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Commentary:

The Current Stimulus Affair

As I sit down to write this edition of "The Advisory" we are about to witness history in the making as Barack Obama takes office as the 44th President of the United States and this country's first bi-racial President. It is hard not to be affected by the joy on the faces of our fellow citizens of African-American descent. They are truly elated and should be. We should all be proud of our country, not only for electing a minority candidate but again for the 44th time in 200-plus years having an orderly transition of power.

President Obama campaigned on a message of Hope and Change. He is taking office in the midst of the worst financial and economic crises since the Great Depression, with Americans in harms way in shooting wars in two far off countries, and with only slightly more than half the electorate having voted for him. We certainly need Hope, Change and a large dose of Confidence. I wish him well and sincerely hope he succeeds, for all our sakes.

I am, and have always been, an optimist. I believe in America with all my heart. I have put my life on the line in defense of our values and in a failed attempt to spread those values in Southeast Asia in the '60s. I believe in the essential goodness of this country and our ability to learn from our mistakes and recover from tragedies.

The level of bad assets on the balance sheets of our financial institutions, the proliferate spending of our political leaders at every level of government, the ballooning credit balances of the consumer and all levels of government, the lack of foresight and prudence on behalf of many of our institutions certainly have shaken my confidence and optimistic outlook. I realize that many dedicated people in and out of government have tried admirably to stem the tide of declining values, bad debts and bring to justice the likes of Bernie Madoff.

What I don't understand is why they are attempting to save the system by doing the same exact thing that

got us into trouble in the first place, i.e. **creating even more debt.** There is a saying about the definition of insanity that goes something like this: insanity is doing the same thing over and over and expecting different results. It usually refers to people with an addiction and I would submit that we as a society are addicted to debt.

Case in point: As soon as GMAC, the financial lending arm of General Motors and owned by the folks who own Chrysler, were approved as a commercial bank with the backing of the government, they lowered their lending rates to 0% and reduced credit score requirements for borrowers by a few notches. Talk about "Hair of the Dog." What do they and their government overseers expect will happen to these new loans in a seriously declining economy that has not yet seen the peak of unemployment rates? Many other examples could be given but I'm sure you get the gist of it.

As one who has closely followed our economic cycles over a career of 35 years, I understand that in the current situation an administration must be seen as doing something for fear that doing nothing will be seen as failure of nerve or worse. Yet again, I don't understand how so many well educated, seemingly intelligent people can be stampeded into borrowing or printing billions and trillions of dollars that will have to be paid back by current and future generations. It has been shown many times that government stimulus and "investments" don't create jobs quickly and are often wasted in the frenzy to get it out into the economy. There may be some positive effects but the inflationary risks and risk to the value of the dollar are huge. I'm also wondering how much more of our debt the Chinese will buy given their slower economy at home. What about the oil producing countries? With oil at less than \$40 per barrel they aren't going to be able to buy many U.S. Treasury Bonds.

The tsunami of borrowing we are creating will cause inflation, severely weaken the dollar, and make it even harder to rebuild confidence in the US and its economy.

I've taken several paragraphs to voice my concerns about our current course. It seems incumbent to offer an alternative solution. I believe that permanent tax cuts for those who pay taxes, individuals and corporations,

Commentary

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coupled with highly targeted infrastructure projects that will truly create economic benefits are the way to proceed. Something on the order of \$400-\$500 billion over two years coupled with the gradual improvement of the balance sheets of our major financial institutions would be effective. To return to earlier metaphors, that is not going "cold turkey", but keeping the stimulus at this level and counting the \$2 trillion already committed would at least give us a chance of limiting inflation and keeping the dollar from collapsing in two or three years. Trillions more in deficits for several years to come are a recipe for disaster.

I'll leave the specifics to the experts but one idea presented by Robert Reich, a former government official and Harvard professor, is intriguing. He suggests lowering FICA payroll taxes to zero on income up to \$15,000 per year. This would have the benefit of immediately putting the dollars into the economy and would effectively be an across-the-board tax cut.

Notwithstanding the problems it causes the Social Security Trust Fund, it is worthy of strong debate. At least we'd have more time to deal with the larger Social Security deficits and less short-term effects.

Who is Bernie Madoff and What Can We Learn from the Scandal?

Bernie Madoff stands accused of running a Ponzi scheme to defraud investors. In this type of scam investors are paid back not with legitimate gains from the stock market but with money from new investors. Prosecutors allege that the scam ran without a hitch during the financial bull market as a constant stream of new investors were encouraged to invest by the promise of consistently high returns. When the credit crisis struck, the new investment dried up and Mr. Madoff was allegedly unable to pay his investors who wanted out. Madoff's game was the first worldwide Ponzi scheme - a fraud that lasted longer, reached wider and cut deeper than any similar scheme in history, entirely eclipsing the puny regional ambitions of Charles Ponzi, the Boston swindler who gave his name to the scheme nearly a century ago.

If you had the good fortune not to have invested in Mr. Madoff's scheme, count your blessings. An alleged fraud like this could have happened to any of us, as it did to some of the world's most sophisticated investors. True, they should have recognized that annual returns of better than 10% in both good times and bad were too good to be true. They should have been suspicious of Mr. Madoff's vague explanations of how he arrived at those results. And to the extent he described his strategy, they should have noticed that the markets could not possibly support the reported gains. However, consistent returns in good and bad markets are the selling point for nearly every hedge fund. Many have reported much larger annual returns without raising eyebrows. While Mr. Madoff's returns were good, they were not so spectacular as to raise undue suspicion. As for his vague explanations, they were no vaguer than those of many other hedge-fund managers and even mutual-fund managers.

Still, there are some lessons we can take away from this debacle. First, Madoff's books were audited by a virtually unknown accounting firm. So the simple but vital lesson here is never to invest in anything whose books aren't audited by a recognized accounting firm with a strong reputation, preferably one of the Big Four.

Diversify. This is obvious, but it's worth repeating given the many stories of people and institutions who tied up almost all of their assets with Mr. Madoff. A sharp market correction can have damaging effects on almost any investment, as recent events have shown.

Don't believe anyone who tells you that you can earn higher returns while assuming a lower risk. If you're realizing high returns, then you're also accepting increased risk.

Don't rely on advisers. With the proliferation of hedge funds and other alternative investment opportunities, many people don't want to have to think about their investments, but you can't abdicate all responsibility.

Finally, never under any condition, write a check for an investment to an individual, be it your investment advisor or the president of a company. That's just an open invitation for fraud.

Whodunit? A Who's Who of the Current Economic Crisis

Will it make me feel better if I know who/what caused all this turmoil and pain in the financial markets and ultimately, in the overall economy?

Will it ease my sense of loss?

Will it give me satisfaction when these culprits are caught and punished?

Knowing myself, it really doesn't matter who did what. What is important, however, is to learn how and why it happened so that I may protect myself in the future. Agreed, some things are out of my hands, but I get a certain satisfaction from knowing how things work. Then it is my responsibility to take action or not. The evolution of the financial crisis in the U.S. took several years. Many of its characters are involved in subtle ways.

Let's start at the bottom and work our way up touching on all those involved.

- Individual investors (like you and me) looking for higher investment returns.
- Individuals looking to make a quick buck on the fast-rising real estate market, flipping a house or a condo.
- Individuals hoping to buy a home even with poor credit, no down payment and unreliable income.
- Consumers refinancing homes at inflated values, using their homes as ATM machines, depleting much of the equity and now owing more than the current value of their home.

Next level:

- Mortgage brokers, paid by commission, eager to help individuals fill out mortgage application forms regardless of ability to pay.
- Appraisers willing to inflate property values.
- Mortgage banks and processors ignoring their own application standards to bring as many fee-paying buyers as possible through the doors.

Next level:

This level shows excess risk, excessive leverage, complexity, lack of transparency and lack of oversight throughout the system:

- Institutional investors (banks, pensions, municipalities, etc.) eager for higher returns; buying "alternative" investments that they really do not understand.
- Credit Rating Agencies like Moody's, Standard & Poor's and Fitch performing inadequate due diligence and rating these debt instruments AAA without knowing exactly what the investments involved.
- "Whiz Kids of Wall Street" concocting ultra-sophisticated investments to "spread risk" while leaving no one accountable.
- Investment bankers aware of the questionable nature of these investments but eagerly reaping the deal fees. They were also instrumental in spreading the risks globally.
- Hedge Funds leveraging the questionable investments to the hilt, beyond reasonable risk management. Merrill Lynch, Lehman Brothers, Goldman Sachs, Bear Stearns and Morgan Stanley were all known to have leveraged as high as 40 to one!

Next level:

- The Federal Reserve keeping interest rates at unprecedented lows far too long, creating moral hazard.
- Congress enacting well intentioned but illogical laws fostering home ownership with successive administrations – Democratic and Republican – not forcing the issue.
- Quasi-federal government agencies Fannie Mae and Freddie Mac, corrupt within, perpetuating loans to ill-suited buyers.
- SEC (Securities and Exchange Commission) not knowing what to look for.
- The Federal Reserve not using its regulatory authority to fulfill its obligation to protect the public.

Just as it took several years to create this monster, it will take many years for the crisis to unwind and return us to some sense of financial confidence and normalcy.

Eileen Hawe

Update on taxes, contributions and conversions

The following is a summary of some information that is new for 2009

401(k) plans	employee contributions have increased to \$16,500 employee catch-up contributions for those over 50 \$5,500
403(b) plans	employee contributions have increased to \$16,500 employee catch-up contributions for those over 50 \$5,500
RMD	Required Minimum Distributions have been waived for 2009
Roth Contributions	income limit remains at \$100,000
Social Security Taxes	the maximum amount of earnings subject to SS taxes rose to \$106,800.
Mileage Rates	business usage will be 55 cents per mile medical usage will be 24 cents per mile charitable works will be 14 cents per mile

Tax Brackets	Single	Couple
10%	not over \$8,350	not over \$16,700
15%	\$8,350-\$33,950	\$16,700-\$67,900
25%	\$33,950-\$82,250	\$67,900-\$137,050
28%	\$82,250-\$171,550	\$137,050-\$208,850
33%	\$171,550-\$372,950	\$208,850-\$372,950
35%	over \$372,950	over \$357,700

Capital Gains Tax

Long term (held 12 months or longer)

10%	0
15%	0
25%	15%
28%	15%
33%	15%
35%	15%

Short term (12 months or fewer)

taxed
as
ordinary
income

Estate Tax Rates	exemption rises to \$3.5 million	2009	Congress expected to maintain this level
	unlimited exemption	2010	
	exemption returns to \$1 million	2011	Congress may change
Gift-tax	exclusion amount rises to \$13,000		

All of the above are subject to change due to new IRS rulings or laws passed by Congress.



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Where We've Come From, Where We're Going

Date	Events	Effect	IAA Actions
Mid to late 2007	The supply of new and existing housing finally outstrips demand. The bubble begins to burst.	Housing prices stagnate and begin to fall.	In August, 2007, following signals from our Trend Tool® IAA pulls out of the equity market. Later, we sell off Kensington Funds and purchase PIMCO Income Opportunity Fund (PKO).
March 2008	Sale of Bear Stearns to JP Morgan Chase. The Bush Administration sends out its stimulus checks	Wall Street begins getting nervous, but stocks continue to behave favorably.	IAA holds steady.
Spring/summer of 2008	Rise in oil/gasoline prices. As real estate prices fall unemployment begins to rise.	Households begin trimming their budgets and start saving. Tax rebate checks have limited effect on the economy.	IAA sells off "C" shares in most managed accounts, sells PKO and moves into ETFs and funds of short term Treasuries and bond indexes.
September 2008	Fannie Mae/Freddie Mac takeover. Lehman Brothers fails. Merrill Lynch sells out to Bank of America. The Fed bails out AIG. Morgan Stanley/Goldman Sachs become chartered commercial banks.	The markets take a header. Treasury Secty. Hank Paulson heads to Capital Hill to beg Congress for \$700/bil to save the financial system and to keep the problem from spreading. Congress is skeptical but finally passes a package.	IAA sells High Yield bond funds and replaces them with short term treasuries or treasury funds.

So that's where we were when we put out the last issue of The Advisory. Now what? As the dust has begun to settle, it has become clear that the next year or two will be difficult for most Americans. Forecasters are painting dire pictures of what might or – more importantly – *what might not* happen. On the next page, we've compiled a few of these forecasts to give you an idea of how IAA will react to protect and grow your financial resources under these various scenarios.

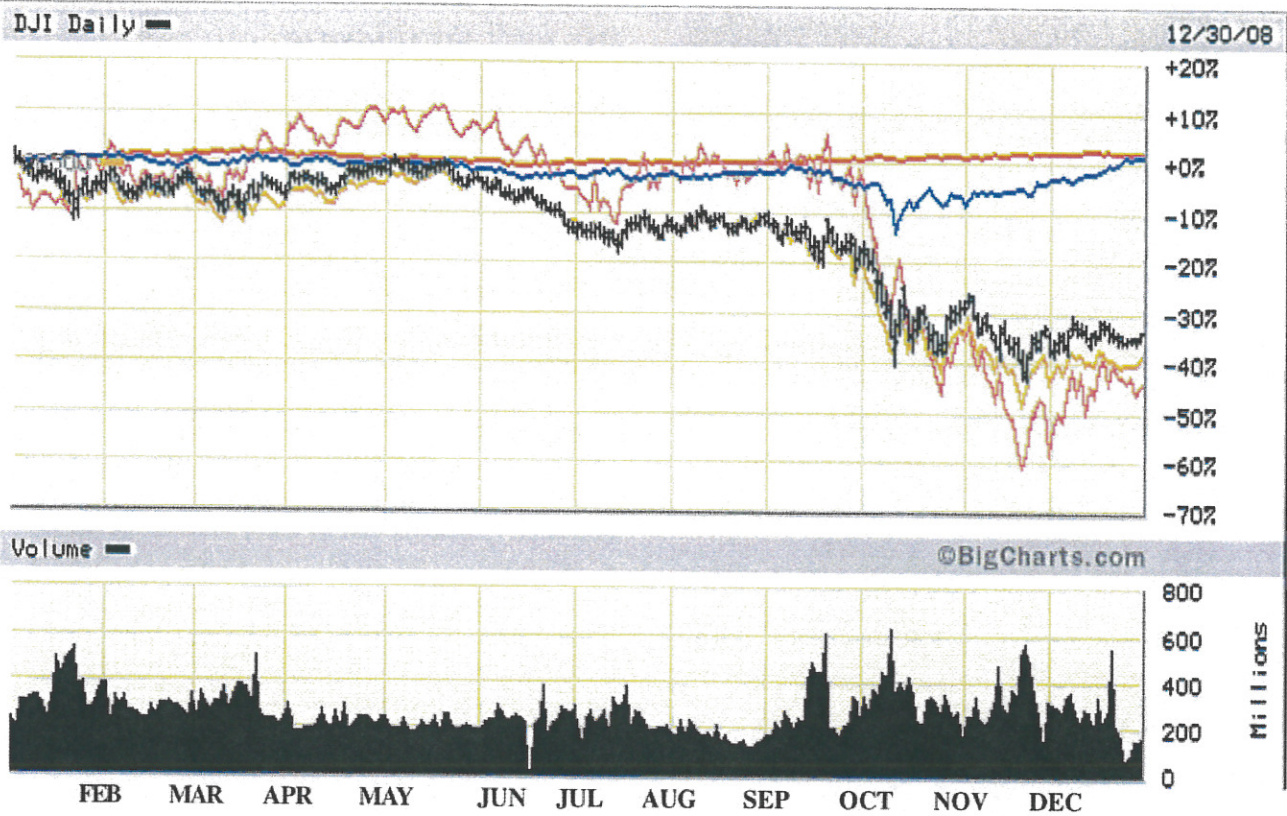
Important note: WE WILL CONTINUE TO USE THE TREND TOOL® TO GUIDE ANY MOVES WE MAKE. REMEMBER, IT FOLLOWS TRENDS. IT DOES NOT PREDICT MOVEMENTS IN SECURITY PRICES.

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Where We've Come From... (continued from page 5)

Severity of the Recession	Possible Events	IAA Actions
Mild Recession (3 to 9 months)	The \$700 TARP is successful. Credit becomes easier to obtain. As money begins to flow, businesses begin to expand, orders for durable goods pick up and things will quickly return to normal. Stocks stop falling and level off or begin to climb. Bond prices fall but municipals rise. Little or no inflation.	<p><u>We're already past this point.</u></p> <p>Staying in 1-3 year Treasuries, Total Bond Market Index and cash positions.</p> <p>7/08 - 1/09 - 3.5% average yield and small capital gains.</p>
Moderate Recession (9 to 18 months in length)	This would involve more than just the US. World economies will continue to retract, oil prices will fall back to below \$40/bl. Congress will add \$1 trillion more stimulus but because credit conditions are still tight for mortgages and car loans there are continued foreclosures, Detroit automakers will be unable to meet their obligations to their retirees and many plants will be closed. Small banks will fail and unemployment will reach 8%. Wealth effect negative as stocks drop 7.2% (12/08 to their lowest point (8.4 trillion lost in US equities). In Washington, the new administration passes more regulation including national health care. Higher taxes and national debt are in store but may be delayed.	<p><u>We're Here Now!</u></p> <p>During the next 2 to 6 months we will begin to lengthen durations in short term positions to 5-7 and 7-10 years. We will also be looking at agency and AAA corporate bonds. We will buy muni index funds and targeted state funds. We will be carefully watching the historic values and spreads over Treasuries.</p>
Severe Recession (1½ to 2 years in length)	Foreign governments money supply increases. Inflation tops 10% as does unemployment. Inflationary effects last for several years. Many businesses will fail. Hedge funds may disappear. The federal government will give up on TARP and begin a public works program to put people back to work building "green" projects intended to make energy sustainable. Many airlines will go out of business and only the very wealthy will be able to afford air travel. Credit card giants Mastercard and Visa will fail.	<p><u>Let's Hope This Doesn't happen:</u></p> <p>At this stage, global sovereign debt will be 10-20% of our fixed positions. We will be experiencing a falling dollar and higher interest rates. Time frames of 6 to 12 months.</p> <p><u>For Growth investors only:</u> We will slowly reposition a portion of our accounts into S&P 500, MSCI EAFE, and Asian securities with moderate risk.</p> <p><u>For Moderate & Conservative Investors:</u> We will remain in U.S. Govt. and foreign gov't debt securities until economic growth is evident.</p>

Significant Indices for Year-to-Date 2009



- DJI – Dow Jones Industrial Average
- SHY – iShares Lehman 1-3 Year Treasury Bond
- VNQ – Vanguard REIT Index ETF
- AGG – iShares Lehman Aggregate Bond
- SPX – Standard & Poor's 500 Index

Market Activity

Market Indicator	Prices			Percent Changes	
	12/31/2007	9/30/2008	12/31/2008	Last Year	Last Quarter
1 Ounce of Gold (<i>London PM Fixing</i>)	833.75	902.00	843.50	1.2%	-6.5%
Technology Oriented Stocks (<i>NASDAQ Index</i>)	2107.05	2183.34	1530.24	-27.4%	-29.9%
Small Company Stocks (<i>Russell 2000 Index</i>)	771.76	704.79	476.77	-38.2%	-32.4%
International, Global Stocks (<i>EAFE Index</i>)	2254.05	1672.49	1210.76	-46.3%	-27.6%
Large Company Stocks (<i>S&P 500 Index</i>)	1478.49	1213.01	872.80	-41.0%	-28.0%
Higher Yielding Stocks (<i>DJ Utilities Index</i>)	537.17	445.11	359.43	-33.1%	-19.2%
High Yield Bonds (<i>M.L. High Yield Index</i>)	847.30	784.63	606.76	-28.4%	-22.7%
Tax Free Municipal Bonds (<i>Bond Buyer Index</i>)	111 25/32	102 8/32	97 8/32	-13.0%	-4.9%
Long Term US Gov't Bonds (<i>Lehman Index</i>)	1772.07	1790.91	2109.97	19.1%	17.8%
Inflation (<i>Consumer Price Index</i>)	210.00	219.10	210.20	0.1%	-4.1%

All indices are unmanaged and not available for direct investment by the public. In addition, past performance is not indicative of future results.



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