



**EXCELSIA<sup>®</sup>**  
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## Deleveraging.....No Pain, No Gain

The level of debt accumulated by developed nations, both in the public and private sector, has raised the standard of living to a level that would have been unimaginable just a couple generations ago. In the US, consumers used their homes as an ATM machine. From 2003 – 2007, the American consumer withdrew over \$2 trillion from the equity in their home. In Europe, the formation of the euro allowed the weaker countries to borrow heavily at interest rates that were only deserving of their stronger brethren to the north. The newly filled government coffers were then used to increase the standard of living through large wage increases, extravagant benefits and a general sense of entitlement, particularly to public sector workers (though it is reported that in Greece, most households have at least one family member that is a public worker).

Then the wheels began to fall off. In the US, it was inconceivable that housing prices could actually go down. In Europe, it was inconceivable that a sovereign country may actually default. The addiction to debt is hard to break. It reminds me of the movie Top Gun when Commander Stinger had a terse conversation with Lieutenant Mitchell, or “Maverick” (Tom Cruise) after buzzing the air control tower at something over 400 knots. Stinger shouted, “Son, your ego is writing checks your body can’t cash!” This is precisely what has occurred in the world’s gorging on debt. It is also referred to as living beyond our means. It cannot be sustained.

The deleveraging process is painful, but not impossible. Typically, the private sector needs to deleverage or reduce debt while the public sector continues to fill the void, lest the risk of recession or depression increases. As the private sector resets its finances and begins to strengthen, the natural progression should then be for the public sector to begin its pullback in spending. The US private sector has actually been deleveraging. To some extent, it has been forced, as extraction of home equity has been significantly curtailed for homeowners. Also, there has been material deleveraging within the financial sector, as the recent crisis forced the collapse of legacy firms like Lehman Brothers.

According to a McKinsey Global Institute study, debt among US households has fallen by 4% in absolute terms since 2008. Strikingly, it is estimated that two-thirds of the reduction came from defaults on mortgages and other consumer debt. It is also estimated that \$254 billion remains in the foreclosure pipeline that would further reduce consumer leverage. While low-income households are experiencing the greatest level of foreclosure, it is further estimated that up to 35% of mortgage defaults are strategic decisions to simply leave the keys on the counter and walk away.

The public sector will need to deleverage, but at a rate that ensures an environment exists that is conducive to capital attraction. It needs to resist the temptation of protectionism and establish a tax environment that makes the US a “no-brainer” for corporate executives. We live in a global economy. The competition is fierce. We cannot afford to have our heads in the sand. When I read emails that are titled, “If Apple was a Country”, it would be ranked 29<sup>th</sup> based on its market value versus countries and their respective GDP, I am in awe. A US company that began a few decades ago in a garage in California is now being compared to entire countries. We must ensure an environment that continues to breed this type of entrepreneurial spirit. The current gridlock in Washington is of great concern. As you may recall from a prior quote, Lincoln professed that no outside power could conquer the US. If it happened, it would come from within.

The earnings season is in full-swing, and we continue to see growth, led currently by strong technology earnings. The economic news continues to be respectable, but we still believe 2012 will be a muddle-through year. Fourth-quarter GDP was up 2.8%, but was primarily due to an inventory adjustment rather than overall robust strength. Consumer confidence continues to improve, though expectations should be tempered. The ATM machine discussed above that was used so liberally a few years ago by consumers has now been removed much like the payphone has at gas stations. A clear plan on dealing with the housing glut and clarity on the regulation and tax front for businesses will remove a large impediment for restoring economic growth. On the housing front, we know the pendulum has swung hard the other way. The perception now is that prices will only go lower, which keeps many potential buyers on the sidelines.

The Federal Reserve met this week and indicated we can expect exceptionally low rates (near zero) through 2014. It also appears likely the Fed will enact a third round of quantitative easing (QE3). Treasury bonds rallied on the news, pushing the 10-year Treasury to 1.9% and the 30-year to just over 3%. With inflation currently running 3% and fiat currencies being freely printed (inflationary), the purchasing power of these investors will be eroded mightily if held to maturity. The Fed has induced artificially low interest rates that continue to inflate a bubble that is reminiscent of technology companies that once traded at stratospheric multiples during the late 1990's.

The economic calendar is attached for your review. It will be a busy week of economic data that will provide numerous insights into the current state of affairs for the US economy.

Please let us know if you have any questions.

All the best,  
Troy

## Economic Data – Week of January 30, 2012

Date/Time	Event	Period	Survey	Prior
01/30/2012 08:30	Personal Income	DEC	0.40%	0.10%
01/30/2012 08:30	Personal Spending	DEC	0.10%	0.10%
01/30/2012 08:30	PCE Deflator (YoY)	DEC	2.30%	2.50%
01/30/2012 08:30	PCE Core (MoM)	DEC	0.10%	0.10%
01/30/2012 08:30	PCE Core (YoY)	DEC	1.70%	1.70%
01/30/2012 10:30	Dallas Fed Manf. Activity	JAN	0.5	-3
01/31/2012 08:30	Employment Cost Index	4Q	0.40%	0.30%
01/31/2012 09:00	S&P/CaseShiller Home Price Ind	NOV	--	140.3
01/31/2012 09:00	S&P/CS 20 City MoM% SA	NOV	-0.50%	-0.62%
01/31/2012 09:00	S&P/CS Composite-20 YoY	NOV	-3.26%	-3.40%
01/31/2012 09:45	Chicago Purchasing Manager	JAN	63	62.2
01/31/2012 10:00	Consumer Confidence	JAN	68	64.5
01/31/2012 10:00	NAPM-Milwaukee	JAN	57.5	57.8
02/01/2012 07:00	MBA Mortgage Applications	27-Jan	--	-5.00%
02/01/2012 08:15	ADP Employment Change	JAN	183K	325K
02/01/2012 10:00	Construction Spending MoM	DEC	0.50%	1.20%
02/01/2012 10:00	ISM Manufacturing	JAN	54.5	53.9
02/01/2012 10:00	ISM Prices Paid	JAN	49.8	47.5
02/01/2012 17:00	Domestic Vehicle Sales	JAN	10.50M	10.45M
02/01/2012 17:00	Total Vehicle Sales	JAN	13.50M	13.52M
02/02/2012 07:30	Challenger Job Cuts YoY	JAN	--	30.60%
02/02/2012 08:00	RBC Consumer Outlook Index	FEB	--	45.8
02/02/2012 08:30	Nonfarm Productivity	4Q P	0.80%	2.30%
02/02/2012 08:30	Unit Labor Costs	4Q P	0.90%	-2.50%
02/02/2012 08:30	Initial Jobless Claims	28-Jan	370K	377K
02/02/2012 08:30	Continuing Claims	21-Jan	3530K	3554K
02/02/2012 09:45	Bloomberg Consumer Comfort	29-Jan	--	-46.4
02/02/2012	ICSC Chain Store Sales YoY	JAN	--	3.50%
02/03/2012 08:30	Change in Nonfarm Payrolls	JAN	150K	200K
02/03/2012 08:30	Change in Private Payrolls	JAN	168K	212K
02/03/2012 08:30	Change in Manufact. Payrolls	JAN	11K	23K
02/03/2012 08:30	Unemployment Rate	JAN	8.50%	8.50%
02/03/2012 08:30	Avg Hourly Earning MOM All Emp	JAN	0.20%	0.20%
02/03/2012 08:30	Avg Hourly Earning YOY All Emp	JAN	1.90%	2.10%
02/03/2012 08:30	Avg Weekly Hours All Employees	JAN	34.4	34.4
02/03/2012 08:30	Chg in Household Survey Empl	JAN	--	176
02/03/2012 08:30	Underemployment Rate (U6)	JAN	--	15.20%
02/03/2012 10:00	ISM Non-Manf. Composite	JAN	53.2	52.6
02/03/2012 10:00	Factory Orders	DEC	1.50%	1.80%

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