



Quarterly Memo

April 2007

Of Special Interest:

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- Matrix relocation now set for May 16 1

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Will "Dark Matter" Avoid the "Big Bang"?

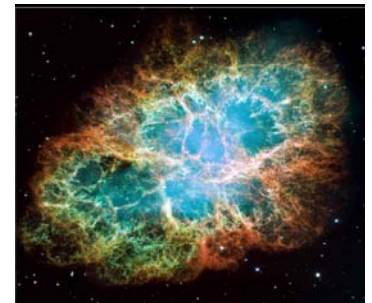
Cosmologists have discovered what the theologians have told us for millennia: a substantial portion of the created universe is invisible. The scientists know it's there – the mathematical calculations of what should exist in the cosmos based on the behavior of the visible universe versus what is observed show a significant gap. A substantial part of the universe consists of matter and energy that we

cannot physically sense or measure, yet we know it's undoubtedly there. The terms "dark matter" and "dark energy" describe these unseen components of our universe.

While the theological implications of this discovery may prove profound, that's not the point of this article. The "dismal science" of economics sometimes encounters situations that seemingly defy logic,

when the numbers don't add up and logic demands that they must. When observed behavior contradicts logical theory, perhaps the theory is

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Matrix Office Relocation Set for May 16

"On time and under budget!" Would you settle for one out of two? How about reasonably close? When decorators, architects, network engineers, and builders converge, things take a little longer. Our expected move date is now **May 16**.

Office Manager Donna Barrow and Jonie Parks, CFP® have skillfully coordinated the planning and execution of the move from the Matrix end. In addition, they have spent many hours on the task of selecting all new office

furnishings for the next location.

You will get to see first hand the results of their efforts on **June 15**, when we will host an open house of our new offices from 11:00 AM to 2:00 PM. Details will follow.

"After ten years of being housed in offices with our strategic CPA firm partners, I think the move to our own space is significant in both a real and symbolic sense," notes Matrix President Giles Almond. "We will

miss our BDO colleagues and will continue to work with them closely on mutual clients, but having our own space will be refreshing after cohabitating all these years."

The new address for Matrix will be:

831 East Morehead Street, Suite 760

Charlotte, NC 28202-2731

All other contact information will remain the same: phone, fax, and email.

Dark Matter (continued from page 1)

overlooking essential data.

Our concern about the mounting US trade deficit is no secret. We have tried to explain its cause as originating in our lack of domestic savings. We have highlighted it at various times in the past with scary charts that seemingly portend our economic demise.

Not that we are alone. Many economists have issued dire predictions for years about the impending debacle when the rest of the world decides to stop funding of profligacy. The trade deficit has been called an “unsustainable black hole” and a “sword of Damocles hanging over the global economy”. Another cheerful observer contends that, given the massive deficit, “The U.S. is now on the comfortable path to ruin.”

The numbers are scary. The twelve month deficit as of February was \$753 billion and around 5.8% of

gross domestic product. It's obvious that we are in serious trouble and it's just a matter of time before the dollar collapses and foreigners own the country. Or is it?

Two researchers at Harvard's Kennedy School of Government, Ricardo Hausmann and Federico Sturzenegger became intrigued that although the numbers were compelling, no crisis seemed to be developing. Why would foreigners continue to lend to the US with no perceived increase in risk?

Between 1980 and 2006, the US accumulated a deficit of almost \$6 trillion dollars. The latest available numbers from the Bureau of Economic Analysis indeed show the difference between foreign assets owned by our citizens and US assets owned by foreigners at roughly \$2.5 trillion. A reasonable person would expect the US to shell out billions of dollars in

interest, dividends, and various capital flows to the owners of that net \$2.5 trillion. Even a 5% return on that amount is \$125 billion – more than a rounding error! What surprised Hausmann and Sturzenegger was the fact that the US return on its net financial position is nowhere near that. In fact, according to the NY Federal Reserve, the number was *positive* through 2005 and was barely negative in 2006. How could we have a positive return when, in effect, we owe them more than they owe us? Could we be investing brilliantly in the rest of the world while foreigners invest poorly here? That's counter-intuitive.

Hausmann and Sturzenegger reviewed the history of the US return on its net financial position, assumed a 5% return, and attempted to infer the “real” net amount owed to foreigners.

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Volatility? What Volatility?

You would not sense it from looking at month-end numbers and returns, but we did experience some bumpy days in the equities markets last quarter. The S&P 500 index lost almost 3½% on February 27 and lost more than 2% on March 13. Yet

the quarter turned out just fine, as discussed in the First Quarter Investment Synopsis on page 5.

Are market movements of that magnitude unusual from an historical perspective? The answer is both yes and no,

depending upon what past period you look at. To create perspective, we analyzed the daily change in the S&P 500 index since 1970. Next, we calculated the standard deviation of returns for all

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Current Account Balance, % of GDP



Source: JPMorgan, BEA. Data as of 12/31/2006 and is reported quarterly. Current Account and GDP data reflect the most recently available as of 3/31/07 which is based on Q4 2006 economic activity.

“Something that's growing too fast forever will stop.”

**Herb Stein
1916-1999**

Volatility? Continued from page 2

9,414 trading days, which turned out to be .98% with a mean daily change of .04%. (Statistically, 68% of the outcomes lie within one standard deviation of the mean in a "normal distribution", 95% within two, and 99% within three.) So a daily market move of -3.5% is clearly a statistical "outlier". However, a movement of 2% is within the three standard deviation band of -2.91% to +2.98%, meaning it's a rare but expected occurrence.

Next we calculated the standard deviation of daily returns on a rolling 200 trading day basis. This

should give us a sense if recent volatility patterns are quiet and pastoral or violent and chaotic.

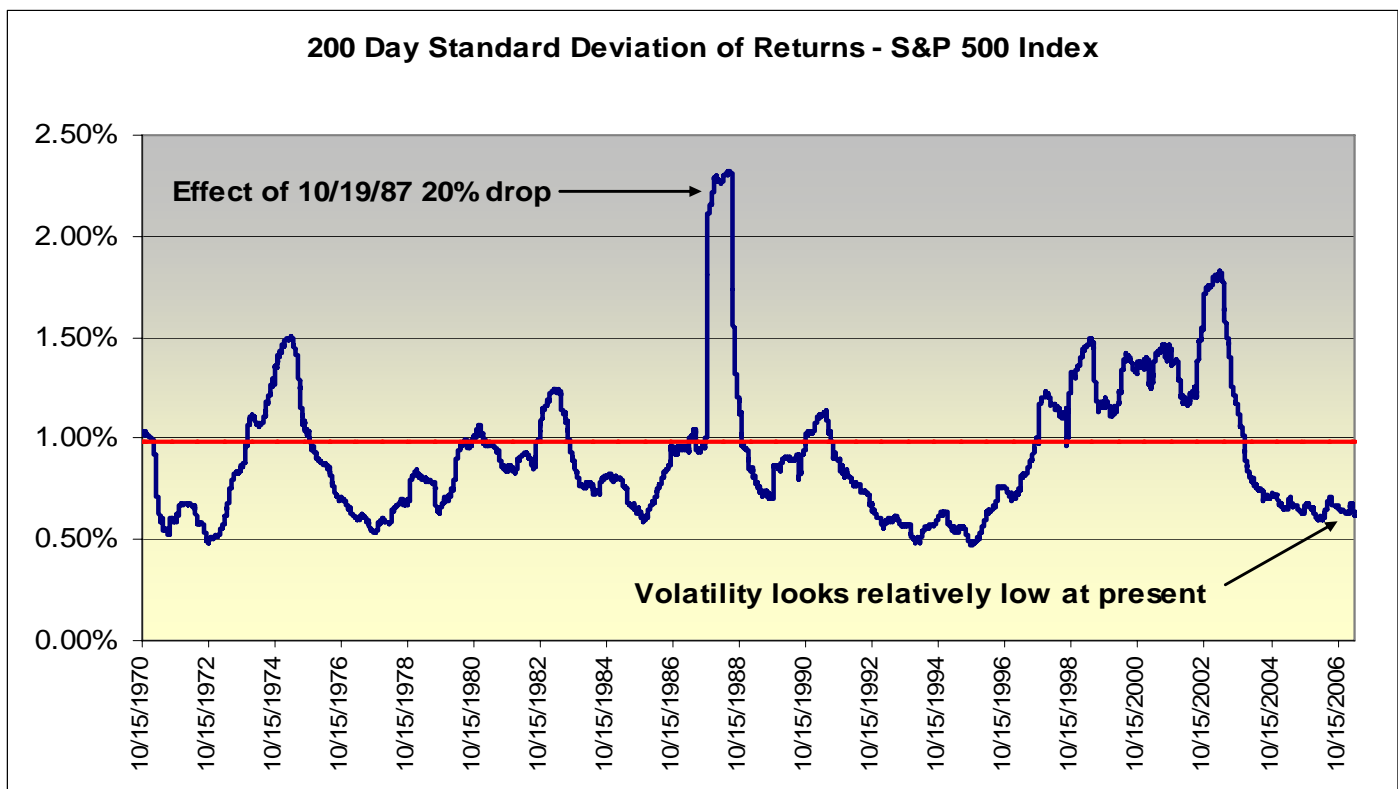
Our analysis indicates things have been relatively quiet lately. The 200 day standard deviation stands at .62%, considerably below the long term number of .98% and even below the median 200 day standard deviation number of .83%. So, from a statistical perspective, stock market volatility has been muted. If you believe in reversion to the mean, you should expect higher volatility in the future.

To put this in context, a

daily change of 130 points in the Dow Jones Industrial Average (currently at 12,962) should not even raise an eyebrow – that would be one standard deviation around the mean. Two and three standard deviation daily movements would translate into 250 and 380 point moves on the DJIA.

Of course, movements could be and have been even greater. Remember October 19, 1987? Statisticians argue that market returns are not normally distributed and outlying occurrences (so called "fat tails") are more probable than we would like to believe.

"...a daily change of 130 points in the Dow Jones Industrial Average (currently at 12,962) should not even raise an eyebrow..."



“Planning ahead versus waiting until a crisis or death offers more choices and a chance for thoughtful communication.”

“Who Gets Grandma's Yellow Pie Plate?”

Just before Anna Krueger was about to enter a nursing home at the age of 85, she held a family gathering to discuss who should get her personal belongings. With each of her four children gathered, Anna shared family history and stories that went with the important possessions in her life, wishes were expressed, and decisions made. Six months later when Anna died, her children not only held onto her possessions, but also the stories of her life. By making inheritance decisions ahead of time, Anna also prevented disagreements about who should receive what items.

Based on her experience with this and many similar families, Marlene S. Stum, Ph.D. Family Social Science at the University of Minnesota, has created ten rules for dealing with the sensitive issue of dealing with personal property distribution:

1. Recognize that decisions about personal belongings are often more challenging than decisions about titled property. Assuming such decisions are unimportant or trivial can lead to misunderstandings and conflicts.
2. Recognize that inheritance decisions can have powerful consequences, emotional as well as economic.

Decisions about personal property involve dealing with emotional and potential financial value connected to objects accumulated over a lifetime and across generations of family members.

3. When decisions are made prior to death, the decisions can reflect the owner's wishes, and special memories and stories may be shared. Planning ahead versus waiting until a crisis or death offers more choices and a chance for thoughtful communication.

4. Issues of power and control do not disappear in inheritance decisions. Unresolved conflicts among parents, adult children, siblings, and others are often at the heart of what goes wrong with inheritance decisions. Listen for feelings and emotions, watch for blaming, and determine if you can agree to disagree if conflicts arise.

5. Remember that different perceptions of what's "fair" are normal and should be expected. Those involved need to uncover the unwritten rules and assumptions about fairness that exist among family members.

6. Being fair does not always mean being equal. In fact, dividing personal property equally

is sometimes impossible.

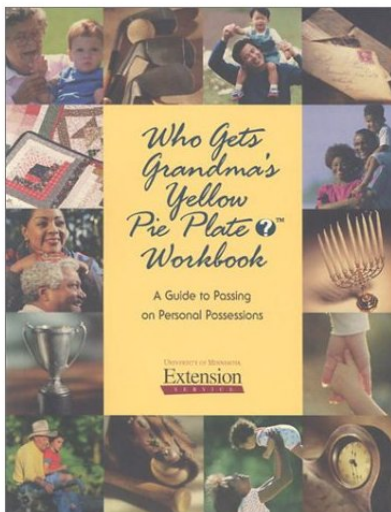
7. Individuals who have input and agree on how decisions are made are more likely to feel the outcomes of those decisions are fair.

8. Discussing what those involved want to accomplish helps reduce mistaken assumptions, misunderstood intentions, and makes choosing distribution options easier.

9. Identifying items that have special meaning can help avoid inaccurate assumptions about who should get what. Not everyone will find the same items meaningful.

10. Putting wishes in writing, typically in a separate listing mentioned in a will, reduces the dilemmas and decisions for estate executors and surviving family members.

All of us have heard of families ripped apart by misunderstandings over who gets a special possession from a loved one. Dr. Stum has written a workbook entitled *Who Gets Grandma's Yellow Pie Plate?* to help families plan ahead for this issue as well as help families dealing with it after the fact. It's available at no charge to Matrix clients – just let us know if you'd like a copy.



First Quarter Investment Synopsis

Following a rough patch in February, equities rebounded in March, putting returns back on positive ground year to date. The large company S&P 500 index was up 0.6% in the first quarter, while the small company Russell 2000 index gained 1.9%. Foreign equities continued their momentum, posting a first-quarter return of almost 4%. On the fixed-income side, the Vanguard Total Bond Market Index Fund gained 1.4% for the quarter. Commodity futures also performed solidly in the first quarter, with the PIMCO Commodity Real Return Fund up 5.6%. Managed futures funds had mixed results, with the MLM Index Fund down (again) while the Aspen Diversified Fund posted a gain.

What spooked investors, albeit temporarily, in the first quarter? After enjoying a seven-month run of mostly climbing stock prices, U.S. stocks fell sharply in the wake of an even bigger drop in the Chinese stock market on February 27. Investors were concerned that a slowing Chinese economy could foreshadow a slowdown in global growth. Another concern for investors is the housing market and associated problems in the subprime lending market. The worry there is that the rising defaults

could spread further weakness throughout the rest of the housing market, which in turn could hurt consumer spending, an important driver of the economy. Many fund managers overweighting financial services stocks turned in poor performances even though their portfolios had minimal exposure to subprime lenders.

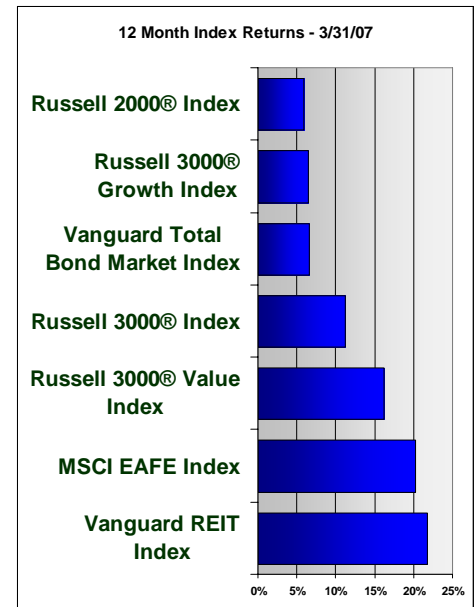
There has been much speculation over the long term effects of the problems in subprime lending. It's no secret that lenders have pushed the envelope in recent years to come up with loans to enable people to buy homes they would otherwise be unable to afford (some in my neighborhood). In so doing, many of these buyers have stretched themselves financially to the point where they have no margin for error. With rates having climbed, and low starter rates and temporary interest-only terms winding down or expiring, defaults among subprime mortgages have climbed sharply. Consider that loans in this segment accounted for 24% of originations in 2006, defaults in this sector are in the 13% to 14% range, and some subprime lenders have either experienced big financial losses or gone out of business. Firms we respect like PIMCO believe that this is a

meaningful source of risk to the housing market, since they are the first rung on the housing-market food chain. So on its face, rising delinquencies in a high-growth part of the market could be a serious concern.

Looking more closely, however, the picture is not as clear. The growth in subprime originations has moved in lockstep with a decrease in Federal Housing Authority loans (FHA borrowers are typically first-time home buyers who are unable to make a meaningful down payment). As of year-end 2006, more than 76% of all loans outstanding were still prime loans. This means that even if the combined subprime/FHA sector had a default rate of 20%—well above the prior peak in 2002—fewer than 5% of outstanding loans would be impacted. While this would be enough to cause pain, it would probably not be enough to result in a disaster for the economy.

The downside is more likely to be that defaults and tighter lending standards will mean that growth in the subprime arena will stall, as PIMCO predicts, and this could cause demand to sag further up the “food chain.” PIMCO believes—and this is one of the more bearish

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“...rising delinquencies in a high-growth part of the market could be a serious concern.”

Dark Matter [continued from page 3]

Based on these numbers, they concluded the inferred net financial position of the US was virtually unchanged since 1980 – almost as if there had been no deficits! This finding was totally at odds with the conventional wisdom that the US is rapidly becoming owned by outsiders as the deficit data alone would suggest.

So one set of numbers indicates the US is a net debtor to the tune of \$2.5 trillion, while another indicates a net zero or even positive position. How can you reconcile the two? Hausmann and Sturzenegger suggest the existence of “dark matter” – unaccounted net foreign assets. According to them, it’s the only way you can account for the fact that the US has continued to have net foreign earnings until just recently. To them, there is obviously something out there that is not being counted.

If one accepts the premise that dark matter exists, then what is it? One possible explanation is that it is a result of the export of our know-how. Let’s say McDonald’s opens a new restaurant in a foreign country at a hypothetical cost of \$1 million. Assuming a successful store, it

produces an annual profit of \$200,000. Because McDonald’s has brand recognition, proven systems, management expertise, research and development, and Ronald McDonald, it can earn excellent returns on its store investments.

How would such a scenario show up in the economic statistics? They would reflect a foreign asset purchase of \$1 million and \$200,000 of investment flows back to the US. What’s missing? At McDonald’s current cash flow multiple, the \$200,000 earnings stream sent back to the US is actually worth around \$2.7 million. In other words, around \$1.7 million of value has been created that doesn’t show up in the trade numbers anywhere. Put another way, Ronald McDonald created \$1.7 million of dark matter!

Can’t other countries do this in the US? Certainly - just look at foreign auto makers’ manufacturing presence in the US. But the argument is the US is still the world leader in profitably exporting ideas and expertise.

Hausmann and Sturzenegger go on to argue that dark matter is also created through the export of cash that is likely never to be returned. There is a

demand for US currency – there’s nothing else quite like it in the world. By providing this liquidity service (mostly to elements you’d rather not meet), the US has, in effect, made a \$300 billion interest free loan that will not likely ever be repaid – another component of dark matter.

Applying their analysis to the rest of the world, they find that net foreign assets including dark matter as a percentage of GDP have been steadily rising in Japan, are negative but improving in the European Union, and deteriorating in the rest of the world. They also calculate that, behind the US, the United Kingdom, Germany, and Korea are the top exporters of dark matter, while Russia, Ireland, France, Singapore, and Saudi Arabia are the top importers.

Can dark matter evaporate? Hausmann and Sturzenegger contend that since the underlying element of dark matter is the earning power of “know-how deployed abroad by US corporations”, we should not be worried. Their calculations show the US stock of dark matter to be rising on a fairly consistent year to year basis.

As you might expect, their study has attracted its share of critics.

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Creator of Dark Matter?

All contend that there are potential problems with the quality of relevant data on this issue, finding fault with both the data utilized and the conclusions reached by Hausmann and Sturzenegger. The critics' objections can be summarized as:

You Don't Need Dark Matter to Explain the Numbers.

A December 2006 paper by staff economists at the Federal Reserve Bank of New York, *Borrowing without Debt? Understanding the U.S. International Investment Position*, points out that U.S. foreign liabilities are almost entirely in dollars, while roughly two-thirds of U.S. foreign assets are denominated in foreign currencies. In 2002-2004, a weaker US dollar generated capital gains for the US, as the value of US assets denominated in foreign currencies rose. In 2005, the dollar strengthened, however, foreign equity prices dramatically outpaced those in the US. "All told, valuation effects have been enough to largely offset sizable net financial inflows from running current account deficits over the period."

What About "Dark Antimatter"?

The Fed economists make a good point that no real analysis has been done on the value

of foreign direct investment in the US. The value of BMW's Greer, SC plant that you pass on I-85, for example, is probably much more than its historical cost. The true "liability" owed to BMW should it sell the plant and take its money elsewhere isn't being reliably measured.

Dark Matter is Based On Unreliable Data

In a paper entitled *Dark Matter or Cold Fusion?*, Goldman Sachs economist Willem Buiter questions whether the net foreign investment income data so critical to the Hausmann and Sturzenegger analysis should be relied upon any more than the foreign direct investment asset and liability data that they discount. Buiter goes on to give his own version of the "dark antimatter" argument, pointing out that the same factors that allow American companies to create dark matter overseas should similarly allow foreign companies to create their own dark matter by locating operations in the US.

Conclusion

The late Herb Stein, Chairman of President Richard Nixon's Council of Economic Advisers, once famously quipped that "something that's growing too fast forever will stop". The concept of dark matter

may help explain why the sky has not fallen – yet. But the theory seems to be subject to reasonable doubt for the reasons outlined above, as well as others not discussed here. Our conclusion is that the concept is interesting and logically appealing, but it's not sufficient to allay our concerns over the magnitude of the current account deficit. Given the size of these deficits, they will eventually overwhelm whatever dark matter assets there may be. As we have stated before, the ultimate root cause of our deficit is lack of domestic savings and investment. To make the books balance, capital must be imported and a current account deficit is the result.

Why should you care?

Mainstream economists are divided on how our deficit problem will resolve itself – gradually or abruptly. We should hope for the gradual scenario. Otherwise, we could see a precipitous decline in the value of the dollar, leading to significantly higher import costs, dramatically higher inflation and interest rates, and a deep and lengthy recession. Is that a prediction? Hardly. While the probability may be small, the potential consequences are of such magnitude that we ignore the implications at our peril.

"Given the size of these deficits, they will eventually overwhelm whatever dark matter assets there may be."

Fourth Quarter Investment Synopsis (continued from page 5)

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views we've read—that we're still only in the middle of the housing downturn, and that this will ultimately cut roughly 1% from GDP growth over the next few quarters (and that there is at least some risk that it could be worse). Clearly that's not good, but it is also not as bad as the outcome many seem to expect given the extensive media hype that the problems have received.

Developments like a slowdown in China or a crunch in subprime lending would definitely impact the economy, perhaps significantly. The real question, though, is

not whether they will have an impact, but rather how much of that potential risk is already reflected in stock prices.

The price of a stock is the product of three variables: the earnings of the stock, how much one is willing to pay for those earnings, and how much one expects the earnings to grow. Currently, earnings are good and growing, but most expect a slowdown in the growth rate, even without some form of economic shock. The earnings multiple is currently 16-17, slightly above the long-term average. It could rise further, but we would give less than a 50% probability to that.

What this tells us is that although stock market valuations may not incorporate the possibility of a major slowdown in earnings over the next five years, they are probably in the right ballpark. Given this backdrop, we do not think it makes sense to be overly defensive, as we continue to expect equities to outperform bonds over the next few years. We continue to believe that intelligent and rational diversification is the only logical course of action given market valuations, ever present economic uncertainties, and the longer term risks we perceive from our national lack of saving and stubbornly persistent trade deficits.

About Matrix Wealth Advisors, Inc.

Planning is in the process of allocating limited resources among unlimited alternatives according to a system of values to achieve life goals.

Founded in 1990, Matrix uses a very personalized, principle-centered process to offer comprehensive financial planning and investment management services that help clients

take action and grow, to close the gap between where they are now and where they want to be. Matrix is a fee-only, fiduciary firm, compensated solely by our clients.



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