I was hoping to finally get this one out via our new blog, but that's not quite ready (see more on that below) and there are a number of things I thought shouldn't wait. Once again, I chose an easily digestible list of bulleted points as the format which I hope is conducive to reading this in multiple sessions. The first few points are economy and investment related including the end of QE2, the worsening sovereign debt issue, the impact of the US debt-ceiling, and a potential bright spot for housing in the near future. The middle are tax and miscellaneous information and reminders and the last few bullets are PWA-operations related. There are some important issues addressed in this newsletter so while no action is required of you, I strongly encourage you to read it in full. As always, please feel free to contact me directly with questions or comments and feel free to forward to anyone you think might be interested. Now, down to business…

- The End of QE - On 3/24/09, just after what we now know was the stock market bottom, I wrote in a "Market Update" note to clients that the announcement that the Federal Reserve was going to purchase U.S. Treasuries and other securities represented a "game changer" for the financial markets. Those purchases became known as Quantitative Easing (QE) with two distinct rounds of purchases being coined "QE1" and "QE2". These were in fact a game-changer for the markets, with the S&P 500 rallying more than 100% from March '09 to April '11. They were a game-changer because the Fed was, in simplified terms, printing money to buy financial assets which put that newly printed money into circulation to offset the deflationary spiral that was occurring (the value of everything from houses, to bank assets, to the stock market, to commodities was falling rapidly and simultaneously causing credit markets, job markets, and the overall economy to grind to a halt). As of July 1st of this year, the Fed ended QE2 and has signaled that a QE3 is unlikely. This means the game-changer is over. However, the Fed is not selling the assets they've purchased to date and they will keep reinvesting in those assets as they mature which means we don't expect a game-changer in the other direction to send the markets back down. What we do expect is that the days of 50% per year stock market gains are behind us for quite a while. We also expect interest rates to start to gradually rise on medium to long-term treasuries and mortgages, though probably not sharply because any sharp increase would set the economy back and likely force more intervention from the Fed. In the next 12-months we expect short-term rates on savings accounts, CDs, and short-term bonds to start to gradually increase as the Fed hikes the Fed Funds rate back to something less extraordinary (we believe 2-3% would still provide support for economic recovery without risking the inflationary dangers of the 0% emergency rate we have today. Finally, we expect a higher level of volatility (up and down) in all financial markets as the Fed-induced tailwind is no longer behind us and now the economy, business cycle, productivity, earnings, and jobs will take more focus.

- The Debt Ceiling - Much is being made of the U.S. debt ceiling and what might happen if it's not raised and we're unable to pay our bills. For the most part, this is political grandstanding. There is absolute certainty that the debt ceiling will be raised. But, there's an important problem in the way Congress is currently dealing with the issue. August 2nd has been set as the "deadline" by the treasury secretary by which the ceiling must be raised in order to proceed with business as usual. For this reason, the credit rating agencies have to consider the possibility that the U.S. will not be able to pay its debts if the ceiling is not raised by that date. Ironically, Congress bashed the credit agencies for maintaining AAA status on collateralized debt obligations that later failed during the peak of the financial crisis, arguing that any risk of default should have caused an immediate downgrade of those instruments way before the crisis occurred. Those same credit rating agencies must now act accordingly and not wait until August 2nd to cut the U.S. rating or they risk having a AAA rating on August 2nd morning and a default rating on August 2nd evening. This means the real deadline to raise the limit is well before August 2nd, because a downgrade of the U.S. credit rating, if taken seriously by the world, will having a snowball effect through the financial markets and set off another deep, albeit temporary, financial crisis. The President's comment that he will not approve a short-term extension, while obviously in good a faith effort to try to prevent this from being a recurring quarterly problem, actually worsens the situation because it makes the possibility of no deal by August 2nd more likely to the credit agencies. Congress is now playing a game of chicken and I expect a short-term deal is likely with an understanding of more short-term deals through the 2012 elections which will keep the ratings agencies at bay for now. In the meantime though, expect potentially violent moves in the markets, akin to those of the days of TARP being voted on, as momentum traders try to take advantage of the headlines. Since even a credit downgrade would be temporary (garnering a swift response in Congress if it ever did happen), market volatility due to these events is in my opinion, nothing more than an opportunity to rebalance portfolios taking advantage of dips in the market and to get a 401k or other savings contribution in at a cheaper price than without the debt ceiling issue. This issue will pass. The longer-term question of our government's ability to govern if it's willing to put us in these kinds of situations to begin with is a much broader issue but I'll leave that discussion to those who enjoy politics.

- European Sovereign Debt - A less-urgent, but much more important issue to long-term global financial markets is the vast amount of sovereign debt that exists in the world and the sudden realization by financial markets that some countries truly may not be able to pay their bills. This issue is not about an arbitrarily set debt ceiling. Countries like Greece and Ireland are struggling to pay their debts because they've taken on so much debt that tax revenues can't support government spending plus interest payments any longer. These countries, with others like Italy, Portugal, and potentially Spain, not too far behind them, have simply lived on a national credit card for the last decade and are now forced with extreme austerity in return for global bailouts or default. Default means the loans made to those countries become worthless and the banks holding those loans lose the loans as assets. This has the potential to kick off a global financial crisis that is all too familiar after the '08/'09 Lehman Brothers default created much of the same. It can also kick off a currency crisis as it threatens the Euro, thereby strengthening the U.S. Dollar and causing harm in our own recovery as it makes our goods, services, and assets seem more expensive to the rest of the world. So far, rescue packages from the International Monetary Fund have staved off default for Ireland & Greece, but this warrants further monitoring. There are three important actions to take here:
    - Like others, we have no crystal ball and believe that markets price information and risks fairly in general. That means that in most cases the market would fall before we have reason to believe it would fall or it would rise before we have reason to believe it would rise meaning there is no way to time news events. However, as I've discussed with all of you at one point or another, if I

hear the whisper of a freight train coming, and sometimes it comes without making a whisper first, I will take corrective action. This means moving all models temporarily to a slightly more conservative allocation or using other protective measures as I see fit.

  - It's easy to be complacent when the stock market is rallying like it has for the better part of the last 28 months. If you have short-term needs for your money that is currently invested as if it was not needed for the short-term, please communicate that need to me ASAP. If your portfolio is 80% stocks and the stock market falls 50%, which has happened twice in the last decade, you will lose ~40% of your portfolio. For long-term money, by definition, you don't need it over the short-term so that's not an issue. In that case, continue to invest as planned, buying at lower prices if markets fall and when markets eventually recover you'll actually be better off than if the fall hadn't happened. For short-term money though, that kind of a loss could mean not being able to fulfill a goal and goal-fulfillment is the only reason to invest.
  - Expect the market to move both up and down. Many have become accustomed to seeing their portfolio balances only increase, and quite sharply quarter after quarter. Don't be shocked to see more volatility. As long as you've heeded the point in the preceding bullet, and you have an overarching financial plan, don't worry about the short-term movements of the markets. The <u>only</u> ways to ensure that your account statements will only show increases in value are to 1) keep your money in the bank earning slightly more than 0% per year in interest while the cost of living increases far faster, or 2) have a crooked financial advisor that's cooking the books (and we all know how that ends… google "Bernard Madoff").

- <u>Potential Game Changer For Housing</u> - On a positive note, I believe there is a potential game-changer, which not currently getting much press, about to come to pass for the housing market. Anyone who's tried to get a mortgage recently knows how complicated the process can be, how long it can drag on, and how difficult it can be to actually close a loan now. This lack of credit availability is a contributing factor in the lack of real estate buyers and therefore the still-falling home prices. One of the reasons lenders have become so picky is because they are unable to easily package and re-sell their loans to investors, something they used to be able to do with collateralized debt obligations ("CDOs") which were a contributing factor in housing's explosion during the early 2000s and implosion during the last 4 years. Without CDOs, if a bank invests its capital in a mortgage (lending it to someone who needs money), they can't as easily sell the loan (getting their capital back from an investor who has a surplus of money) and re-start the process with another person in need of a mortgage. Recently, the House of Representatives signaled bi-partisan support for a financial instrument called a "covered bond", which is something that has been used successfully in Europe for centuries. A covered bond is like a CDO in that a bank can gather investors and sell them a mortgage-related product allowing the bank to regain their capital so they can lend to another borrower. The key differences with a covered bond are that the bank has to pay the investor the agreed to principal and interest whether or not the borrower pays his or her mortgage. That means the investor can have a higher level of faith in getting paid. It also means the bank has a huge incentive to only lend to the credit-worthy since they're on the hook for the payments to the investors whether the mortgage defaults or not. Finally, because the investor is taking on less risk than the bank (he gets paid whether or not the mortgage goes belly up as long as the bank doesn't), the bank can pay the investor a lower interest rate than what they charge on the mortgage itself and capture some income from the difference in rate, fueling the banking system which provides the oil for the economic engine. This not only could be a way to loosen up the mortgage market, it could be a way to reduce the country's reliance on FHA, Fannie Mae, and Freddie Mac as a backing-source for mortgages, something that puts us in danger of becoming the next Greece, Ireland, etc. We haven't used covered bonds before because the thought was that a purely socialized form of lending for housing (FHA) plus a purely capitalist form of lending for housing (CDOs) was better than having a more regulated, yet still capitalist form of lending in the covered bond. The wisdom now is that middle-ground will prove better than a combination of extremely liberal and extremely conservative ways of thinking and the products that result from those ways of thinking. We're not there yet, but I think the covered bond is a step in the right direction for housing.

- Quickies - A few other quick positive notes, some maybe surprising:
    - Small-cap U.S. stocks hit all-time highs in May 2011. Higher than the dot-com days and higher than the S&P 500 peak in 2007. A strong case not to just stick your money in the S&P 500 and forget about it.
    - Mortgage rates are back in the mid-4% range again while house prices have come down more in the last year and incomes have increased making affordability (mortgage payment as a % of income) off-the-charts good.
    - S&P 500 companies earned $83.66 per share in 2010, just off the peak of $87.72 in 2006. For 2011, estimates are for $98.40 per share in earnings. The corporate economic recovery is real.
    - The national average savings account rate of interest is about 0.16%. The Vanguard U.S. Total Stock Market ETF is paying a 1.77% dividend. I don't know of any other time in history when stocks were paying dividends 11x higher than savings accounts.

- Mileage Rate Change - The IRS recently announced a rate change effective July 1 for mileage driven for work or for medical purposes. Make sure you capture your odometers around mid-year to be able to accurately report your mileage if you drive for work. The new/old rates are (in cents per mile driven):

| **Purpose** | **Rates 1/1 through 6/30/11** | **Rates 7/1 through 12/31/11** |
|---|---|---|
| Business | 51 | 55.5 |
| Medical/Moving | 19 | 23.5 |
| Charitable | 14 | 14 |

- Credit Reports & Scores - If you haven't recently, remember to check your credit report. You can check for free at www.annualcreditreport.com. You can also keep tabs on an estimate of your credit score at www.creditkarma.com.

- Endless Paper Statements - A few of you have recently asked why you keep getting paper account statements from your custodian even though you've requested electronic statements only. Legislation was passed in late 2010 as part of the financial reform laws that states that brokers must send paper statements to clients who work with any sort of an advisor so that they can compare their statements to those provided by the advisor. The idea is to make sure clients aren't being "Madoffed". I actually have a legal obligation to perform a check annually to ensure that my clients are getting the paper statements that most of you don't want. If your custodian is sending you paper statements, there is no way to make it stop. I know it's a giant waste of paper. I know it's a security concern. Please feel free to write to your Representative or Senator and tell them your reasons for disliking the law.

- <u>Texas Registration</u> - As of last week, PWA is officially a registered investment advisor in Texas. That's in addition to Georgia, Minnesota, and California where we're already registered. Registration means we've sent our disclosure documents, client agreements, and other required documents to the state board for review and to ensure our business practices conform with the laws of their land. Registration is required in any state where we have more than 5 clients. We will continue to register in additional states as necessary to serve clients. Completing registration for Texas involved a few minor edits to our ADV Part 2, our disclosure document, and you'll soon be receiving an updated copy as required by law. No action is required by you.

- <u>New Client Policy</u> - Soon you'll see a few new key words added to PWA public materials and web pages: "By Referral Only". This is a new official policy under which I'll only be taking new clients that are referred by existing clients or, in unique circumstances, by other financial professionals. The reason is that I have limited capacity to take on new clients, and in my experience, the new clients who I'm able to help the most come from my existing clients who've already been through the process and understand the value that PWA financial planning, asset management, decision support, and tax prep can add. I appreciate and thank you again for all the client referrals I've already received and I will continue to accept new clients who you refer and who are a good fit for what I offer.

- <u>Social Media</u> - Social Media continues to be a challenge from an investment advisor regulation standpoint which has caused the delays to date with our Blog, Facebook Page, and Twitter Page. We must have an archiving mechanism in place that records every post and every update permanently in order to be in compliance. An additional challenge is that investment advisors are not allowed to offer testimonials on their advertising. Well, the SEC and states have made it clear that websites and social media are advertising (whether we'd define it that way or not, and clearly I wouldn't if I'm working by referral only!). So, is a Facebook "Like" a testimonial? Is a recommendation on LinkedIn a testimonial? Is a comment on a blog post from an existing client saying "nice post!" a testimonial? The answers to date are unclear so we're trying to err on the side of caution wherever possible. Thank you again by the way to those of you who've written LinkedIn recommendations which we've been forced to hide from public view. They are appreciated nonetheless. Regardless of the challenges, the PWA Blog, Facebook Page, and Twitter Pages will be announced officially later this quarter.

- <u>Yogi</u> - I'll end this update on a bit of a lighter note. Those of you know who know me know that I'm a New York Yankees fan (and the majority of you like me a little less for that reason but I'm ok with that). I recently saw a few highlights from Old-Timers Day, one of my favorite days of the baseball season when I was growing up and had the time to watch the games more regularly. One of this year's participants was Yogi Berra, famous catcher for the Yankees but perhaps even more famous for his "Yogi-isms". In one of his memorable quotes that I think is so applicable to financial planning, Yogi says, "If you don't know where you're going, you might not get there." Those who know where they're going have a plan that dramatically increases the chances of achieving their goals. While it's sometimes a winding, bumpy road, you at least know you're on the right path and trying to make life happen instead of letting it happen to you. I hope I'm helping you all to stay focused on where you're going and that you're getting closer every day. I wish you all a great pothole-free summer.

Thanks,
Tom