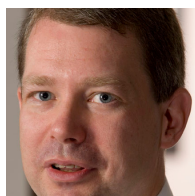


Parsec Financial

SECOND QUARTER 2011 NEWSLETTER

Portfolio Benchmarks



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SPECIAL POINTS OF INTEREST

- Expansions have been getting longer and recessions generally shorter.
- Social Security and Medicare programs are likely to see some future changes.

Starting in 2011, we are changing two of the equity benchmarks on our quarterly reports. We are removing the S & P 500 and Russell 2000, and replacing them with the Russell 3000. We will continue to display the MSCI EAFE (Europe, Australasia, and Far East) index of international companies.

What's the difference? The S & P 500 index consists of the 500 largest U.S. companies by market capitalization. Market cap is a measure of company size; it is simply the number of shares outstanding times the price per share. Since our client portfolios include small and mid-sized companies for diversification purposes, we believe the Russell 3000 is a better benchmark to use. It will make it easier for our clients to make an apples-to-apples comparison at a glance.

The Russell 3000 is a broader market index consisting of the 3000 largest companies in the U.S. by market capitalization. It is more reflective of the total stock market rather than only large companies. The Russell 3000 is

also what we use internally for portfolio management, including setting target weightings for various economic sectors and company sizes. We believe it is logical for our performance reporting to reflect the composition of the index that we use when managing client assets.

Client portfolio returns are best compared to a blend of the Russell 3000 for U.S. companies and the EAFE for the portion of the portfolio invested internationally.

We have also changed our fixed income benchmark from the Barclays Aggregate Bond Index to the Barclay Intermediate Government /Credit Index. We believe this is a better reflection of our client's fixed income holdings with regard to the maturities and types of securities that we purchase. For example, the Intermediate Government/Credit Index does not include mortgage-backed securities, which we typically do not invest in.

These minor changes should help clients better understand how their portfolio compares to a more relevant index for benchmarking purposes. If you have questions, we invite you to contact your advisor.

Dr. Jim Smith's Economic Commentary



Dr. James F. Smith

CHIEF ECONOMIST

Stop Worrying and Enjoy the Ride

We now have official confirmation from the Bureau of Economic Analysis (BEA) that the recovery from the 2007-2009 recession was fully accomplished in the fourth quarter of 2010. The U.S. economy went down from December 2007 to June 2009, a period of 18 months, and has grown steadily, at least on a seasonally adjusted basis, ever since.

That means it took 18 months of economic growth to recapture all the ground lost in the preceding 18 months of decline. That sounds pretty much like a “V-shaped” recovery to me, a notion that was widely derided as impossible by all the purveyors of “gloom and doom” who dominate the media coverage of the economy.

There are two facts about the U.S. economy that you should always keep in mind. The first is that for over 100 years now, expansions have been getting longer and recessions generally shorter and much farther apart than before. The second is that once economic growth has been reestablished, it tends to continue for a long time. The best evidence of this is the economic record for real GDP from the start of 1983 through 2010.

That's a period of 28 years or 112 quarters. Of those 112 quarters, one (the third quarter of 1990) came in with a percentage change of 0.0. There were only nine quarters with declines. The other 104 quarters posted positive rates of growth on a seasonally adjusted basis ranging from 0.1 percent (the third quarter of 2006) to 9.3 percent (the second quarter of 1983).

That means periods when the economy has been growing over the past 28 years are slightly more than ten times as common as periods of stagnation or decline. Yet those dastardly “nattering nabobs of negativism” are always trying to convince us that disaster is just around the corner except for those relatively rare periods when we are actually in a recession.

The official chronology of business cycles from the National Bureau of Economic Research (NBER) gives a longer term perspective. Since the first official trough in December 1854, there have been 33 business cycles in the U.S. For all those cycles, the average is 42 months of expansion for every 16 months of decline.

From 1854 to 1919 there were 16 cycles. They averaged 22 months of declines for every 27 months of expansion. That period includes the longest recession in U.S. history, the 65-month long original “Great Depression” of October 1873 to March 1879 and the ensuing 38-month long recession of March 1882 to May 1885.

From 1919 to 1945, there were six cycles. These saw an average of 18 months of decline for every 35 months of expansion. This period included the 43-month long “Great Depression” of August 1929 to March 1933.

In the 1945 to 2009 period there were 11 cycles. These averaged only 11 months of decline compared to 59 months of expansion. This period included all three of the longest expansions we've ever had. The leader is the 120-month one from March 1991 to March 2001. In second place is the 106-month long one from February 1961 to December 1969. In third place is the 92-month long expansion from November 1982 to July 1990.

By contrast, the longest recession since World War II is the 18-month one from December 2007 to June 2009. That is exactly the same length as five previous recessions, which makes it very hard to understand why any intelligent observer would call it the “Great Recession.” Moreover, there have been six recessions longer than 18 months.

The U.S. economy has posted six straight quarters of economic growth entering 2011. My current forecast is for real GDP in the U.S. to grow by 3.4 percent on a year-over-year basis in 2011. My expectation is that we'll see growth pick up to 4.3 percent in 2012 and 4.8 percent in 2013.

The entire world needs to see good economic growth from the U.S. Europe remains mired in economic difficulties and is still well below its peak of economic activ-

ity set in 2008.

Japan, even before suffering the horrendous earthquake of March 11, which was the worst one ever to hit them with its 9.0 reading on the Richter scale, was experiencing declining real GDP. Indeed, their economic problems are so severe that many analysts believe their potential growth rate is a negative number. That is a terrible situation to be in and is really unprecedented.

Among the seven largest developed countries in the world (the U.S., Germany, France, the U.K., Italy and Canada in descending order of economic size), only Canada and the U.S. have reached new record levels of economic activity. Among all developed economies, only Australia did not experience a recession in the 2007 to 2010 period. They just had one quarter of declining real GDP and then went on to a string of new records. It helps to be an exporter of commodities that the entire world wants to buy.

The retail and food services sales report released by the Census Bureau on March 11 was full of good news. The total for these sales on a seasonally adjusted basis was \$387.1 billion, a new record for this series. Sales were 1.0 percent above the upwardly revised level for January and a huge 8.9 percent higher than February 2010.

Most major categories showed big increases from a year earlier; led by auto dealers with a stunning 25.9 percent increase. Not surprisingly, gasoline stations posted a 12.9 percent increase, all due to price increases. Non-store retailers had a 12.6 percent increase.

Building material and garden equipment and supply dealers saw a rise of 10.9 percent. Miscellaneous store retailers were up 10.5 percent.

Furniture and home furnishings stores sales were 4.0 percent below a year earlier in February. This is primarily a reflection of the very weak housing picture.

Electronics and appliance stores posted a 2.2 percent decline. This was caused by both lower prices for television sets and weak demand.

Total retail sales excluding food services finally were at new record levels first in January and then in February 2011. The latest total is \$346.3 billion, up 8.8 percent

from a year earlier. Before this year, the record was \$342.3 billion, set in November 2007, which was the last full month of growth before the recession began on December 16.

We received more good news on the economy from the Board of Governors of the Federal Reserve System on March 10. Their "Flow of Funds" report (the Z.1 release) showed that the net worth of consumers and non-profit organizations was \$56.8 trillion on December 31, 2010. This was up \$3.2 trillion (after rounding) or 5.9 percent from the \$53.7 trillion in the fourth quarter of 2009.

At the end of last year, this sector had total assets of \$70.7 trillion. Despite declines in their value, their homes remain the largest asset for consumers at \$16.4 trillion. Pension fund reserves came second at \$13.0 trillion. Third was corporate equities at \$8.5 trillion followed by time and savings deposits of \$6.4 trillion and equity in non-corporate businesses of \$6.3 trillion. Sixth was mutual fund shares of \$4.7 trillion.

Liabilities of the household sector at the end of 2010 were \$13.9 trillion. Home mortgage credit dominated this category at \$10.0 trillion. Second was consumer credit at \$2.4 trillion.

Household net worth was 4.9 times disposable personal income of \$11.5 trillion. Home owners had \$6.3 trillion of unborrowed home equity. That was 38.5 percent of the value of household real estate. This compares to 49.5 percent at the end of 2007 and 56.5 percent at the end of 2006, which saw the peak of house prices.

The household sector thus seems to be in good shape to keep the expansion rolling along. Employment, incomes and net worth are all rising. These are very good signs.

Inflation Is Not a Problem

All the hullabaloo over rising oil prices caused by the unrest in Tunisia, Egypt, Libya and other countries that has pushed up crude oil prices from about \$88 to over \$100 a barrel has all drivers in the U.S. complaining and many analysts who should know better voicing concerns about inflationary pressures. This is utter nonsense.

These people forget that inflation is a generalized rise in prices in a BROAD index such as the consumer price in-

dex (CPI) or the implicit price deflator for personal consumption expenditures (the statistic preferred by the FOMC). An increase in fuel prices is just a change in relative prices (meaning that oil prices have gone up relative to other items in the index), no matter what its impact on a broader index.

An increase in the relative prices of fuel compared to all other goods and services causes two types of reactions: 1) producers of fuels invest more in finding more oil and natural gas and 2) consumers look for alternatives (such as carpooling, public transportation, buying a diesel, hybrid or electric vehicle, walking or other measures to consume less fuel).

Only a few years ago natural gas prices were soaring. This led to an exploration boom that has resulted in such huge increases in supply that natural gas is now both cheap and plentiful.

It currently costs about \$1,000 to convert a normal passenger vehicle from burning gasoline to using natural gas, which costs less than \$2.00 a gallon at the moment. High-mileage drivers fed up with gasoline prices well above \$3.00 a gallon might be thinking about converting to natural gas.

While it's unlikely that we will find enough new sources of oil in the U.S. to eliminate the need for all of the ten million barrels a day we import from other countries, it is likely we could increase domestic supply dramatically by allowing offshore drilling as well as exploration in the Arctic National Wildlife Reserve (ANWR). Stepping up efforts to develop our oil shale deposits in Colorado and Wyoming should also result in greatly improved supplies of oil produced in the U.S.

Rising food prices have also become a concern lately. Once again, these are relative prices. Furthermore, a great deal of the problem is caused by our insane efforts to subsidize the production of ethanol from corn, thereby diverting corn from the food supply.

We now devote about 40.0 percent of corn harvested to the energy-inefficient and economically nonsensical production of ethanol. We have a \$0.45 subsidy for each gallon produced as well as a mandate from Congress to use 13.95 billion gallons of ethanol this year. In addi-

tion, we have a \$0.54 a gallon tariff on imported ethanol.

That keeps out ethanol from Brazil that is produced from sugar cane. That is an energy efficient process (less energy is used to produce the ethanol from sugar cane than it provides when used as vehicle fuel), making it economically sound.

Representative Jeff Flake (R-AZ) has introduced legislation (HR 426) to repeal both the ethanol subsidies and the tariff. It would also eliminate the mandate. It will be interesting to see if this effort makes any headway.

It would have to be enacted rather soon if it is going to pass. That's because the Iowa caucuses, which will be the first official part of the 2012 race for president, are not that far away. A lot of corn is grown in Iowa, which is the main reason we have our ethanol program in the U.S.

Of course, using more corn to feed people and animals would lower food prices around the world. It is quite ironic that one of the main reasons for the protests in Tunisia and Egypt was the high price of corn.

The Outlook Is Very Good

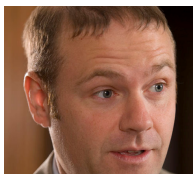
The recovery is over and I believe the U.S. economy will set new records throughout 2011, 2012, 2013 and beyond. We will see rising employment, growth in disposable personal incomes, retail sales, industrial production and business fixed investment among many positive economic developments.

Even if the growth in nonfarm payroll jobs were to get to the rather high level of 400,000 a month it would still take 20 months to get back to where we were before the recession. That is why no one expects to see new employment records on either measure before the latter half of 2013 at the earliest.

Still, there does not seem to be any reason why we won't see real GDP growth of 3.4 percent this year on a year-over-year basis. The growth rate should pick up to 4.3 percent in 2012 and 4.8 percent in 2013.

All of us will be very happy if that pattern turns into reality. Here's hoping it will.

The Government's Other "Debt" Problem



Rick Manske, CFP®

MANAGING PARTNER

During our meetings with clients we hear some recurring concerns. An increasingly shared view is of the desperate state of public finances, both Federal and State. Your concerns in this regard are understandable when one considers the extent of the debt levels and unsustainable trajectory at which our nation is adding to the accumulated debt. The United States is running a \$1.65 trillion budget deficit for the current fiscal year and has an accumulated debt of over \$14 trillion. Of the total debt, approximately \$9.5 trillion is debt held by the public, which is individuals, corporations, and state-local-foreign governments. The other \$4.5 trillion is intra-governmental debt, or debts that the federal government owes to itself. The largest portion of this is held in the Social Security and Medicare Trust funds (~ \$3 trillion).

The national debt and ongoing deficit is disconcerting, but the situation becomes much direr when one considers the third category of government indebtedness: implicit debt. This off-balance sheet debt represents the unfunded obligations of programs such as Social Security and Medicare. By unfunded we mean the amount of benefits promised in excess of anticipated revenues. It is difficult to calculate the amount of this debt, but it is incredibly large. By some estimates the unfunded obligations in Social Security now run more than \$16 trillion and Medicare, which is even more impossible to project, might be as much as \$85 trillion. To contend with these unfunded obligations would require legislative action to change them. This is particularly challenging because both programs enjoy favorable opinions by the majority of Americans who anticipate receiving their "entitlement", since they have paid in for many years.

The fiscal situation will require serious and prompt attention. We are likely to see significant tax reform in the coming years. Many of the proposals involve limiting tax deductions designed to encourage certain activities, thereby broadening the tax base.

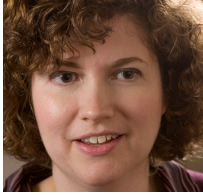
Social Security and Medicare programs are likely to see some future changes. The President's Fiscal Commission and Debt Reduction Task Force came out with some viable plans to improve the long-term solvency of Social Security.

- Gradually raise the amount of wages subject to payroll taxes;
- Change the calculation of annual cost of living adjustments;
- Keep increasing the age for the full retirement benefit.

Solutions to the unfunded obligations within the Medicare program are not so easily addressed. The rapid increases in health care spending that are part of our ever-expanding medical capabilities, rising demand by an aging population, and a somewhat inefficient delivery system are greatly straining State and Federal budgets. The baffling problem of improving health outcomes while reducing costs has proven to be a difficult task despite being analyzed by professional economists, physicians and policy makers. Some proposals suggest that we need the free market to help reign in abuses and inefficiencies, while others propose a single payer system that centrally controls the administration of healthcare. When combined with Medicaid, these entitlement challenges create budget problems that are likely to be with us for many years to come. Most improvements are likely to come from investment in information technology, tort reform, and end of life care and slower growth in reimbursements.

We at Parsec Financial believe that the unsustainable long-run budget outlook is a growing threat to our well-being and that inaction and stalemate are irresponsible. We know that the measures needed to address the long-run deficit are politically difficult, but think it is better to act sooner when adjustments can be made without too much pain, rather than later when adjustments are likely to be much harder.

Parsec Spotlight: Cristy Freeman



Cristy has been with Parsec since 1992 and acts as the firm's unofficial historian. In her time at Parsec, she has worked in nearly every area of the business. In her current role, she manages special projects, calculates the firm's performance data, coordinates IT activities and a multitude of other things. She rarely interacts with clients, but you may have heard the comment, "I'm not sure about that, I'll have to ask Cristy." She has been here longer than any other employee and will have 20 years with the firm in 2012. She was here when we only used one floor of our building - we now occupy three.

She is a rare thing in this area: a native. She was born in Madison County and enjoys her little country cottage there. She is an avid reader and a big proponent of adopting pets from shelters and rescue groups. All three of her pets are rescues. She maintains and writes for her own website, rescuepetsrule.com. Her goal, as she ages, is to evolve into the Hallmark character "Maxine." To that end, she has two cats and a little white dog.

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