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THE GREAT AMERICAN DEBT

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The newspapers are full of accounts of the great debt repayment going on in America. In the month of July, we consumers collectively paid down \$21.6 billion of our debt. This is the largest monthly drop in history. In fact, the rate of repayment has been accelerating all year. Excellent! This is a wonderful indication that people may be learning to live within their means. Or is it? Let's peek below the headlines.

From 1990 to 2008, total consumer debt rose from about \$800 billion to a peak around \$2.6 trillion. Since that peak last year, we have paid off about \$100 billion. While it's certainly a move in the right direction, it's also obvious that we have a very long way to go. At this rate, it will take us 25 years to pay everything back, and that's assuming no interest and no more is borrowed. Of course, paying everything off and becoming completely debt free is neither realistic nor desirable. Somewhere in between too little debt and too much lies some level that is "just right," and with luck, that is where we are heading.

There are many reasons for this frantic race to repay our debts and try to get them down to more manageable levels. We know that a significant amount of the total debt taken on by consumers was related to speculation in the real estate market and exists in the form of mortgages. Among those are the interest-only mortgages. These are mortgages in which the borrower is expected to pay only the interest on the loan for the first few years. After that, they must begin to make principal payments in addition to the interest. When that happens, it can significantly increase the monthly payment. For many, the new amount is simply beyond their ability to pay.

Credit Suisse estimates that there are in the neighborhood of \$900 billion worth of these mortgages outstanding, and that over the next two years about half of them will be required to begin making principal payments. Notice that \$900 billion is roughly 35% of the total of all outstanding consumer debt. To underestimate the significance of this issue could be disastrous. We are talking about a high probability of default on a huge chunk of all consumer debt in this country within two years time.

Of course, the original plan was to refinance or sell the house before the payment reset occurred, thereby never seeing these increased payments. I think we are all now aware of the problems with that plan. In order to repay the loan, one would have to sell for at least what was paid for the house. Even to refinance would require the value to be the same or higher than the purchase price. The likelihood of that being the case today is rather slim. The homeowner could pay the difference in cash, assuming they have it. Unless the house is sold, refinanced, or the owner can afford the new payments, the house will go into foreclosure.

Now if that doesn't give you a reason to want to pay down debt as fast as you can, I don't know what will. The banks all know this day of reckoning is close at hand. They are unwilling to lend money because they know they will need all they have to weather this new, huge foreclosure storm that is coming. If there will be no

money to borrow, then those with cash, being the only buyers around, will be able to buy whatever they want at terrific prices.

Meanwhile, as we are all trying to minimize our debts as best we can as fast as we can, what is the government doing? Why, they're going on the biggest spending spree in the history of the world, all with borrowed money and then sticking us with the tab. It's as though we are in a leaky rowboat, bailing water out with our little bucket, and Congress comes along to help us out by opening a fire hydrant and pouring water into our boat at full force.

Ronald Regan said, "The nine most terrifying words in the English language are: 'I'm from the government and I'm here to help.'" This is a marvelous example of what he meant.

So what is the plan? What should we do to make our way through the coming turmoil?

First, and most importantly, recognize that this is an opportunity. Fortunes will be made by some and lost by others in the next few years. I think that it's possible that the amounts and structures of debt may go a long way in determining who will wind up in each group.

Continue to reduce your debt as best you can. It is a great irony that spending by consumers is needed to strengthen the economy, but preserving capital is what is needed to strengthen the individual. This letter is not about what is good for the economy. It is about what is good for you. What is good for you is to reduce your debt, increase your saving, and get ready to see and take advantage of lower prices on all sorts of distressed assets.

Watch to see which companies are doing the same things. Who's raising their cash balances? Who has plenty of cash on hand to service their debt and their expenses? These are the people and the companies who will be able to benefit greatly from the stresses we will see over the next few years. They are the ones who will be able to buy at the bottom. They will become the new leaders, able to move and position in ways their competitors cannot. And we, of course, will need to own those companies.

There will be times in the coming months that I will be raising cash again. Right now the greater focus needs to be on identifying the survivors, accumulating the new leaders as they emerge, and making and saving money whenever we have the opportunity.

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