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December 2010: Ripping off the Band-Aid

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"It is incumbent on every generation to pay its own debts as it goes. A principle, which if acted on, would save one half the wars of the world."

Thomas Jefferson, 1820

With all the gyrations on the political front and the financial media's obsession about the strength and duration of the current "recovery," the debt issue still lurks in the background – largely unaddressed. At some point, absent any political developments, global investors will refocus on the U.S. debt issue. Until that time, the overhang of debt and the attendant policy responses it brings will continue to have major implications.

From an investment standpoint, the size of the debt doesn't mean one should be particularly optimistic or pessimistic – it just needs to be factored into scenario planning and brought into consideration when evaluating the risk-reward merits of any particular investment. It is important to know that the current level of debt is unsustainable and it will be reduced somehow, some way at some time. The challenge will be building agreement on a debt reduction strategy in the political sphere.

Until *real* solutions are embraced regarding the debt issue, band-aids will continue to be applied through political bickering, lip service and wishful thinking. However, to reduce total debt in the United States means ripping off the band-aid and applying tough medicine through a combination of fiscal austerity (lower spending and higher taxes), default/ restructure (on non-tradable liabilities such as Social Security and Medicare, which will come in the form of reduced benefits) and inflation from money printing. What combination of these three it will be is almost impossible to predict.

From a macro standpoint, the structure of Wall Street itself also has far-reaching implications to be considered when building investment portfolios. Oligopolistic financial institutions that are *too interconnected to fail* (and have obscene amounts of influence in the U.S. Congress) will likely lobby heavily for policies that protect the oligopoly and its various interests.[1] The oligopoly needs, and will likely continue to receive cheap credit from the Federal Reserve.

Prior to November's much-telegraphed announcement that the Fed would be buying $600 billion of Treasury securities, big bank proprietary trading desks and hedge funds had already front-run the trade (bought Treasurys), thereby forcing the Fed to buy bonds at peak prices and pulling off another massive transfer of wealth from taxpayers to themselves. Now that the QE 2.0 announcement has been made, many traders are unwinding those purchases by selling bonds, and

[1] For more on this, see *"A Secretive Banking Elite Rules Trading in Derivatives"*, published in the December 11th edition of the *New York Times.*

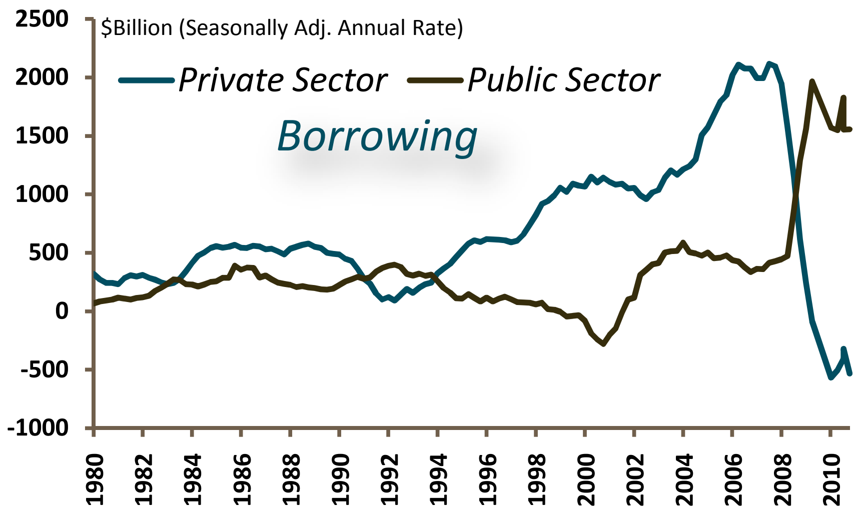
longer-term interest rates have spiked. What effect this will have on financial markets is uncertain. We feel that it may be a headwind for real estate and a net neutral for banks: banks can earn higher spreads (net interest margin), but they may also see a drop-off in trading profits, as well as a decline in their mortgage businesses.

At some point, if politicians don't get serious about reining in fiscal profligacy and Wall Street's influence in government, *markets will*. Greece, Ireland, California, Illinois and the City of Chicago are all cautionary tales of the mismanagement of public finances to which the U.S. government should pay attention. The mismanagement of public finances is far worse than the mismanagement of private financial institutions because taxpayers *cannot opt-out* of providing the financing to the public sector (through tax payments). At least with financial institutions, investors of private capital can analyze the price and terms of securities and can decide if they are worth the risk.

In our opinion, the investment themes that have worked so well for our clients continue to be in play. We wish to build exposures to the long-term trends of rising living standards in the emerging markets and global infrastructure development while avoiding risks associated with flat-to-declining living standards in the U.S. and Europe, monetary hyper-stimulus and excess capacity and leverage in banking, investments and financial services. We strongly prefer well-capitalized businesses that don't need cheap credit to exist or thrive and whose products and services are not sensitive to domestic discretionary incomes. Smart management teams who take periods of economic weakness to invest in and strengthen their businesses are also preferred.

The size of total debt in the U.S. and its impact on politics and economics remains a key consideration in our investment strategy. It has already impacted the precious metals market as awareness has become more pervasive and lenders begin to question the U.S. Treasury's creditworthiness. We expect this to continue.

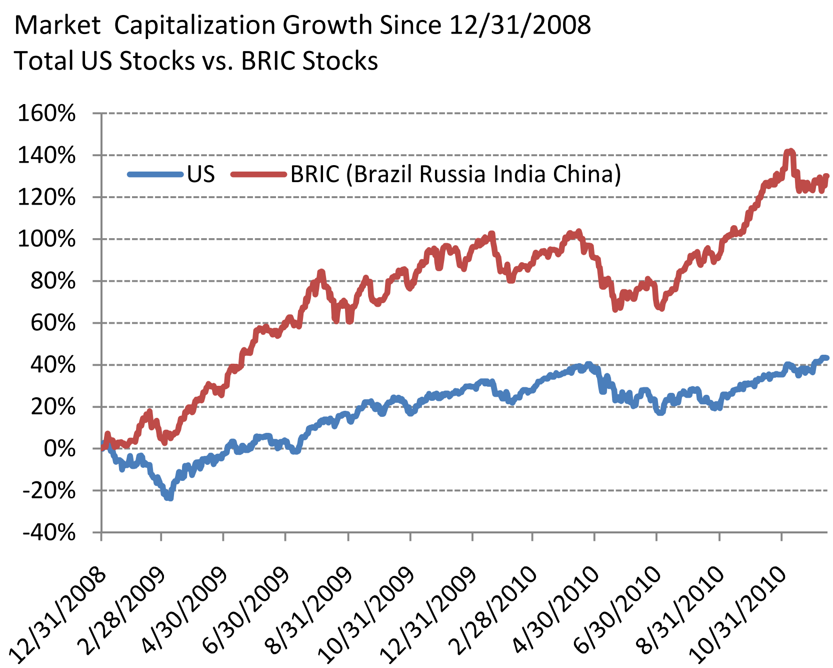
Because these issues are well known, we understand investors' tendency to be risk averse in the current environment. An investor's natural reaction to adversity and loss of confidence is to deleverage and avoid risk. However, as the private sector deleverages, the public sector leverages (see chart below), and this needs to be factored into investment strategy.



Source: *Federal Reserve*, Flow of Funds

Because no aggregate deleveraging has taken place, the Fed will find it almost impossible to tighten monetary policy for a long period of time. Moreover, with the U.S. government now being the big issuer of debt, politicians get to decide how to allocate the proceeds. This is not to imply that the private sector does a better job of allocating capital – especially when there are perverse incentives involved such as obscene compensation levels, short-term payoffs with no downside sharing, and implicit government guarantees if things go badly – but it's not hard to imagine capital in the hands of the politicians ending painfully.

As investors obsess over next year's earnings or what the retail sales numbers look like as we approach Christmas, other more important developments are at work. The reality is that retail sales, no matter what they are, have very little meaning for future investment returns or portfolio strategy. The fact that the strength of the U.S. economy continues to be measured by Americans' penchant to consume, and that there continues to be very little serious discussion about debt ratios is concerning. It continues to boggle our minds that the financial press fixates on Apple, Netflix, Google and Amazon and not on the excessive leverage – both public and private – still in our system. In the end, it is debt monetization itself that will likely continue to provide a massive transfer of wealth to the emerging markets (see below) *and* a relative decline in the dollar and euro vs. emerging-market currencies.



Source: *Bloomberg*

For a long time, we've been writing about the structural problems in the U.S. – excessive consumption, excessive speculation, excessive debt, insolvent banks, etc.–and how at this point the Fed feels it has little choice but to print money. These are indeed big factors and they need to be addressed realistically.

As is always the case, developments within the political environment and perceptions within the financial markets will change on a day-to-day basis. However, the size of the nation's debt and the policy action that it brings (and what it means for investments) will not change for the foreseeable future.

But from a big-picture standpoint, the major drivers of future investment returns will be how the debt issue is addressed and how we cope with declining demography. It is incumbent on us to help our clients preserve their net worth as this process unfolds and position their investments in issues that benefit from and avoid the risks associated with big trends. While we can't make portfolios deliver returns in a linear fashion, we *can* make what we think will be high quality decisions, where time is on our side, and where clients are protected from policy decisions that, while popular, make generating real returns difficult.