PREMIER FINANCIAL PLANNING, INC.
Planning Makes It Possible℠
A Registered Investment Advisor

3rd Quarter 2012 Commentary | *October 2012*

A Late-Summer Glow: Every major U.S. stock mutual fund category enjoyed strong third–quarter gains. But unresolved economic and political concerns are weighing on investors as the year draws to a close. Will QE3 help or hurt in the long run?

A Bumpy Road Ahead

While the stock market continues to be worried about the major ongoing issues of euro-zone inertia, uncertainty surrounding the U.S. election, the danger posed by the "fiscal cliff" of tax-cut expirations and looming federal-spending changes, and now the Federal Reserve's third round of quantitative easing, it showed strong resilience with pockets of healthy economic activity with positive housing data and stronger money inflows. Regardless of the outcome of the election, we expect increased volatility going into the first quarter as the president and Congress wrestle with fiscal responsibilities and avoidance of the fiscal cliff. Pressure for an agreement has become so intense that most investors assume Congress and the president will deliver a plan after the election. Moody's Investor Services said in a 9/11/12 report that it will downgrade the U.S. rating next year if Congress doesn't come up with a way to stabilize the growing debt. Should the U.S. go over the fiscal cliff, Moody's said it would wait to see if "the economy could rebound from the shock" before giving the nation a stable outlook.

Will Inflation or Deflation Prevail?

The answer to this question determines portfolio construction. With a "titanic battle" underway between inflationary and deflationary forces, expectation is that inflation is about three times more likely, but we do not see a return to the extreme inflation of the 1970s.

Deflation: Debt and deleveraging drives deflation. The last 40 years have seen debt balloon at every level of the economy – from individual debt all the way up to the country's debt as a whole. In a talk recently delivered by Bill Gross (founder and managing director of PIMCO), he likened countries with debt in excess of their GDP, like Greece, Italy, and Spain, to individuals with sub-prime mortgages on overvalued homes. In both cases, it became quickly obvious that they couldn't support that type of debt and were heading toward bankruptcy. Gross blames the current state of the worldwide economy on the "natural tendency of the global financial markets to deflate very risky, highly indebted" entities – whether they happen to be individuals, institutions or countries. With no intervention, the world would continue its "downward spiral," with decreasing asset prices and increasing defaults, just like the 1930s.

Inflation: Having already cut interest rates deeply, the Federal Reserve, ECB and other central banks are warding off chaos by adopting a policy of quantitative easing – buying Treasury bonds, mortgages, and other assets with newly created currency. Gross identifies this as the government's "attempt to reflate" the economy. The Fed, with Ben Bernanke at the helm, has managed to maintain a 2% rate of inflation for the U.S. in the face of powerful deflationary forces. Though he acknowledges that, so far, this "simplified version of the trickle-down theory" has succeeded, Gross does not expect a change in strategy until unemployment drops below 7% or inflation approaches 2.5% at an accelerated rate. He believes both of those are a long way off.

Sept 30, 2012 Benchmark Returns

2012	3rd Quarter
Large-Cap US Indices	
Dow Jones Industrial	5.02%
Standard & Poor's 500	5.76%
NASDAQ Composite	6.17%
Russell 1000 Growth	6.11%
Russell 1000 Value	6.51%
Small-Cap Indices	
Russell 2000 Growth	4.84%
Russell 2000 Value	5.67%
Large Cap International Indices	
MSCI EAFE (Local Currency)	3.90%
MSCI EAFE (US Currency)	6.92%
Fixed Income Indices	
Barclay's Cap Aggregate Bond	1.58%
Citigroup World Govt. Bond	3.98%
Real Estate Indices	
Dow Jones US Select REIT	-0.38%

* *Index performance is provided as a benchmark only. The performance of your individual portfolio will vary from that of any one index. Past performance of an index is never a guarantee of future results.*

When is There Too Much Debt?

Total U.S. federal debt recently surpassed the $16 trillion mark. This debt level has become an important election issue, especially since several European countries are in financial crises because their debts increased to unsustainable levels. Many investors are concerned that the U.S. could experience similar problems if the newly-elected Congress does not seriously address the debt and deficit issue after the election. But how much debt is too much? There is no major debt number that is too big. The answer depends on economic conditions much like driving speeds depend on road conditions. When driving through a neighborhood with stop lights, 35 mph is an appropriate speed. But on the highway, where there are no stops, a faster speed is appropriate. Similarly, in a weak economy, low debt levels are less of a burden, whereas in a strong economy, investors are often willing to fund high debt levels. History shows that debt becomes too great when future economic prospects deteriorate and investors worry that the government cannot support that debt. At that point, interest rates often increase to attract unwilling investors. Those higher interest rates can lead to even more borrowing to service that debt. When that happens, investors may worry that the debt is even more unsustainable.

To compare debt levels with economic conditions, many investors look at the amount of debt that needs to be financed relative to the size of the economy as represented by yearly gross domestic product (GDP). In the United States, only $10.8 trillion of the total outstanding debt needs to be financed by investors. The remaining $5.2 trillion is nonmarketable debt held in government trust funds. The U.S. economy is currently producing more than $15.6 trillion of output or GDP. That means that the marketable debt-to-GDP ratio is a little less than 70% of GDP. This compares with 163.3% of GDP for Greece in 2011, 100.4% of GDP for Portugal in 2011 and 99.5% of GDP for Italy in 2011. This comparison indicates that the U.S. is not at the same crisis point faced by several European countries. The key to keeping U.S. debt levels sustainable will be to reduce the federal deficit to the point that federal debt is growing slower than the economy is expanding. At that point, the federal debt-to-GDP ratio would decline, making U.S. debt potentially more sustainable.

Continue an Asset Allocation Strategy with Sufficient Cash Reserves

Our continued recommendation is to maintain an asset allocation strategy with investments that will help offset the impact of both an inflationary (equities) and deflationary (bonds and tangibles) climate *and* to hold sufficient cash reserves for any short term cash flow needs.

Enclosed Investment Reports

3rd Quarter 2012 Reporting:

- *Aggregate Overview; Current Value, Asset Allocation and Performance; summarized by Portfolio and Combined Portfolios, as applicable*
- *Holdings Analysis by Account; summarized by Asset, Account and Asset Allocation*
- *Statement of Fees* for the 4th Quarter 2012 (based on 09/30/12 values)
- *Disclosure Statement*

Please remember that this investment reporting is for informational purposes only and you should also refer to the investment statements you receive from your brokerage custodian. Benchmark returns listed on page one are per 9/30/12 Morningstar *reported values.*

As always, we appreciate your continued confidence and trust. Should you have any questions or concerns, please contact us.

Best regards,

Patricia C Patterson

Patricia C. Patterson, CFP®, CMFC®