P GSCI) rising by 16.5%. Energy and precious metals have increased most dramatically. Energy was impacted by the turmoil in the Middle East with crude oil rising 16.6%. Precious metals have been fueled mostly by widespread concerns over the stability of the U.S. Dollar. Gold has gone up 9.3% and silver has risen a whopping 56.9%. Some believe that these sharp increases in commodity prices have been a result of the Federal Reserve's quantitative easing programs which have dramatically increased the money supply. The Consumer Price Index was measured at an annual rate of 3.1% in April, but pundits believe it can go much higher if policy makers do not intervene soon and begin to tighten the money supply.

However, it is important to note that the first two weeks of May have produced ferocious selling of these commodities. The month-to-date returns through May 12<sup>th</sup>

for the S&P GSCI is -10.3% with oil (-13.2%), gold (-3.2%), and silver (-28.4%) all posting rapid declines. This is a noteworthy reminder that with the growing number of ETF's and other investment options aimed at the commodities market, speculation plays an increasingly important role in commodity prices and price volatility.

With the end of the Federal Reserve's quantitative easing program scheduled in June, interest rates are expected to rise, possibly dramatically. This will not only hurt the returns for fixed income investments, but would also serve as a headwind for anyone borrowing money. Businesses, consumers, and even government borrowers will have to pay more in interest. In addition, if significant levels of inflation take hold, lenders will require even higher interest rates. Many believe that the trend of ever lower interest rates seen over the last thirty years may have reached an inflection point leading to a steady rise in interest rates for an extended period.

Even with all that has happened so far this year, we remain fairly optimistic about the economy and by extension, the stock market. We believe that employment will continue to improve and that growth in corporate profits will support higher stock prices. We do not think that we will experience runaway inflation in U.S. in the near-term as there is far too much slack in the system (i.e. high unemployment and a high level of spare capacity to meet increasing demands). However, we are concerned about the potential for rising interest rates and what affect that might have on our clients' fixed income investments. As a result, we have taken steps to reduce the risks in these portfolios if interest rates were to rise.

Thank you very much for your continued confidence in our service and advice. If you would like to discuss our

opinions, outlook, or your portfolio in greater detail, we would be happy to schedule a meeting or a conference call at your convenience.

## Making Cents

### Insurance Check-up

Our planning process requires a thorough understanding of the client's complete financial circumstance, not just their investments. One of the things we review in a client's financial plan is life insurance. While many of our clients have existing relationships with a full-service life insurance agent, others do not or no longer do. In these situations, we often look to Low Load Insurance Services, Inc. ("Low Load") based in Tampa, Florida. These life insurance and annuity specialists provide us with resources to review and analyze new and existing policies and provide objective recommendations and comparative quotes from multiple carriers. Low Load caters to clients of fee-only advisors like Horizon, rather than to the general public. You can read more about Low Load at [www.llis.com](http://www.llis.com). If you have questions about your financial plan including life insurance and need some help, please give us a call.

## COLLECTED THOUGHTS

*"Faced with the choice between changing one's mind and proving there is no need to do so, almost everyone gets busy on the proof." - John Kenneth Galbraith*

*"If you torture data long enough, it will confess to almost anything." - Unknown*



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