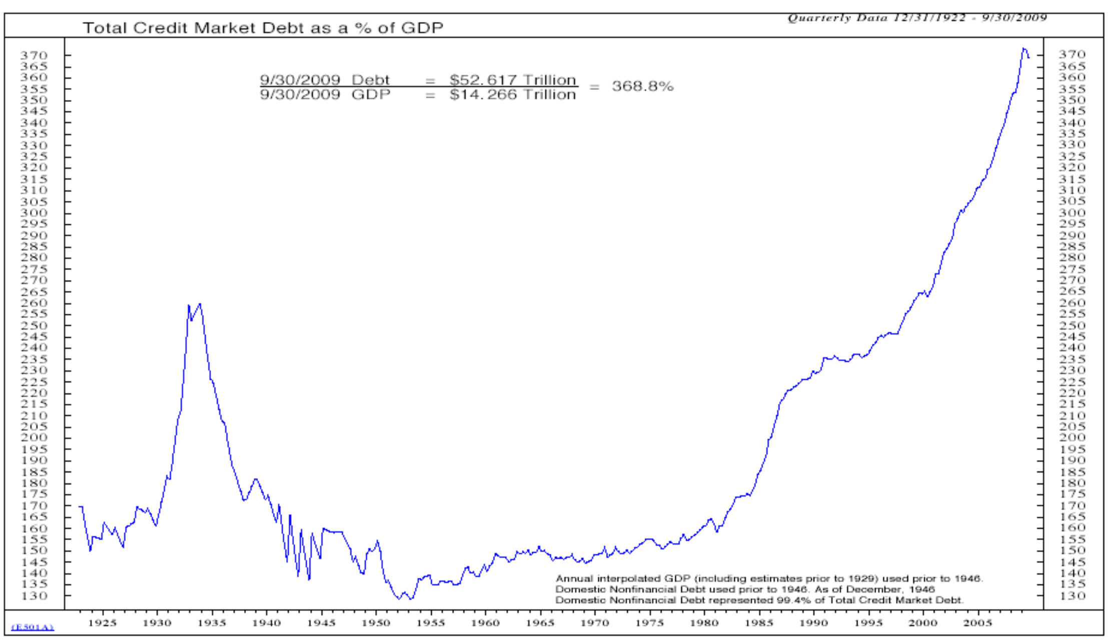
MONTHLY
INVESTMENT
COMMENTARY

February 2010: The Downside of Debt

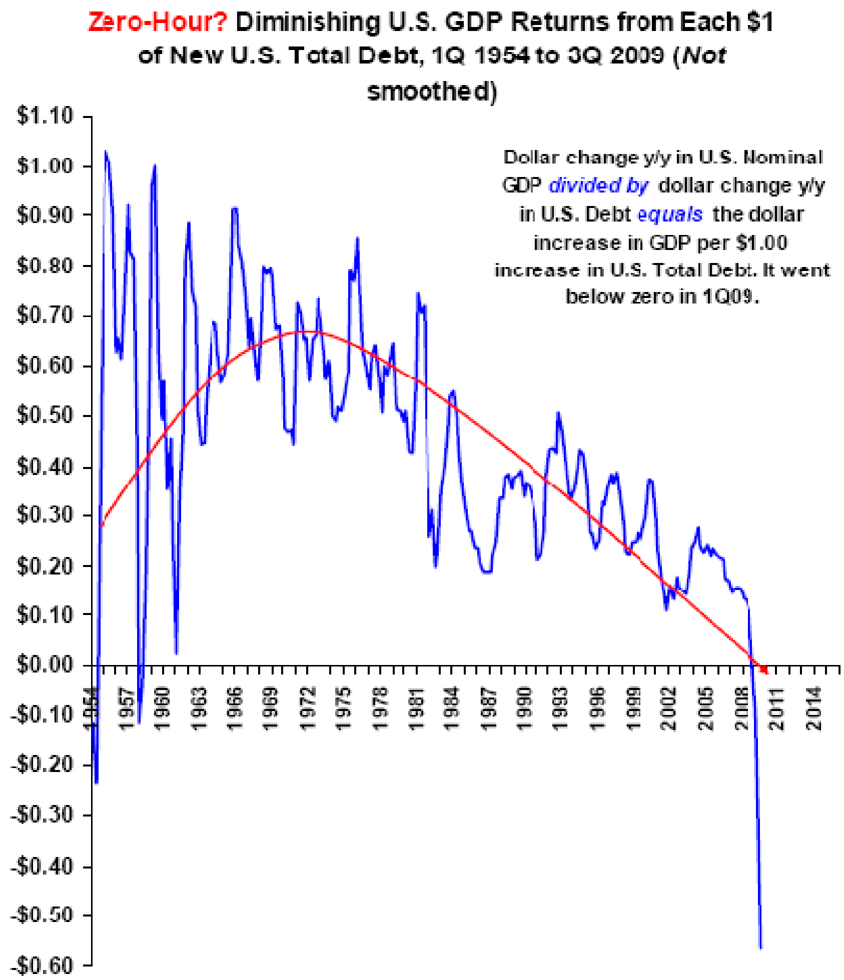
As investment managers, it is important to balance opportunism with risk. The trouble with risk, however, is that it is often derived from factors that are not evident until after they are exposed – like the unintended consequences of the removal of Glass-Steagall and ensuing levering up of large banks to unsustainable levels (many with 30:1 and greater leverage), and the use of Fannie Mae and Freddie Mac as political tools causing a proliferation of toxic loans, a broad competitive relaxation of lending standards, and subsequent insolvency in the banking system. It was impossible to know how or when those excesses would unwind in financial markets. In retrospect it may look painfully obvious, but prospectively, it isn't.

It is often excess liquidity movements, the negative, unintended consequences of government policy, and/or structural issues (like excessive debt) that give rise to risk. Some examples of excess liquidity are the speculative run-up in technology stocks in the late 90s without an associated increase in economic value, or the craze in residential housing based on the theory that house prices "can never go down". At present, the next bubble may be in U.S. government bonds, resulting from massive capital flows to bond funds as aging individual investors have turned risk adverse. The debt financing instruments of the U.S. government, to us, present one of the worst possible prospective long-term real returns possible, because the issuer may be broke.

One of the big issues that causes us continued concern is excessive debt. As the chart on the following page (one that we frequently publish) points out, we currently see unprecedented levels of debt in our economy and this is in no small part due to past and current government policy. Moreover, as debt levels become larger, there is a diminishing return in terms of GDP growth on marginal new debt creation (see 2nd chart). This means that new debt won't help grow the economy much from current levels.



Source: Ned Davis Research Group Inc.



Source: Barry Bannister, Stifel Nicholas

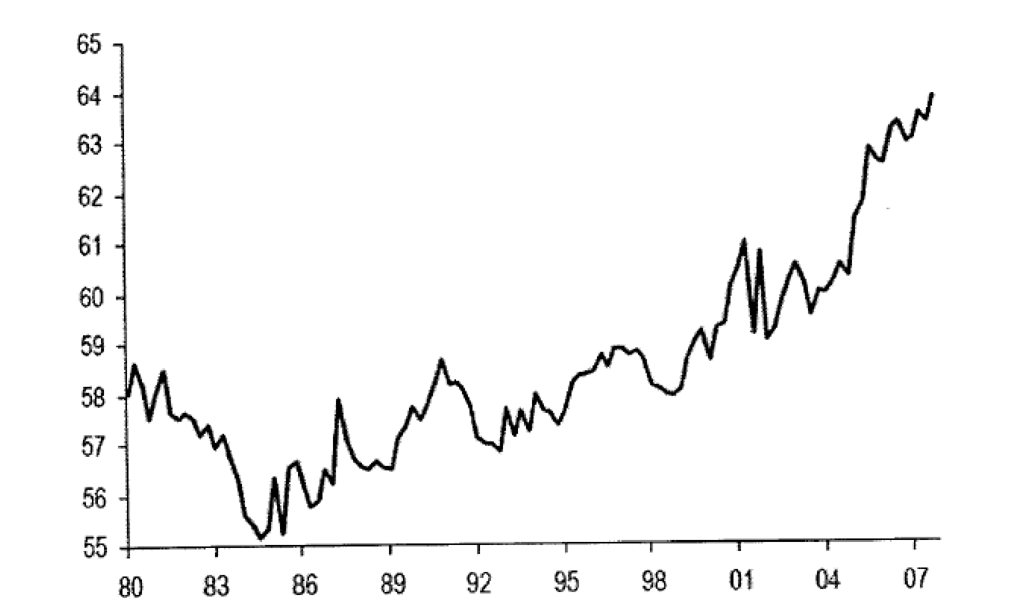
Many investment managers and market pundits largely ignore the debt situation outlined above and remain focused on what near term earnings might be, or at what level the stock market trades relative to next year's earnings projections. But the big structural issue that *matters a lot* remains excessive debt.

Debt used for acquiring productive assets is one thing, but debt used to purchase speculative assets and consumption is quite another. Unfortunately, in the U.S. the big use of debt over the last 10 years has been for speculative purposes.

Central banks can influence the *price* of credit (through setting the Fed Funds rate), but they can't control where all the money from credit issuance ends up. By holding the policy rate too low for too long, the Fed caused a housing bubble, but also forced up the prices of commodities and energy, which pinched discretionary income, in turn making debt service more difficult.

The following chart illustrates this dilemma:

Consumer Spending on Energy, Interest Payments, Medical Expenses, Food, and Taxes as a Percentage of Personal Income, 1980–2008



Source: David Rosenberg, Federal Reserve

These are the factors that precipitated the credit crisis in 2008 and our feeling is that not only have those factors *not* been unwound, they have merely changed form – from debt being in the hands of private creditors to the government. New debt created by the Treasury and monetized by the Fed may again have the effect of juicing up food and energy prices, as well as future interest expense (because of U.S. citizens' declining creditworthiness) – laying the seeds for the next credit/banking crisis.

The following is an excerpt from a newsletter authored by Marc Faber, an Asian-based economist who is a friend of the firm and reprinted here with permission. In our opinion, it accurately challenges the consensus thinking that recent policy actions have ended the conditions that brought about the experience of 2008. While financial markets may have calmed in the short-term, the U.S. still faces the same structural challenges it faced in 2008 before the crisis:

> As far as the government's interventions having prevented the current crisis getting out of hand, I should like to mention that the government repeatedly intervened into the free market in recent times and that these interventions were largely responsible for the current economic mess. Had LTCM not been bailed out in 1998, the financial sector would never have continued to increase its leverage as it did prior to the 2008 meltdown. Moreover, had interest rates not been slashed to 1% after January 2001 (the U.S. economy began to expand again in November 2001) surely a smaller, or no credit and housing bubble would have followed.

Faber also references an article by David Stockman which appeared in the WSJ on January 20, 2010:

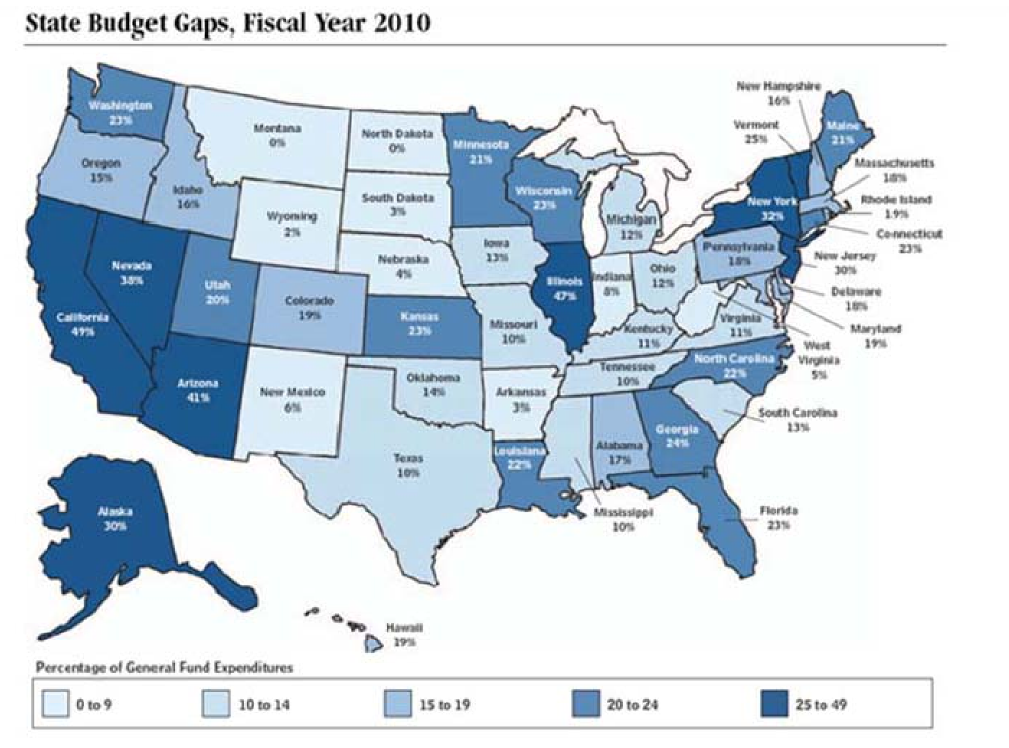
> The banking system has become an agent of destruction for gross domestic product and of impoverishment for the middle class. **To be sure, it was lured into these unsavoury missions by a truly insane monetary policy under which, most recently, the Federal Reserve purchased $1.5 trillion of longer-dated Treasury bonds and housing securities in less than a year. It was an unprecedented exercise in market-rigging with printing-press money, and it**

> **gave a sharp boost to the price of bonds and other securities held by banks, permitting them to book huge revenue from trading and bookkeeping gains.**
>
> Meanwhile, by fixing short-term interest rates at near zero, the Fed planted its heavy boot squarely in the face of depositors, as it shrank the bank's cost of production – their interest expense on depositor funds – to a vanishing point. The resulting yield curve for banks is heralded, by a certain breed of Wall Street tout, as a financial miracle cure. Soon, it is claimed, a prodigious upwelling of profitability will repair bank balance sheets and bury toxic waste from the last bubble's collapse. But will it? In supplying the banks with free deposit money (effectively, zero-interest loans), the savers of America are taking a $250 billion annual haircut in lost interest income. And the banks, after reaping this ill-deserved windfall, are pleased to pronounce themselves solvent, ignoring the bad loans still on their books. This kind of Robin Hood redistribution in reverse is not sustainable. It requires permanently flooding world markets with cheap dollars – a recipe for the next bubble and financial crisis…..**The baleful reality is that big banks, the freakish offspring of the Fed's easy money, are dangerous institutions, deeply embedded in a bull market culture of entitlement and greed**…..During recent quarter, for instance, the preponderance of Goldman Sachs' revenues came from trading in bonds, currencies and commodities. But these profits were no evidence of Mr. Market doing God's work, greasing the wheels of commerce and trade by facilitating productive financial transactions. In fact, they represented the fruits of hyperactive gambling in the Fed's monetary casino – a place where the inside players obtain their chips at no cost from the Fed-controlled money markets, and are warned well in advance, by obscure wording changes in the Fed's policy statements, about any pending shift in the gambling odds. To be sure, the most direct way to cure the banking systems' ills would be to **return to a rational monetary policy based on sensible interest rates, and an end to frantic monetization of federal debt and a stable exchange value for the dollar** (emphasis added).

We agree with Faber and Stockman on their comments that big banks having become the "freakish offspring of the Fed's easy money," and that "the banking system has become an agent of destruction for gross domestic product and of impoverishment for the middle class." When Fed began to slash interest rates in September 2007, the middle class was hurt significantly by soaring commodity prices at a time of high levels of indebtedness, and the ensuing fallout in financial assets decimated retirement plans. We believe strongly that the banking industry's level of influence in Congress and in policy making needs to be curtailed significantly as current policy encourages excessive borrowing and speculative activity.

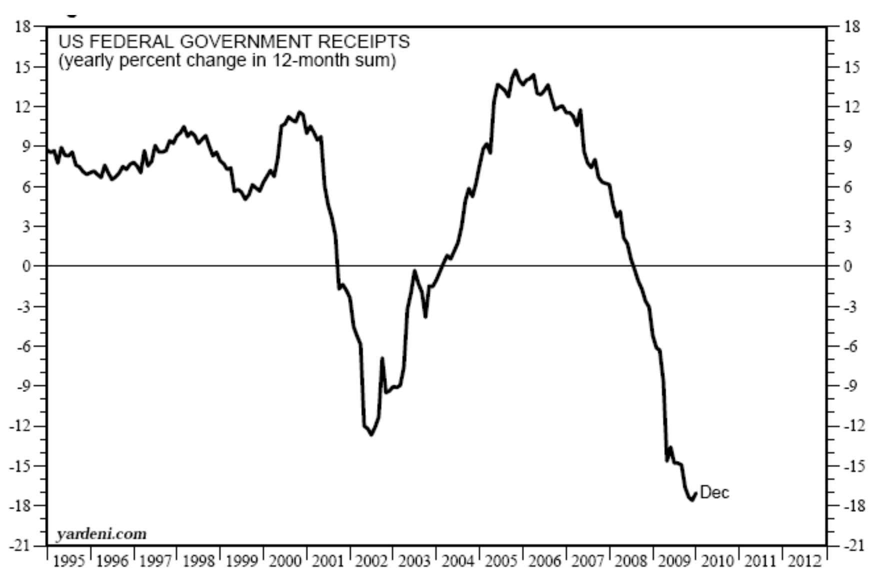
Another situation that bears watching is the fiscal condition of the states. Recent estimates vary, but there ranges between $2 trillion and $4 trillion of unfunded pension liabilities for state and municipal workers. This is a massive future albatross on taxpayers and a function of overly-aggressive assumptions of future asset returns, and under-aggressive estimates of future pension costs as well as decades of granting extremely generous pension benefits for government workers. Some individuals can start working for the state at age 18 and retire at 38 on 75% pay for life. What a great way to get incentivize your best employees to leave and start a second career!

The chart below illustrates the distribution of budget problems across the states. A state's budget gap is the difference between its expenditures and revenues, expressed as a percentage of the general fund expenditures for that state.



Source Michael Panzner

Not helping the situation are declining tax revenues. In December 2009 tax receipts were down 7.8% from December 2008 (a symptom of a still shrinking economy).



Source: Ed Yardeni

What about radical spending cuts, which would be the most desirable way to address the budget problems? Under the current administration and given the view by several "leading" U.S. economists that more fiscal stimulus is needed, this likely won't happen in the next few years. So, how will the U.S. get out of its "debt trap?" There are two ways: by defaulting on obligations (default on state, municipal and federal government debts or default on obligations to the U.S. population through smaller entitlement payments or by increasing retirement age) or by massively monetizing U.S. debts and reducing the debt through inflation.

Massive monetization of debts is the most likely outcome. This is so because the economic pain that inevitably follows a period of excesses (excessive debt growth and excessive consumption in the case of the U.S.) is postponed through monetization.

From an investor's perspective the process of monetization has important implications: avoid long term fixed income securities, avoid cash, and buy assets such as equities, real estate and commodities (in particular precious metals) which should hold their value reasonably well in *real* terms. This is all from a longer-term point of view. This is not to say that any of these investments won't be great or horrible at any given moment in time, particularly if risk aversion returns and everyone rushes to buy Treasuries. It may be that gold continues to trade down below the $1,000/oz. level if liquidity continues to tighten temporarily, but given the current environment the real risk is to *not* own any precious metals at all. We feel investments in high quality assets remain the most appropriate strategy and provides the best odds of protecting clients' standard of living over the long haul.

The point of all this information is not to cause undue concern. It is to reiterate that the world is complicated, with many factors influencing the movement of various investments. The best we can do is to try to manage the risks that we know, but also to recognize that there are many that we don't know. The current environment is one conducive to taking some prudent risk, but also to building in some sensible hedges because there are many factors that can cause a return to risk aversion and for liquidity to flow out of riskier assets. Our goal is to try to build a portfolio that enables real returns for our clients (returns above the annual cost of living increases), but also to maintain a balance of investments and securities that enable capital preservation if something unforeseen should occur.