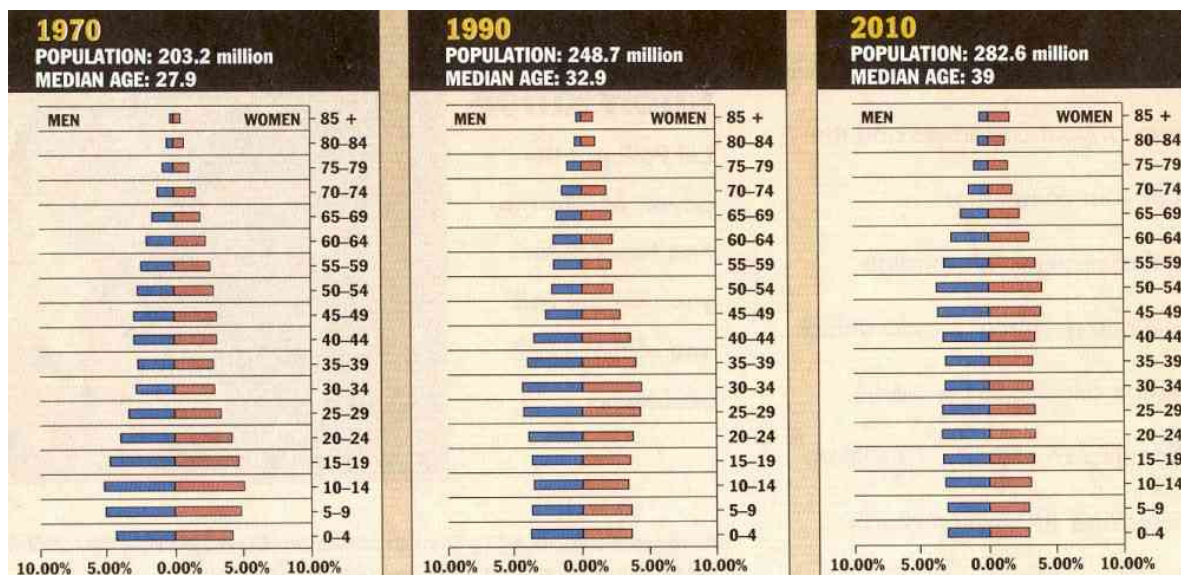


“The American Republic will endure until the day Congress discovers that it can bribe the public with the public’s money.” ~ Alexis de Tocqueville, 1835

July 2011: It’s the Demography, Stupid

By John Goltermann, CFA CPA

James Carville’s slogan for Bill Clinton’s 1992 presidential campaign, “It’s the economy, stupid” capitalized on the 1991 recession to unseat George H.W. Bush. In 2011 and beyond, it is *demography* that will be the driving force behind fiscal policy, economic growth and the outcomes of the 2-year election cycle. Although it is unlikely that demography will ever be discussed or acknowledged in the run-up to the next U.S. presidential election or in the debate leading up to the debt ceiling, it is the biggest challenge to our society in a very long time.

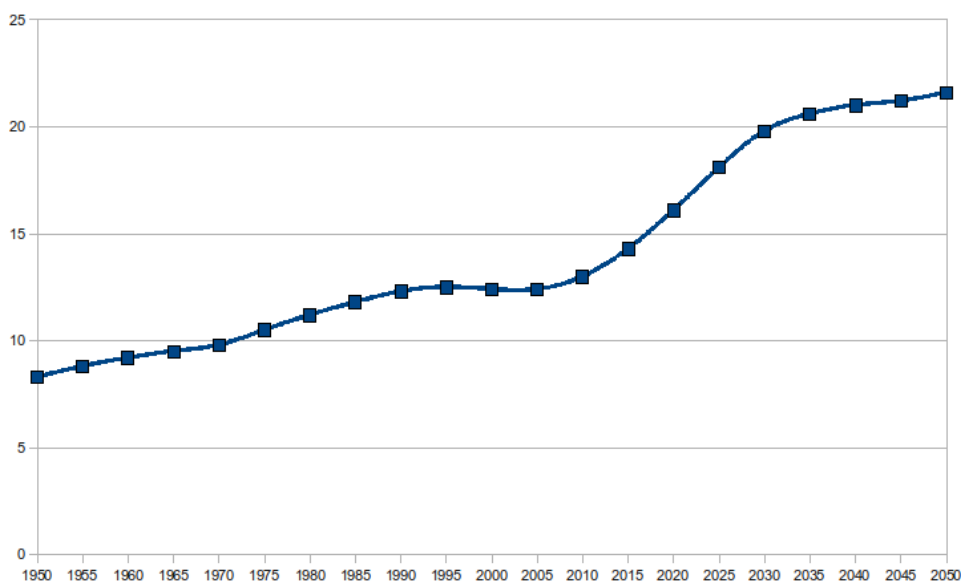


Source: U.S. Census Bureau, 1992 (2010 is a projected figure)

The pyramid charts above clearly show a bulge in the population moving upward through time. By 2010, most of this demographic bulge is seen between ages 45 and 65. This graphical view of the baby boom in the United States represents a population surge that began in 1945 and was followed by a period of more modest birth rates, in part due to cultural factors, birth control and legalized abortion. Moreover, with medical advances, people now live much longer than they used to, adding to the fiscal pressures.

Percentage of US Population Over Age 65, 1950-2050.

Source: UN World Population Prospects 2008



Demography has changed the political landscape, labor markets and economies; now, as we see unfolding in real time, it challenges sovereign governments' fiscal health. Expensive promises made by politicians, municipalities and union leaders to garner votes, defer compensation (to keep true compensation costs off income statements and balance sheets) and otherwise placate people could serve as a drag on U.S. economic growth, catalyze a sizeable increase in taxation and inhibit well-functioning capital markets for a long period of time.

The battle over austerity and bailouts in Europe is really just a preview of the potential for social tension and conflict as a result of these promises. Yes, the peripheral countries in the EU have different economic structures than the United States, but overpromising expensive programs could lead to similar consequences here. The conflict will not be a struggle between nations or social classes, but between generations — and it could begin in earnest this year.

Because of the size of the U.S. government's entitlement liabilities, estimated to be \$61.6 trillion as of the end of the 2010 fiscal year, it would take 100% of the 2010 Federal tax revenue year-in and year-out for the next 28.5 years to fund those payouts, assuming no growth in Federal revenue *or* in entitlements. Moreover, there would be no money left to operate the Federal government, the Department of Defense, make interest payments, provide food stamps or fund research. U.S. citizens would basically work, invest and pay taxes at the current level to fund promised payouts to citizens over 65.

Large entitlements are why governments everywhere are running out of money – not just in Greece, but also in America, Germany, Britain, Japan and France and are why deficits are exploding in all advanced capitalist countries. Funding such entitlements is also why public spending is being cut on schools, universities, science, culture, environment and transport, while spending on health and pensions continues to rise.

But it's not just sovereign governments that face problems: a recent study conducted by Stanford University analyzed the actuarial health of The California Public Employees' Retirement System (CalPERS), California State Teachers' Retirement System (CalSTRS) and the University of California Retirement System (UCRS). These three entities are the pension administrators for public employees and teachers in California, and in total they serve 1,914,000 members. According to the study, if the liabilities of the plans are discounted properly, the three funds have a combined funding shortfall of over \$500 billion (which would be even greater if Cost of Living Adjustment provisions are higher than expected).¹

Many people believe that the current malaise, fear and financial market jitters are all about the greed of feckless bankers and the ensuing crisis in confidence that they caused, but this is only partly true. According to the IMF, in Britain, which had a major banking crisis like the U.S., the credit crunch, bank bailouts and recession only accounted for 14% of the expected increase in Britain's public debt burden. The remaining 86% of the long-range fiscal pressure is caused by the growth of public spending on health, pensions and long-term care.

According to Shadow Government Statistics, the GAAP negative net worth of the U.S. Government grew by \$12.4 trillion from 2009 to 2010.² Only \$1.3 trillion of this amount (or 10.5%) was attributable to the cash basis deficit that is widely reported in the media and by politicians and purported to be heightened by the credit crisis. *The rest is the increase in the liability associated with growth in health benefit costs, Medicare, Social Security, prescription drug benefits and disability insurance.*

The credit crunch and recession did not create today's pressures on public borrowing and spending, but merely accelerated an age-related fiscal crisis that would have been inevitable by 2020 because the majority of the baby-boomers will be retired.

Part of a rational solution to this crisis would be for governments to reduce their spending on pensions, health and long-term care. Yet these are precisely the entitlements protected and ring-fenced by politicians in the U.S., Britain and many European countries – even as other government programs are ruthlessly cut.

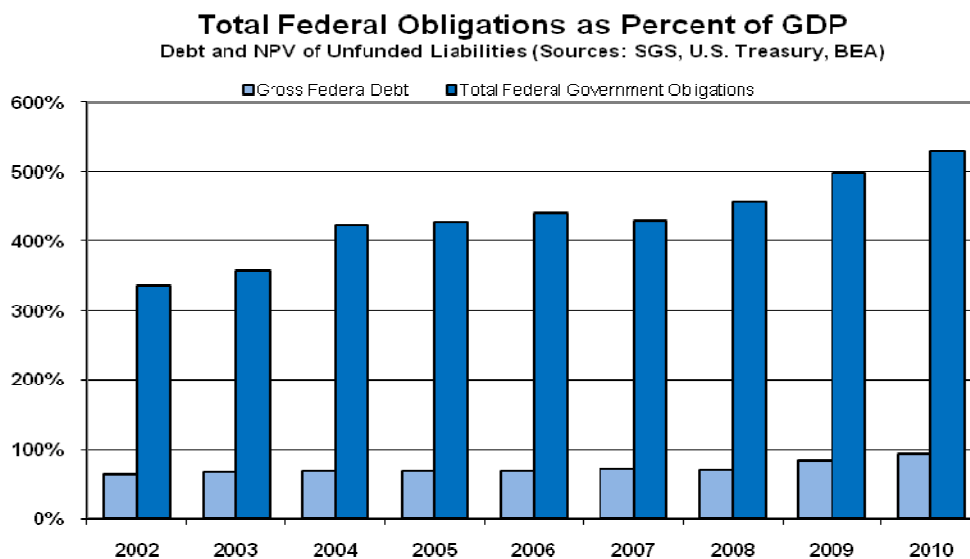
We believe that the politics of the next decade could easily be dominated by an intergenerational battle over public spending and taxes and, if not tackled in a meaningful way, investment markets could be characterized by periodic credit and currency crises. Young people will begin to realize that different categories of public spending are in direct conflict: if they want more spending on schools, universities and environmental improvements they must vote for cuts in health and pensions. But because they are outnumbered at the voting booth, this presents a problem.

¹ SIEPR policy brief, April 2010

² Using a U.S. Government Accountability Office (GAO) disclaimer of opinion published with the U.S. Treasury Department's most recent financial statements and its 'Illustrative Alternative Scenario'

In the United States, there are approximately 75 million baby boomers. It's a freak demographic occurrence, but it has caused a major societal impact in that one demographic group has managed to dominate culture, morality, employment, wealth accumulation, housing and social mobility. But now, because of promises made by governments current and past, baby boomers will also dominate fiscal and monetary policy.

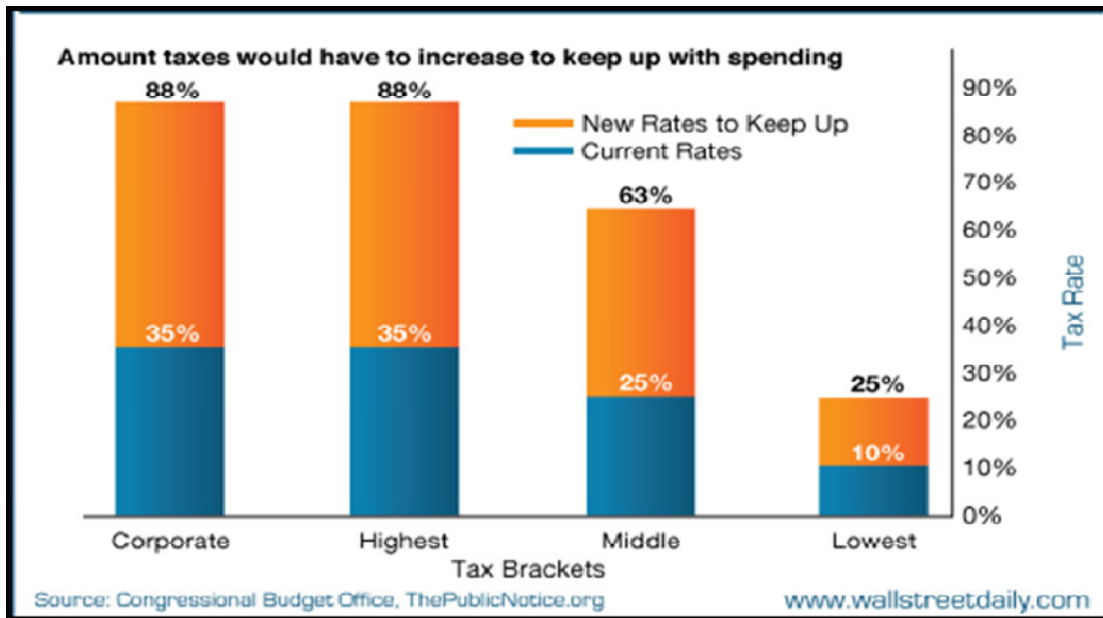
As baby boomers begin to retire, we see major expansions in the size of government – not just in the U.S., but across the globe. The increase in government expenditures and deficits has been attributed to the banking crisis and deemed necessary by officials to mitigate the economic pain that came with it. But government expansion will now be even more important to facilitate the necessary wealth transfers to the public sector that fund the retirement, housing and health care benefits promised by legislation.



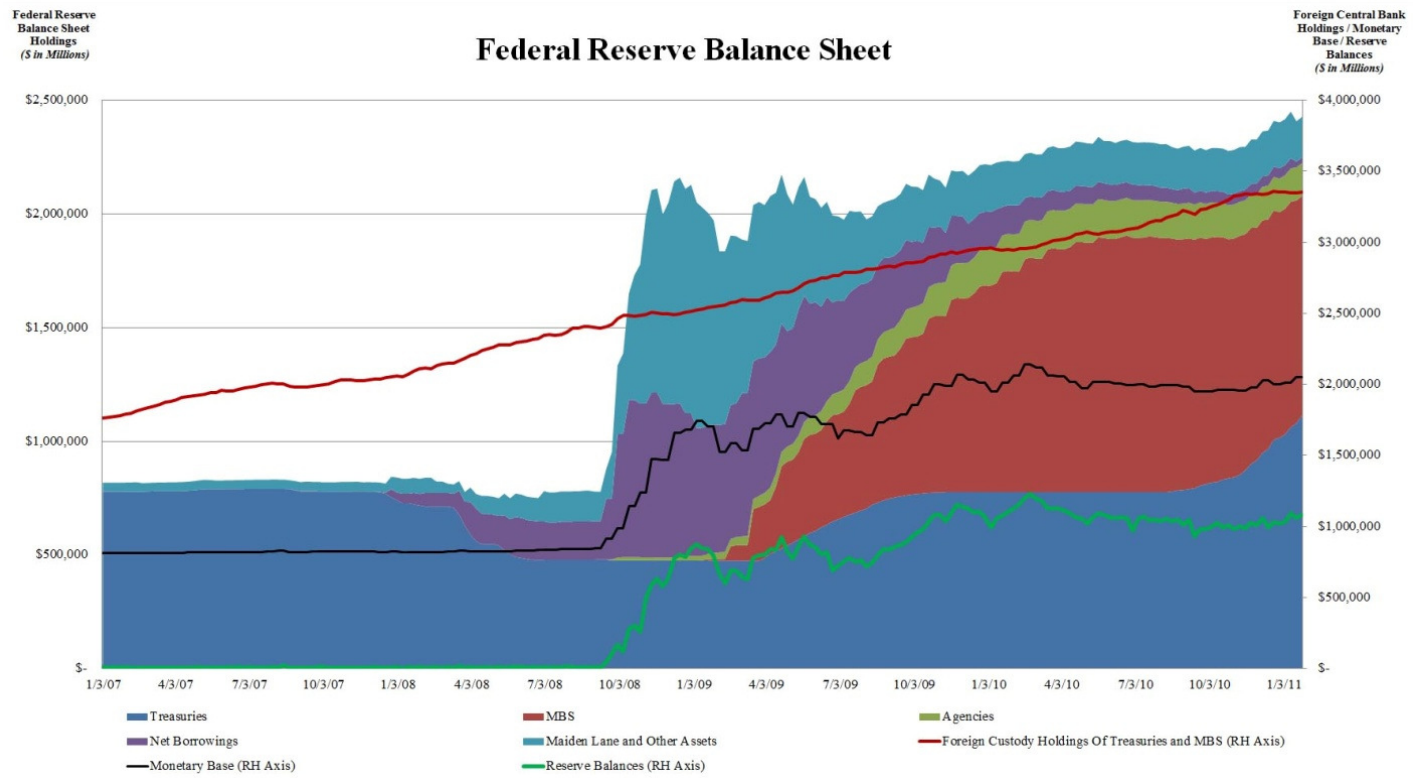
The problem is not necessarily the dramatic increase in the size of government all by itself, but rather that it has *not* been funded by a commensurate increase in tax payments. Because taxes can't be raised even close to a level sufficient to fund government expansion in the current period, the expansion can only be enabled by an explosion in government *borrowing* – much of which has been purchased by the Federal Reserve Bank itself.

Now, with the Fed involved in Treasury purchases through QE1 and QE2, there is no externally imposed mechanism or capital market discipline to keep government debt expansion in check. In theory, the U.S. could continue raising the debt limit forever as long as the Federal Reserve continues to buy its debt – until a credibility loss and dollar crisis happen.

To fund government payments *as we go* instead of borrowing current payments from the future, would mean politically impossible tax increases. As the next chart shows, to balance the budget on *a current period basis* would mean that people in every income level plus corporations would need to contribute dramatically more in taxes to fund the cause.



Needless to say, no politician in his or her right mind would propose these sorts of tax increases. It's much easier instead to borrow the difference and let future voters and politicians worry about it. If interest rates get too high on account of the deteriorating fiscal situation, then the Fed can always ride to the rescue and buy more debt in order to keep rates at a level where a highly leveraged economy can keep functioning. This is the game we're in and it can't continue forever (if even for long).



As illustrated in the chart above, the explosion in government borrowing is being financed in large part by the Federal Reserve Bank itself (a policy maker with its own agenda). As the Fed purchases assets (Treasury bonds, mortgage-backed securities, etc.), it creates liabilities (reserves) in the banking system out of thin air. This is what is referred to as “printing money.”

A choice was made at the highest levels of Washington to address the problem of excessive leverage by devaluing the dollar (increasing the Federal Reserve Bank leverage and lowering the asset quality of instruments that collateralize dollars in circulation). An alternate approach would have been to face the problem, allow overinflated asset prices to come down, force reckless lenders, speculators, hedge funds and carry-trade gurus to take appropriate haircuts, allow the system to clear on its own through a nasty recession and operate with a sustainable amount of leverage and on a realistic basis in the future. Washington’s choice was more politically expedient, but it will likely have longer-lasting negative effects than the alternate approach.

In effect, Washington’s choice creates a transfer of wealth from dollar owners to non-dollar owners. Non-dollar owners can take the form of commodity investors and speculators, shareholders in resource-producing properties as well as holders of foreign currencies. The end result is a decrease in standard of living *by stealth* for dollar-depositors and the risk-averse and higher prices paid by all for basic necessities – including by our trading partners whose governments peg their currency to the dollar.

Concurrently, as 1) the private sector deleverages; 2) investors become increasingly risk-averse; 3) the Fed seeks to stimulate the economy; and 4) our major trading partners seek to keep their own currencies suppressed vs. the dollar, *they’re all buying Treasuries*. This collective action provides cheap financing for the aforementioned government expansion and facilitates the issuance of Treasury bonds far beyond what today’s and future generations can reasonably pay back from taxes on their labor and investment.

Moreover, many savers and investors have been lulled into buying Treasury bonds by the government manipulation of the CPI statistic, economic fear-mongering and the premise that Treasury bonds are the safest instruments available (never mind the fact that they are on the verge of technical default). This has further enabled trillions in low-cost financing to the U.S. Treasury. It is a risk for every citizen that the strong demand for Treasuries is mistaken by policymakers as a vote of confidence and that it seeds a false belief among them that the government will *always* be able to rollover its debt.

In order to grow the economy, the system needs more savings and capital formation. Instead, the government is spending the country’s accumulated wealth on increasing entitlements. The government has never spent as much money as it has right now, and it’s mostly borrowed from the future, leading to the current decline in confidence that has befuddled policy-makers and, in my opinion, risks creating a vicious downward spiral.

The bottom line:

The reality is that the U.S. government doesn't have enough money or the available financing options to fund what has already been promised, let alone what its representatives would like to additionally promise.

We are at a serious crossroads and there are an infinite number of possible scenarios to consider, but the likeliest outcome of the current debt debate is that Congressional leaders will take the path of least resistance and defer the hard decisions in a way that allows each side to save face. The implications of this will continue to be dollar-negative.

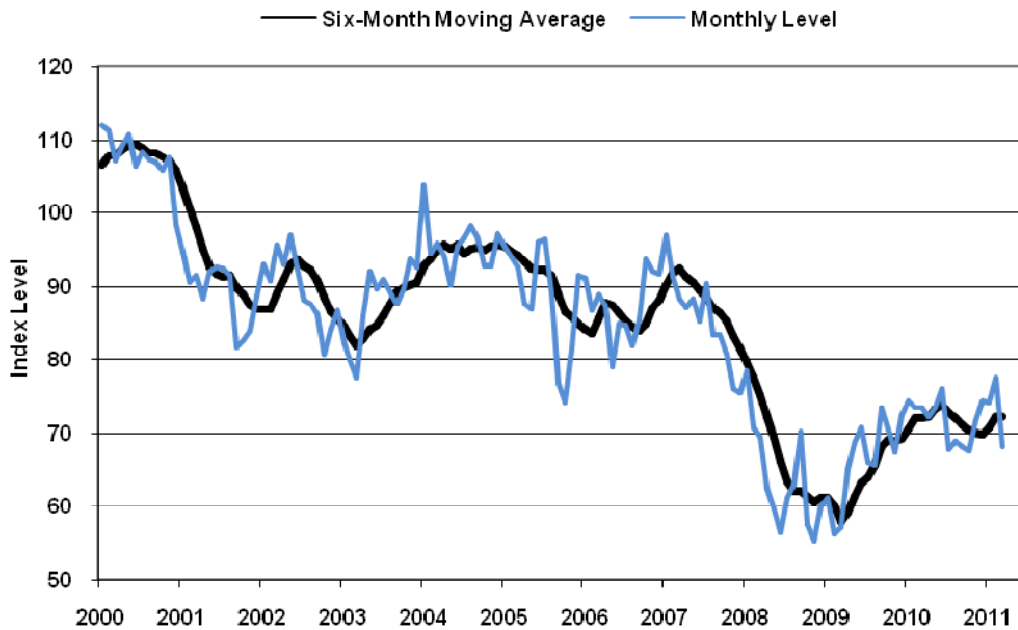
I am confident that Congresspeople have enough knowledgeable advisors telling them that there is a serious risk of a dollar crisis and financial market meltdown if a Treasury default is allowed to occur. It's no secret that Treasury bonds serve as collateral for trillions in derivative contracts, not to mention \$1.5 trillion of the assets of the Federal Reserve itself. Let's hope they listen to their advisors this month.

As the Federal government now comprises 27% and state governments comprise 14% of the U.S. economy, for the economy to grow, it becomes increasingly important for *governments* to grow, and they can't unless they borrow more. So fiscal austerity could easily lead to flat-to-negative GDP growth and, with dollar debasement, could lead to severely negative *real* growth. For this reason, government policy should be crafted to support the private sector so that it can compete within an increasingly competitive global economy. The private sector needs to be encouraged to innovate and create jobs – not jobs that require government subsidies, but jobs involved in the production and delivery of products and services that are valued within a global marketplace. Finally, major entitlement reform is inevitable; without it, we get closer to a dollar crisis on a daily basis.

Our view is that the size of the cash-basis deficit and the unfunded liabilities will require the Federal Reserve to continue participating in Treasury bond buying, which will keep its balance sheet expanding and the dollar under pressure. This is why Ben Bernanke is playing both sides of the fence by urging Congress to focus on deficit reduction but also urging it to avoid “sudden and sharp fiscal consolidation in the very near-term.”

The uncertainty over the path forward in the political sphere, how to fund promises made to large voting blocs and the deteriorating household fiscal positions have naturally led to a decline in confidence.

Consumer Sentiment (SGS, University of Michigan)



There seems to be increasing awareness of the unsustainability and unservicability of deficits and the increasing conflict between the public and private sectors. Demography is a major contributor to the problem, and we hope that there is a serious policy debate instead of just rhetoric, demagoguery and finger-pointing. It would be good for investors and for economic activity in general to have more policy clarity soon; in the interim, continuing dollar debasement is a very high probability outcome.

To protect our clients, our equity portfolios continue to hold investments that benefit from a rise in foreign currencies vis-à-vis the dollar. Part of this strategy includes an emphasis on resource producers and precious metals, but we also own many stocks of stable, cash-generating businesses as well. We anticipate financial market volatility through the 2012 elections and a wide variety of opinions among the television punditry, but at some point in the future we expect a more realistic approach to entitlements. Whether it comes through the political process or whether it is forced by markets remains to be seen.

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.