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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

Around this time last year, the markets were struggling with the potential downgrade of US Treasury debt. Investors were wringing their hands and gnashing their teeth about the potential ramifications. Just what would happen if the ratings organizations took the Treasury from AAA down to AA+? The general consensus, as fueled by the broadcast media, was it couldn't be good.

Those of us who have been in this industry long enough know a downgrade of that, um, magnitude is the financial equivalent of a heaping helping of "so what." I am not trying to be cavalier, but borrowing costs for a solid AA+ credit aren't through the roof. In fact, investors and bankers line up around the block to lend money to such credits. AA+? Would that all borrowers would have such a high credit rating. To put it in layman's terms, I would equate this type of rating to a personal credit score (FICO) of around 800.

Are borrowing costs significantly higher for someone with an 800, as compared to someone with an 825 or so? Not especially, if really at all, and I said as much to anyone who would listen last year. In fact, I even went as far as saying the impending downgrade would be analogous to the Y2K imbroglio. Yeah, everyone got into a lather about it, but, when the dust settled, so what? The world didn't end, did it? Of course not.

So, perhaps I was a little too sanguine about the situation, as I head off to the annual 'extended family' beach trip. S&P and Moody's would state the obvious, and we would all go on with our lives. Again, it would be a fizzle, or so I thought.

That first weekend, well after trading on Friday night, the shoe fell, and S&P did what we all knew it was going to do. My male in laws questioned me about the endgame, and I told them pretty much what I have already written. In fact, I was happy the inevitable was finally behind us, and I expected no real detrimental outcome from it all. You might remember what happened next.

The domestic stock market woke up on the wrong side of the bed Monday, as the Dow Industrials sank over 600 points. On the flipside, US Treasury securities rallied like absolute blankety blank crazy, with the yield on the 10-Year Treasury falling a full 0.24%. Trust me, that is a ton. What the heck? S&P downgrades the debt, and it rallies? At the same time, stocks fall apart? This didn't make sense; it was supposed to be a fizzle, an admission of what we all knew.

The rest of the week was a blur of phone calls, emails, interviews, and just general consternation as the markets flipped and flopped. There was, indeed, great gnashing of teeth and wringing of hands, and I almost cut my trip short on several occasions to drive back to the office...for appearances more than anything else, as we had sell tickets ready to go, just in case, and had raised a chunk of cash at the market open on that fateful Monday. Still, I told Beth I was going to go leave the beach IF futures were down on Thursday morning, and drive back to get them, Beth and the kids, on Saturday.

Fortunately, they were up, and I was actually able to relax the last day of my vacation. But what about since then? What has the impact of the downgrade been?

In a word, bupkis, or its alternative spellings: bubkes, bupkus, and bupkes. Basically, absolutely nothing.

Inside this issue:

Worry is the interest paid by those who borrow trouble.

George Washington

Something to Think About, *cont.*

Roughly one year later, the yield to maturity on the 10-Year Treasury Note is significantly lower than it was that fateful week, and the stock market is significantly higher. In other words, the markets have created significant wealth, and our borrowing costs have gone down. That is what you might call the old win-win. Hey, downgrade Treasury debt as much as you want if these are results 12 months out! Don't throw me in that brier patch!

For all the hype, and the initial consternation, we are no worse for the wear for the downgrade. In fact, outward appearances would suggest we are better off. However, there is a difference between spurious correlation and correlation. Further, there is a difference between correlation and causation. In the end, I would argue we were a bunch of worrywarts about the S&P downgrade, and, had we been rational about it, we would have seen it was really much ado about nothing. Where else are the Europeans, Chinese, and others going to put their excess liquidity? In countries whose balance sheets are even worse than ours? Not likely.

The purpose of this is simply: we have become a nation of pessimists. We view the world with dark eyes, and expect the worse. Hey, I am guilty of it as well, and have made a conscious decision to break out of the habit. It won't be easy; the data is far from robust, and the overall psyche of the country is far from encouraging. As I told someone the other day: "while I don't seen another 2008 financial collapse in the offing in the near-term, it is much easier to make the case for the worst case scenario than it is the best case scenario." Frankly, things are a mess, and we all know it.

However, there is an adage: "it is better to light a candle than curse the darkness." Then there is Maya Angelou's famous saying: "If you don't like something, change it. If you can't change it, change your attitude." There is a lot of truth to both of these, but they are nothing more than more poetic versions of: "Blank or get off the pot." Indeed.

Right now, as a country and as a society, those are our choices: 1) blank, or; 2) get off the pot. Unfortunately, we can't seem to decide which one. The future is uncertain and rife with worst case scenarios. Perhaps if we ignore our problems long enough; perhaps if we kick the can down the road a little further; all of our problems will disappear, and we can go back to the way things were. After all, isn't that really what all the fuss is about, really?

I think it fair to say no one wants to pay higher taxes or have their entitlements cut. I also think it fair to say a majority of people would say a strong, efficient military is better than the alternative. I don't know of anyone who thinks it a good idea for the government to shirk its promises and perceived obligations. Finally, I would bet you a plug nickel everyone would like to have a well-educated, well-paid, productive workforce and a vibrant, dynamic economy.

The trouble is no one can seem to make the numbers work, and make all of the above happen. Something has to give, and it will. Once we come to accept that; once we realize we will have to work harder for the riches we have been given, we can start the process of moving forward. The payouts will be less; the taxes will be higher; the military will have to shrink, and the education system will have to restructure to better reflect the needs of the global economy. Does this make anyone happy? Or course not.

Is it fair? On an individual, case by case basis, naw, it ain't fair. However, on aggregate, at the societal level, yeah, it is more than fair. Consider the penalties the NCAA recently doled out on the Penn State football program. Where they fair to the players, the cheerleaders, the vendors, and others who had absolutely nothing to do with the scandal up there? No, absolutely not, and no one could sensibly argue they are/were. It stinks, and I feel for these people, as they have been hurt through no fault of their own. However, was it fair to penalize Penn State for its alleged, intentional cover up of the scandal. I imagine most people would say it is.

But how do you penalize the institution without penalizing the people who make up the institution? You don't, and such is the case in America today. How do you reform, invigorate, and change the institution without reforming, invigorating, and changing the people who make it up? Again, you don't; however, is this necessarily a bad thing?

I am not certain it is.

Over the last several years, my economic presentations have been a little less than positive. I tell it like I see it, and what I see is analogous to a half-full glass of lukewarm water. It is what it is, but it still depresses the heck out of most everyone. Where is the good news?

About 18 months ago, I decided I couldn't leave people with such bad feelings, as it serves no purpose. It is one thing to tell the truth; however, it is quite another to tell the truth without giving any hope. So, now, in my closing remarks, I allude to a scene and passage from the movie “Field of Dreams.” It is a good choice of flicks, because most people have seen it, and it is weirdly uplifting, even though there is a lot of negative stuff in it….what with financial ruin, ghosts, and estranged family members (father and son), However, near the end of the movie, James Earl Jones has a soliloquy which contains the following:

> “People will come Ray. The one constant through all the years, Ray, has been baseball. **America has rolled by like an army of steamrollers. It has been erased like a blackboard, rebuilt and erased again**. But baseball has marked the time. This field, this game: it's a part of our past, Ray. It reminds of us of all that once was good and it could be again. Oh... people will come Ray. People will most definitely come.”

Now, Jones could read the back of a ketchup bottle and make it sound like Shakespeare. Still, that line in there, about America being an army of steamrollers, etc., is so very apt. When you go back through our nation’s history, you will find financial panics, the lack of efficient leadership, corrupt politicians, unpopular wars, even more unpopular taxes, and, really, disagreements on just about everything. Shoot, on May 22, 1856, Rep. Preston Brooks beat Rep. Charles Sumner with a cane to within an inch of his life on the Senate floor. And you thought today’s politicians don’t get along!

However, at every step along the way, Americans eventually took their medicine, went through some hard financial times, and came out the better for it all, mostly, on the other side. Yes, people lost fortunes in the Panic of 1837, the Long Depression of 1873-1896, the Great Depression in the 1930s, the 1970s and early 1980s, and this last go around. We have run massive budget deficits at numerous times in our history, but have always been able to work them back down to acceptable levels. The list goes on and on.

Still, everyone wants to think ‘this time is different.’ True, the causes might be different, but the end result is the same: financial stress. What do you have if you break your arm falling off a jungle gym? That’s right; you have a broken arm. Now, what do you have it you break your arm if you dive into a shallow pool of water? Well, you have a broken arm. Yes, the causes might be different, and, yes, the breaks themselves might be different, but what do you do? What is the result?

You put a cast on it; reduce the mobility, which inconveniences you for the duration of the healing process; and, then you take the cast off, and, hopefully, you will be as good as new. Right? In the process, you will have learned valuable lessons about jungle gyms and shallow pools, making you the smarter for it.

As such, I am trying my darnedest to turn my mental corner, to make that leap, and to wearing rose-colored glasses of some tint. We will eventually figure it out; we will come to some kind of common ground on what needs to be done, and we will start slowing working our way out of this situation. It won’t happen this year, if the political campaigning is indicative of anything, but it will when the 2014 elections roll around. November 4, 2014; mark it. That will be D-Day, one way or the other; right or left, conservative or liberal...it won’t matter, as we will ALL share in the responsibility, and the pain, of returning our nation to fiscal responsibility.

This won’t be fun, but it is necessary, and we will come out better on the other side. That is what has happened over and over again in our nation’s history. As Jones said in “Field of Dreams”: “It has been erased like a blackboard, rebuilt, and erased again.” But, make no bones about it, the United States of America is that proverbial steamroller IF only we believe it ourselves AND look at our problems soberly. Yes, we WILL have short-term dislocation, but 20 years from now I will be using goods, services, and technology which seem like science fiction today. That is the truth.

In the end, a year on, what has the S&P’s downgrade of US Treasury debt taught us? Are we any worse for the wear, for all the consternation? Hopefully, it has taught us we need to get our act together at some point, and, no, we really aren’t any worse for the wear. Hmm. Think about that.

IF we aren’t any worse off, indeed we are wealthier, and we still haven’t gotten our ducks in a row, hmm, imagine what will happen when we DO straighten this mess out! How much wealth can we make THEN? The mind boggles, if only you let it...if only you discard the negative vibe...if only you face up to reality, and aren’t scared about the future. If only we quit wringing our hands and gnashing our teeth, we will get it done.

Important Economic Releases

<table>
<tr><th>Release</th><th>Survey</th><th>Actual</th><th>Prior</th><th>Comments</th></tr>
<tr><td>Personal Income (June)</td><td>0.4%</td><td>0.5%</td><td>0.3%</td><td rowspan="10">All told, there was nothing in this week’s economic data to write home about. Sure, the Change in Nonfarm Payrolls was higher than expected; however, it still wasn’t what I would call real robust. In fact, you could pretty much say that about most of the releases this week: okay, but not bespeaking a rapidly growing, vibrant economy.

Even the FOMC meeting failed to surprise, even if the markets dallied and sallied afterwards.

In so many ways, the reports told us what we already knew: the US economy isn’t growing the way we would like for it to. However, it isn’t collapsing the way the people in the broadcast media seem to think either. All told, it is so much like PIMCO’s famed “new normal.” It is what it is, and what it is is not all that exciting one way or the other.

Sure, there are risks out there, and the worst case scenario is nightmarish. However, if all you did was worry about the future, you wouldn’t get anything accomplished, now would you?

In the end, we will have a positive week in the markets thanks to today’s massive, massive rally. The cause? People took off their sunglasses for one day, and saw it wasn’t really as dark outside as they thought.</td></tr>
<tr><td>Consumer Confidence (July)</td><td>61.5</td><td>65.9</td><td>62.7</td></tr>
<tr><td>ISM Manufacturing (July)</td><td>50.2</td><td>49.8</td><td>49.7</td></tr>
<tr><td>FOMC Rate Decision</td><td>0.25%</td><td>0.25%</td><td>0.25%</td></tr>
<tr><td>Total Vehicle Sales (July)</td><td>14.00M</td><td>14.05M</td><td>14.30M</td></tr>
<tr><td>Initial Jobless Claims</td><td>370K</td><td>365K</td><td>357K</td></tr>
<tr><td>Factory Orders (June)</td><td>0.5%</td><td>-0.5%</td><td>0.5%</td></tr>
<tr><td>Change in Nonfarm Payrolls (July)</td><td>100K</td><td>163K</td><td>64K</td></tr>
<tr><td>Unemployment Rate (July)</td><td>8.2%</td><td>8.3%</td><td>8.2%</td></tr>
<tr><td>ISM Non-Manufacturing (July)</td><td>52.1</td><td>52.6</td><td>52.1</td></tr>
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Tables & Data Points

STOCKS	Dow Industrials	S&P 500	NASDAQ	Russell 2000	Nikkei 225 (¥)	DJ STOXX 50 (€) Price
12/31/10	11,577.51	1,257.64	2,652.87	783.65	10,228.92	2,792.82
12/31/11	12,217.56	1,257.60	2,605.15	740.92	8,455.35	2,216.55
7/12/12	12,573.27	1,334.76	2,866.19	789.62	8,720.01	2,228.01
7/19/12	12,943.36	1,376.51	2,965.90	802.17	8,795.55	2,302.45
7/26/12	12,887.93	1,360.02	2,893.25	777.11	8,443.10	2,251.05
8/2/12	12,878.88	1,365.00	2,909.77	768.60	8,653.18	2,263.36

BONDS	3-Mo UST	6-Mo UST	2-Yr. UST	5-Yr. UST	10-Yr. UST	30-Year UST
12/31/10	0.13	0.19	0.60	2.01	3.30	4.34
12/31/11	0.01	0.06	0.24	0.83	1.88	2.90
7/12/12	0.10	0.15	0.26	0.62	1.48	2.56
7/19/12	0.08	0.13	0.22	0.61	1.51	2.61
7/26/12	0.10	0.14	0.23	0.59	1.44	2.50
8/2/12	0.09	0.13	0.23	0.61	1.48	2.55

OTHER	Prime	Fed Funds	3-Month LIBOR	Gold/troy oz.	Oil—WIT/brl.	$/Euro	JPY/$	$/GBP	CAD/$
12/31/10	3.25	0.25	0.30	1,421.40	91.38	1.337	81.19	1.559	0.994
12/31/11	3.25	0.25	0.58	1,566.80	98.83	1.296	76.99	1.551	1.017
7/12/12	3.25	0.25	0.46	1,565.30	86.08	1.220	79.31	1.543	1.019
7/19/12	3.25	0.25	0.45	1,580.40	92.66	1.228	78.59	1.573	1.007
7/26/12	3.25	0.25	0.45	1,615.10	89.39	1.228	78.22	1.569	1.010
8/2/12	3.25	0.25	0.44	1,587.40	87.13	1.218	78.24	1.552	1.007

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