
December 2011: Endless Ironies, Challenges and Volatility**By John Goltermann, CFA, CPA****Ironies**

One of the major challenges of investing is that sometimes other investors do not act rationally. One needs to look no further than recent dynamics in the Treasury market for evidence of this.

Since the early 1950s, U.S. Treasury bonds were considered riskless investments – not necessarily from an interest rate standpoint, but from a creditworthiness standpoint. As America worked, invested and grew, the government remained a good credit. Its instruments, U.S. Treasury bills, notes and bonds, are backed by the “full faith and credit of the U.S. government.” The U.S. government has not had a problem rolling over its debt since that time.

In 2011, long-term Treasuries were the best performing asset hands down. Nothing else even came close. Of course, during this same time, U.S. Treasuries were downgraded, politics became more polarized, the debt expanded by about \$5 trillion (in 2011 alone on an accrual basis) and the general public became increasingly anxious about the amount of outstanding debt. The only reasonable explanation for the recent Treasury bond rally is that there is so much risk aversion that Treasury buyers are willing to accept the government’s guarantee of principal and interest as their best option in a world of high uncertainty.

Unfortunately, the recent Treasury bond buying spree has had the effect of enabling a confident feedback loop among politicians that validates their view that as long as financial markets are not objecting to reckless fiscal profligacy and lack of a debt-servicing plan, that the fiscal path must be sustainable. The rally is viewed as a *de facto* blank check to continue on their merry way of running \$1.3 trillion cash-basis annual deficits.¹

Essentially, the Treasury bond has become a safe haven by default – not by merit – in light of an ill-structured and unraveling Eurozone. Treasuries are also a parking place for financial institutions to redeploy their free loans from the Federal Reserve in order to earn a spread during times of risk aversion.

¹ This is the number that gets all the press, but further examination reveals that it is really a \$5 trillion *accrual* basis annual deficit – a number that gets very little press.

The price rise of Treasury bonds is in part due to a policy called financial repression, in part due to foreign buyers who purchase Treasuries to suppress their own currencies vs. the dollar and in part due to liquidity. While the full technical explanation of financial repression is beyond the scope of this commentary, suffice to say that the policy's goal is to artificially suppress interest rates to force savers to either accept negative real returns or put their savings into riskier channels. It's a form of discharging debts, and it has been shown to work in the past – but that was before entitlement programs grew to their current size.

Treasury bonds finance a \$15 trillion public debt, \$100 trillion of total liabilities and are paid in a currency that is issued by a central bank levered 50:1, mostly to the same instruments. Yet people don't seem uneasy about this and keep buying.

As investors, we are willing to keep our exposure to Treasuries to a minimum and forgo the prospective positive performance of this asset because, in our strong view, the fundamentals backing the long-term value of Treasury claims do not compensate our clients for the risk in constant-currency terms. To us, this is a game of musical chairs that we have seen before in banks stocks, mortgage-backed securities, tech stocks, Japanese stocks and Nifty Fifty stocks, to name a few. It is a belief system that stays in place... until it doesn't.

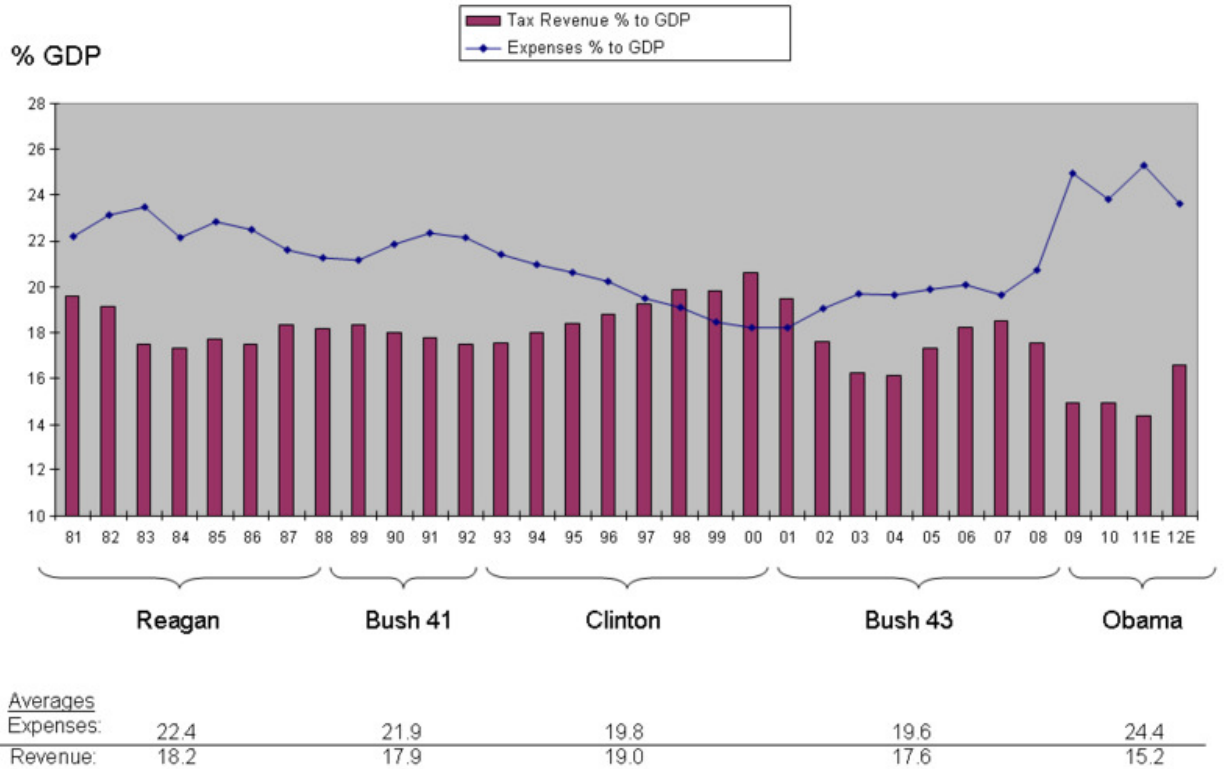
Technically, “full faith and credit” is an unconditional commitment to pay interest and principal on debt. It is backed by the U.S. government and is contingent on the government's ability to collect taxes, issue more debt or print currency to make good on those payments. We believe interest and principal will indeed be repaid. However, what “full faith and credit” doesn't promise is that these payments will be paid with sound money and a stable store of value. The money that makes payments on the debt are issued and backed by a central bank that has a huge portfolio of Treasuries on the asset side of its balance sheet.

The chart on the next page helps illuminate whether the Treasury bond itself is a money-good instrument. This chart shows that the budget moved toward being balanced during the late Clinton years of the 1990s. This balance, however, was an illusion and a product of politicking. For one, the economy back then was strong due to the wealth effect, confidence and the tech bubble – which was really a product of excess liquidity pumped into the system by the Fed because it was afraid of Y2K's potential economic fallout. Even more importantly, the Tax Relief Act of 1997 created the Roth IRA. This in effect enticed people to convert their IRAs to Roth IRAs, meaning the late 1990s saw future tax receipts brought forward into the current period. Since Federal budget numbers are accounted for *on a cash basis*, presto...the budget was balanced!

Later years lacked those tax receipts (that were paid in the late 1990s), and the budget was thus already vulnerable. Then we had 9/11 and, subsequently, the Iraq War, which brought tax cuts that in turn devastated the government's finances.

Because Treasury bonds have always been considered a “safe” investment, many are willing to lend to the Treasury (including the Fed itself); this means that there is no externally imposed discipline on Congress to run a balanced budget or demonstrate fiscal conservatism. We worry about the overconfidence and the ultimate threat to the value of a dollar because the Fed, in effect, is responsible for the irresponsibility of Congress – an irony that will be adjusted somehow, someday, sometime.

Federal Tax Revenue & Expenses as % to GDP (FY 1981 – 2012)

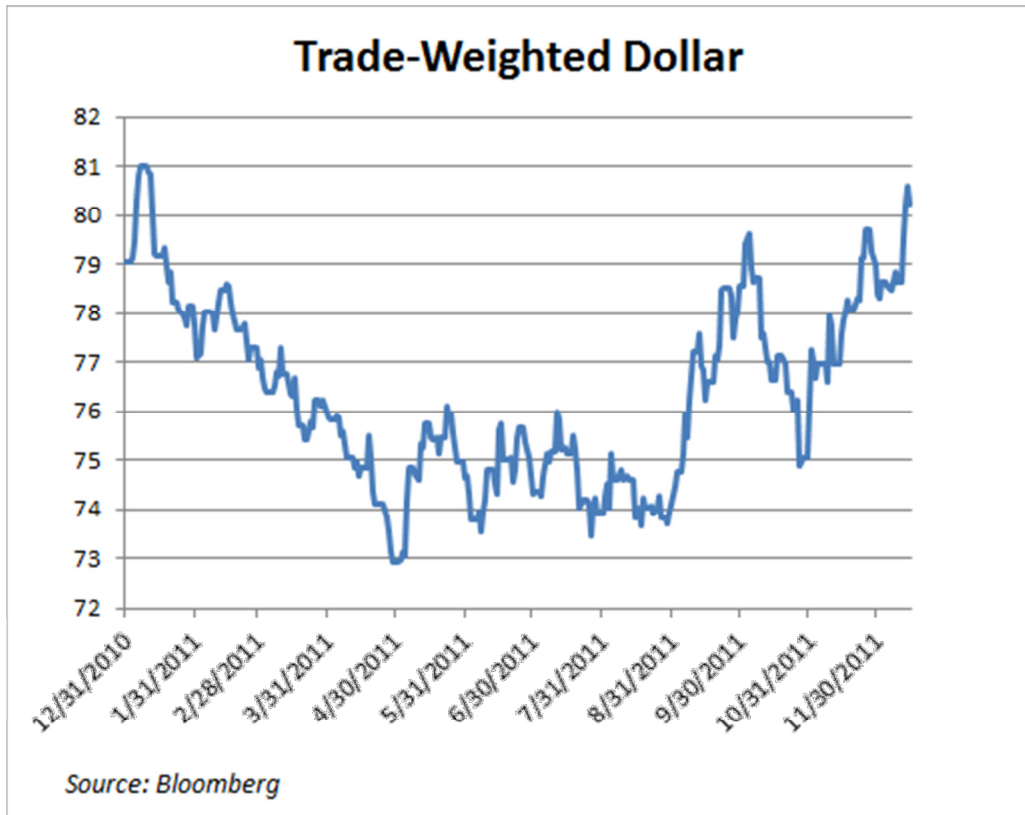


Source Data: Congressional Budget Office; 2011 Budget

Challenges

From a global perspective, the U.S. is in what may be the early stages of global currency wars. This partially accounts for gold’s run from \$275 an ounce in 2000 to \$1,575 today. In order to support their economies, the three major trading blocs (U.S., Europe and Asia-Pacific) would like weak currencies because it makes their exports cheaper to foreign trading partners. Strong economies also help fund governments through higher tax receipts. At the moment, the U.S. dollar is the strongest it has been in a year (basically because other major currencies are in

worse shape and because of deleveraging and general risk aversion), which we're sure the Fed is looking at, because it runs contrary to the Fed's objective of promoting economic growth.



Major financial institutions can borrow for free from the Federal Reserve and redeploy that capital where they see fit. Sometimes they finance housing, sometimes they buy commodities, sometimes they turn it around and re-lend it to hedge funds and sometimes they just buy Treasury bonds to earn the spread. In order to earn a return greater than Treasuries, however, they have to be confident that investment in other assets is worth the risk. When confidence deteriorates as it has recently, they (and everybody else) deleverage and pay back the dollar-loans that they used to fund their risk-taking. This helps explain the correlation between a strong dollar and a decline in asset prices.

Because of the Fed loans' current zero cost, the dollar – similar to the Japanese yen – has become a funding currency where it is used for leverage by global investors. Non-dollar investors hedge their exposure to adverse dollar moves by shorting their own currencies in the futures market vs. the dollar, then taking delivery of dollars when the loan is due. When there is a general deleveraging, they all need dollars to pay back their loans, so there is huge demand for dollars on a global basis and a price decline (because of sales) in other asset prices to source the needed liquidity.

A strong dollar is disproportionately bad for commodity prices, gold and other assets where investors use more leverage than normal. When we see sudden, adverse price moves in these asset classes, it usually does not speak to their fundamental long-term merits but instead is indicative of what is going on with global liquidity. When the dollar rallies, global liquidity is weak, and vice versa. A strong dollar also causes bank lending standards in the U.S. to tighten because declining asset prices impair banks' balance sheets and make them more reluctant to lend.

When liquidity is weak, as it is currently, the *best* performing assets are liquid, dollar-based ones such as Treasuries and large cap S&P stocks. Investors highly value the liquidity in these markets and perceive these investments as less "risky."

At the moment, with problems in the Eurozone and concerns of a potential euro collapse, global investors are deleveraging and demanding dollars. It's somewhat ironic that investors would do this because the Fed can expand its balance sheet without limit, but the European Central Bank *cannot* by its charter.

Many assets' prices are down as a result of the movement into dollars from euros because this move makes their leverage more expensive and those that use leverage become more risk averse. We're not sure where the line is in the dollar-euro relationship, but the weakening of the euro vis-à-vis the dollar has surely captured the Fed's attention. This will likely result in more quantitative easing in an effort to weaken the dollar, bolster the U.S.'s export economy, loosen bank lending and increase asset prices.

While it is easy to get consumed by recent market movements, it is more important to step back and take stock of the global economy. Indeed, the U.S. has improved its industrial competitiveness through cheap natural gas prices, cheaper labor, technological innovation and dollar weakness versus Asian currencies. While the regulatory environment could still use some relaxation, the future looks brighter in the U.S. economy (assuming the dollar doesn't strengthen much more).

It's questionable whether the Eurozone will remain in its current form. My opinion is that, despite the vast majority of Europeans wanting the EMU to work, the disparities between various Eurozone economies are too great and the current coalition likely will be restructured. As such, we may continue to see a strong dollar, weak asset prices and/or high levels of market volatility as Europe works through its problems.

During this very tricky period, we continue to stay away from busted growth stories such as Netflix, Research in Motion and Green Mountain Coffee, or *potential* busted growth stories. We will continue to avoid financial institutions and industrial companies that are too difficult to analyze because of high and rising input costs. We retain some exposure to what we view as high-quality, cyclical companies because they possess assets, resources or intellectual property

that are difficult to duplicate – and price declines to-date already largely reflect a significant slowing in the global economy.

A Word about Market Volatility and Gold Prices

Through globalization, derivatives contracts, technology, the shadow banking system, political incentives and similarly minded central banks, we get a high level of correlation among risky investments. The global financial system is a complex organism that possesses many hidden and unpredictable correlations. This is why the financial press has coined the term “risk on, risk off” to describe how investors (and asset prices) oscillate between euphoria and despair.

We understand why investors are skittish. A lot of daily trading is driven by machines that use algorithms and models to move capital around. Since volatility has effectively been taken out of the fixed-income market by the Fed and its cohort of large banks due to the large-scale Treasury purchases discussed above – *and because volatility has to go somewhere* – we see increased price swings in riskier assets such as stocks and commodities. We understand that this is disconcerting for individual investors and it causes many to want to opt out, but we still believe that a long-term investment approach is sensible, that intelligent risk taking will be rewarded and that well-managed assets and businesses increase in value over time.

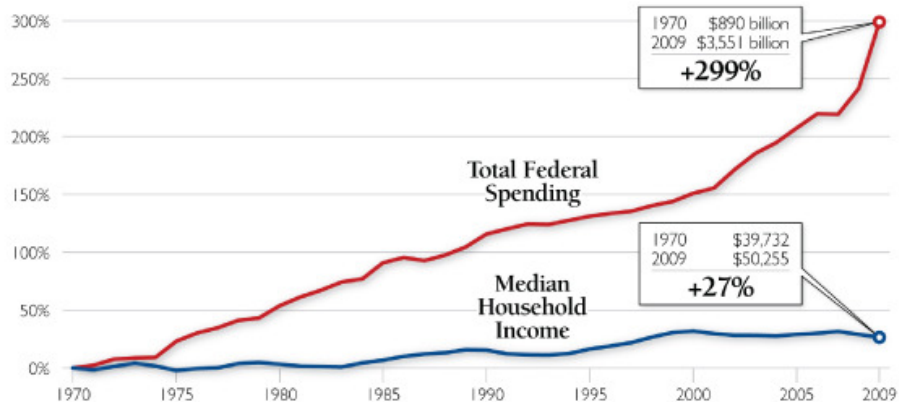
Gold is one investment that has experienced significant selling pressure in recent weeks, leading many to question its merits. We believe that it is still appropriate to hold gold because there is still too much leverage in the financial system and in governments for their central banks *not* to monetize debt. Furthermore, the gold market is dominated by leveraged participants, so huge price swings are the norm. Our *modus operandi* is as investors, not as traders, so we tend not to trade around short-term price moves because they cannot be predicted. Our goal, now as always, is to try to stack the odds in our clients’ favor and minimize opportunity costs.

If we look at gold’s bull market in the 1970s, it traded from \$35/oz. in 1971 (when the U.S. went off the gold standard) to \$200/oz. in three years. Over the next two years gold traded back down to \$100/oz., effectively being cut in half. Then, over the next four years it traded to \$800 in a euphoric market top. We do not see euphoria in the gold market at the moment, but rather we see much skepticism toward gold among the investment establishment. The same argument that gold has no intrinsic value is heard among professional investors, but they do not acknowledge that paper money has no intrinsic value either and can be devalued to the point of being worthless. This has happened frequently through history.

Federal Spending Grew More Than Ten Times Faster Than Median Income

When federal spending grows faster than Americans' paychecks, the burden on taxpayers becomes greater. Over the past few decades, middle-income Americans' earnings have risen only 27 percent, while spending has increased 299 percent.

PERCENT CHANGE OF INFLATION-ADJUSTED DOLLARS (2010)



Source: U.S. Census Bureau and White House Office of Management and Budget.

While the price of gold may go lower, there is a case to be made that it is cheaper now than it was in 2001 when it traded at \$275. While this sounds counterintuitive, if one thinks of the proliferation of financial assets that, in effect, were packaged bad loans that were created between then and now, as well as the expansion in governments' liabilities over the last ten years, the growth in the gold price is far less than the growth in the dollar amount of these unfundable debts. We continue to believe that, despite what happens in the near term, gold likely will be much higher (dollar lower vs. Gold) at some point in the future. While we don't like owning gold, we see it as one of the most efficient ways to hedge the negative consequences of what, in the end, is politicians' poor decision-making (or non-decision-making).

DISCLOSURE: Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be suitable for an existing or prospective client's investment portfolio. Therefore, no existing or prospective client should assume that future performance of any specific investment or investment strategy (including the investments or investment strategies recommended herein) will be profitable or equal any historical performance levels. Certain portions of our newsletter may contain discussions of recommendations as of a specific prior date. Due to various factors, including changing market conditions, such discussions may no longer be reflective of current positions or recommendations. Information included herein should not be construed as the receipt of, or a substitute for, personalized individual advice. A copy of our current written disclosure statement discussing our business operations, services, and fees is available upon written request.