

**August 2010: “If something cannot go on forever, it will stop”**  
*by John Goltermann, CFA*

This phrase, first uttered by Herb Stein, father of Ben Stein and economic advisor to Presidents Nixon and Ford, was a comment on policy decisions. What Stein meant was that policy initiatives to re-direct unsustainable trends are not needed because unsustainable trends stop all on their own. We think this will eventually apply to government borrowing, rapidly increasing entitlements and excessive consumerism and we want to be on top of the investment implications

The benign activity in financial markets of late may mask some important problems that lie beneath the surface. Moreover, the financial press, especially television, rarely reports on big picture issues, or warns about risk factors that are meaningful for long-term investors. As such, they cannot be relied upon to help construct portfolios that take into account today’s unique risks of deflationary pressures, policy responses, high levels of speculation and short-termism, excessive debt in the OECD, and improving terms of trade in the emerging markets.

Last week I attended a week-long conference sponsored by the CFA Institute (Chartered Financial Analysts) which featured numerous sessions with prominent economists, strategists and institutional investors. The common theme that resonated in these discussions is that the U.S. is not out of the woods by any stretch and the investment implications are many-fold. In preview, cash and Treasury bonds do not offer long-term protection, but certain holdings that retain their value in the face of a declining dollar should continue to perform well.

The combination of large-scale structural imbalances in the U.S. (namely excessive debt from a long period of overconsumption), the migration of some of our productive industries offshore, and the near-death experience of Wall Street has cost federal, state and local governments their relatively sound fiscal position (due to underperformance of asset markets and a massive increase in government size and scope). This in turn has brought about high levels of volatility and instability in financial markets.

Excessive consumption in the U.S. has benefitted the emerging economies tremendously and their role in the *global* economy has been elevated substantially. Emerging market countries such as Brazil and China are now leading the global recovery. Many of them now supply global markets (including the U.S.) with capital, commodities and increasingly, human capital and technical know-how. Most sport very low debt-to-GDP ratios.

*This is a major deal.* No longer are emerging market countries price-takers – they are price-setters on many fronts. This includes the price of their capital, which is in effect rented to global financial institutions due to their massive holdings of U.S. government and agency securities. As the emerging economies develop through investment (in infrastructure, R&D, equipment and education), these countries may decide that the opportunity cost of investing in U.S. loans is too great (especially given the currency risk) and better returns are available

within their own economies. This will likely result in across the board interest rate increases in the United States as they slowly begin to reallocate their reserves.

The U.S. economy being 70% based on consumption and possessing a 350% debt-to-GDP ratio (not including non-tradable liabilities such as Social Security and Medicare) puts us in a vulnerable position. Moreover, productivity improvements and an aging demographic (i.e. the baby boomers), many of whom have little or no net worth, may mean that unemployment will remain at very high levels for an extended period and the need for health care and retirement subsidies will be ever-increasing, requiring higher taxes and making our domestic businesses less competitive globally. Finally, because of excessive debt, the U.S. will probably not be able to impose tight monetary policy again in our collective lifetimes unless forced by a currency crisis and/or hyper-inflation, which would ultimately have to be dealt with through dramatic measures such as significant cutbacks on non-tradable liabilities like Social Security and Medicare or an outright default (with the latter being highly unlikely).

### **Implications for market returns**

Despite the challenges facing the United States, the U.S. market (as measured by the S&P 500) has held up relatively well because it is dominated by multi-national companies and U.S.-based banks that benefit from hugely accommodative monetary policy.

We, however, believe the S&P will lag investments tied to the improvement in living standards in the emerging markets (e.g., commodity producers and infrastructure businesses). This is because 1) currently proposed government policies may reduce earnings of certain industries (e.g., the proposed tax on multi-national corporations), and 2) the U.S. banking sector will have a difficult time achieving robust profit growth because accounting changes forced by Congress last year allows them to continue to defer asset impairments, hence needed write-downs will take place over a *long* period of time instead of a short one. The problem is that if banks wrote down impaired assets to their fair value, many would be insolvent.

An asset class which we view as highly vulnerable is U.S. Treasuries and cash. There is a belief at many levels of government that deficits don't matter because the U.S. can print the currency that we run the deficits in – and the rest of the world will absorb it because foreign markets depend on keeping their own currencies suppressed vs. the dollar (to support their export industries). While this may be true in the short-run, we view this as a misguided belief because it assumes that the only thing other countries have going are exports to the United States. Moreover, it assumes that the U.S. will continue to consume at the same level it always has and that commodity prices will stay the same.

Other governments see this and are speaking in uncharacteristically blunt terms about it for the first time:

Aug. 3 (Bloomberg) – U.S. Treasuries fail to provide safety or liquidity when it comes to managing China's \$2.45 trillion foreign-exchange reserves, said Yu Yongding, a former central bank adviser. "I do not think U.S. Treasuries are safe in the medium-and long-run," Yu, a member of the state-backed Chinese Academy of Social Sciences, wrote yesterday in an e-mailed response to questions. China is unable to sell the securities in a "big way" and a "scary trajectory" of budget deficits and a growing supply of U.S. dollars put their value at risk, he said.

This reality requires investment advisers to take a somewhat unconventional approach to investing for their clients and to create portfolios that looks different than the S&P combined with a ladder of bonds. We have to be cognizant of factors that influence the future value of a dollar given the U.S. fiscal position and the fact that the central bank is not constrained by any monetary standard such as the gold standard. There is a reason why dollars have lost 75% of their value vs. gold in the last 8 years.

Most investors (professional and non-professional alike) equate risk with volatility, but the best definition of risk is the probability of a loss times the *severity* of a potential loss in real terms – in other words, *after the erosion of purchasing power of the currency that the loss was denominated in*. If there is a currency crisis, the *real* (after inflation) loss in cash and Treasury bonds could be huge.

This leads us to the famous inflation/deflation debate. To watch CNBC is to hear most pundits make the case that the big risk these days is deflation – that we live in a deflationary world. Indeed, there was an article to this effect in this weekend's Wall Street Journal. The deflationists point to what is happening with banking lending, in the real estate markets and interest rates. More importantly, central bankers believe this argument and set policy accordingly.

Certainly there are deflationary pressures as the private sector is contracting and lending is anemic, but the deflationists ignore the offsetting increase in government borrowing that will ultimately need to be monetized because *it is unfundable from the tax base*. The deflationists also forget that the currency is not tied to a gold standard as it was in the 1930s.

Most importantly perhaps is the fact that *inflation is already occurring* in items that people need to maintain their lifestyle: food, energy, healthcare, insurance, legal services, entertainment, etc. In fact, the Shadow Government Statistics organization, which unwinds the effect of the government's manipulation of statistics, shows inflation (as it relates to a realistic basket of goods that people actually consume in the U.S.) is running about 7% at present. CPI, as calculated by the Bureau of Labor Statistics, is running around 1%. One can argue about the accuracy of 7%, but in our view, it is clear that the real rate of inflation is well north of 1%.

From an investment standpoint, this means that Americans are forced to put their capital to work in an environment where interest rates are zero, inflation is running at much higher levels and monetary policy will not be tightened meaningfully (when I say 'tightened' I mean rates increasing *above the actual inflation rate*). This is why we believe dollar denominated bonds are unattractive over the long run.

### **Obermeyer's approach**

We advocate a balanced, flexible yet somewhat unconventional approach to investing. This is not a good time to be indexing to the general U.S. market because sectors with excess capacity such as real estate and financial services offer little or no long-term return potential (and have significant weights in the index), and sectors with needed capacity, such as agriculture, energy and metals production have almost no representation in major indices. Emerging markets also offer great opportunities, but are usually associated with high levels of risk. However, in the current environment the political risk now actually resides in

western/developed countries. In addition, we argue that hedges to a decline in the purchasing power of the dollar are mandatory – non-dollar bonds, precious metals and claims on hard assets.

We will continue to avoid companies that only remain in business because of taxpayer largesse (subsidies such as the ones provided in banking and autos) and stick with investments in long-lived assets tied to infrastructure development and living standard improvement in the emerging markets. In the U.S., we prefer investments that will hold up to and perhaps benefit from a declining living standard, an aging demographic and enterprises that provide basic necessities. We will continue to avoid those too exposed to improving U.S. discretionary incomes, which will likely remain under pressure for years to come.

There are now significant global changes afoot after a 30-year period of unabated credit expansion, which in turn has caused major misallocations of capital (to equity in real estate, banks, and tech stocks). The unwinding of those misallocations has put the United States in an unsustainable fiscal position. **We don't relish being cautious about the future in the U.S., but it's better to know about problems than to not know.** The good news is that there are still plenty of opportunities to earn significant returns and to avoid the big risks. It will just take patience, focus and fortitude.

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