October 2011: It's Relative

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> We naturally imagine that the spot on which we ourselves stand is fixed, and that the things around us move. The man who is in a boat seems to see the shore departing from him, and it was the doctrine of the first philosophers that the sun moved round the earth, and not the earth round the sun. In consequence of a similar prejudice, we assume that the currency which is in all our hands, and with which we ourselves are, as it were, identified, is fixed, and that the price of bullion moves; whereas in truth, it is the currency of each nation that moves, and it is bullion, the larger article serving for the commerce of the world, which is the more fixed.
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> Henry Thornton*, An Enquiry Into the Nature and Effects of the Paper Credit of Great Britain* (1802)

The above quote helps contextualize the relative price movements of various investments. U.S. investors continually measure returns and price movements in dollars because that is their frame of reference. Because the dollar is used to pay expenses and liabilities, the price movements of investments, goods and/or services appear to be either favorable or adverse (usually adverse for goods and services, and only sometimes favorable for investments). In fact, price changes can be caused by fluctuations in the supply of available dollars in the system on any given day. Because this supply is not fixed or anchored by anything, it is important to keep in mind that dollars themselves are a poor guide as to how to formulate an investment strategy because there is an illusion of stability.

Negative real interest rates, excessive debt and governments' numerous short-term 'fixes' have created an extremely volatile and unpredictable environment for all asset classes, including bonds. Last month, as the European debt crisis heated up and as the Federal Reserve announced Operation Twist to lower long-term interest rates, investment markets experienced a general return to risk aversion. As a result, investors hastily liquidated many investments, especially those tied to global economic growth. What is certain in my mind, however, is that the elements that give *any* investment a good long-term risk-return profile *do not change nearly as often or dramatically as the investment's price changes imply that they do*.

Governments' and central bankers' proposals of short-term incentives and temporary policies to spark economic activity do not help confidence. In fact, one could argue that they often have the opposite effect because investors crave a sense of permanence in order to commit long-term capital – and capital investments (e.g., stock purchases or business investments) are long-term by their very nature. The suggestion of short-term fixes is, at the same time, a *deferral* of a more permanent set of rules, incentives and structures that are *required* for a restoration of confidence and a willingness to commit long-term capital. However, we continue to hold a diversified basket of assets in client portfolios in an effort to preserve *real* (after-inflation) wealth because bonds and cash carry their own set of risks as the U.S. fiscal situation deteriorates and as the incentive to create dollars and push them into the system increases.

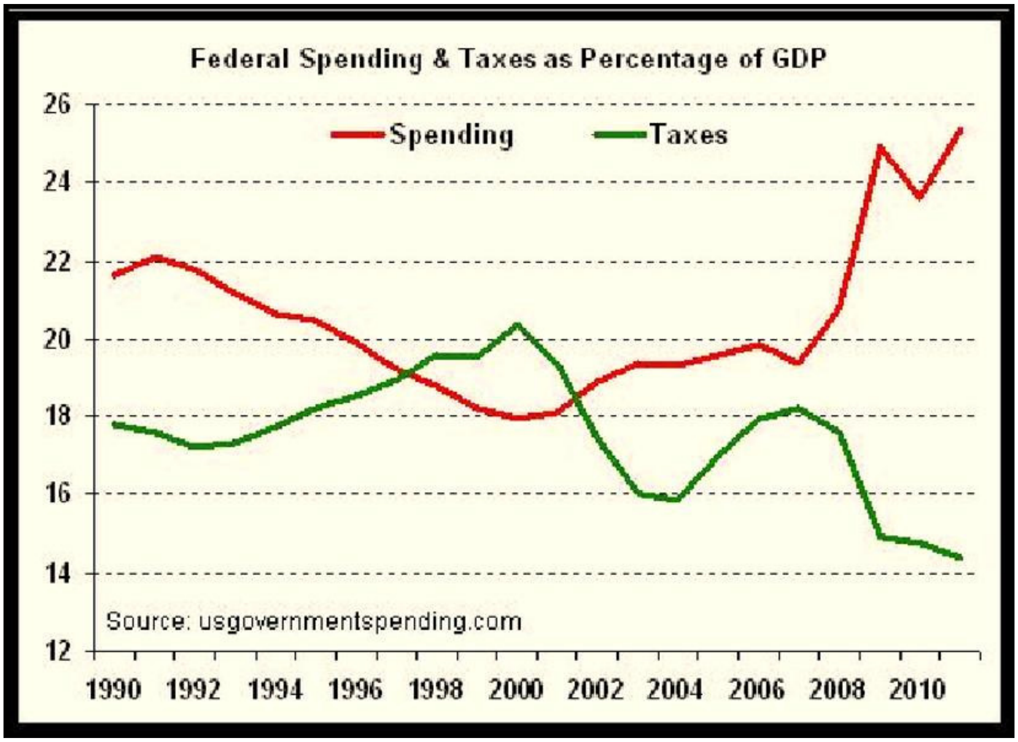
The market domination of high-frequency traders and computer algorithms contribute to increased short-term volatility, dramatic price declines and sharp rallies; but the volatility itself yields long-term opportunities. In reality, global prospects don't tend to oscillate 3-5% on any given day. We acknowledge that this is an extremely tricky time to invest capital. The combination of excessive debt, a highly politicized fiscal and monetary policysetting process, declining demography, a poorly structured euro, a general lack of confidence *and* the interconnectedness of markets all converge to make the future nearly as opaque as one of Enron's financial statements. But looking out into the future *through* all the challenges gives hope.

Global investors have been sitting on the edge of their seats for months watching the high-stakes politicking play out on the financial stage. We too have been following the slow-motion spectacle that seems to have no end, and have a number of views and suggestions:

1. Don't panic, as there is little to be gained by fleeing to the sidelines until this is all over. While the risk of contagion from Europe is serious and while we will probably have anxious moments as we go forward, ultimately the euro-crisis will abate. It is a political challenge because there is no one powerful overseeing organization to take charge and address the doubting with concrete action; but in the end, there is likely to be debt monetization, a restructure of the eurozone and better enforcement.
2. Watch for the recapitalization of European banks. Dexia, the large Belgian bank, was split into a good bank and a bad bank, which was nationalized. Expect more of this.
3. Expect action to remedy the predicament of weak debt-laden countries. They need to lower their borrowing costs, so some sort of refinancing mechanism – whether it's loan guarantees, subsidies, extensions, haircuts, etc.– needs to be found. Most countries could implement spending cuts and repay the debts over time if they could borrow more cheaply. If no political solution can be found to split the cost of distressed bonds, a default is likely and perhaps a few countries will exit the eurozone.
4. Another possibility is that Germany withdraws and returns to the Deutschmark, which would be more disruptive to markets in the shorter term, but ultimately could stabilize the European situation.
5. Expect the political situation to improve in the U.S. Right now it's just about as toxic as it can be, but we expect an eventual movement towards cooperation and bipartisanship. While this may seem like a longshot at the moment, the electorate is fed up, so it's really in no politician's interest to continue to be oppositional *all* the time.

As the chart below shows, the U.S. cannot afford to have the economy fall into recession because tax revenues would collapse and government may be tempted to increase borrowing/spending.

The problem now is that because of already high levels of debt, the prospect of *more* debt makes people even more fearful and risk-averse. This dynamic risks a self-perpetuating feedback loop of more monetary stimulus and debt monetization, causing more fear and uncertainty.



This imbalance cannot be addressed without pain being dispensed somehow, somewhere. These problems are well known by market participants and are reflected in most asset prices at this point. This is what politics is all about these days.

To us, however, the core of the problem is weak economic growth in the U.S. and parts of Europe. Strong growth can pay for a lot (through an increase in revenues) and reduce the need for government spending. So growth without government spending will be the key, and that will require a competitiveness agenda on governments' part instead of borrowing, spending and transferring. Domestically, sound tax policy and pro-growth economic policy, and the ability to create mass buy-in that bolsters confidence will be extremely critical for the U.S. fiscal situation going forward. We expect that the political discussion will take this turn going into the election season.

Naturally, periods of high volatility and rapidly deteriorating confidence can test one's patience. Both bond prices and the dollar rally, and the prices of everything else decline as risk aversion sets in. Understandably, price declines of investments cause angst and dismay because our brains project the declines forward. We are simply wired this way. But we believe things will improve as it becomes clear the status quo is not working.

At the moment we’re being forced to analyze and react to the latest ministration, announcement, contrivance and plan on the part of the President, Congress and the central bank – not just in the U.S., but also in Europe. This makes it difficult to project what the future will look like. However, assuming the private sector in the U.S. once again becomes an engine of growth, and that some confidence returns, many stock prices are cheap. Capitalizing on these opportunities is critical to successful long-term outcomes as current negative sentiment seems to be overlooking real, sustainable global prospects. Sometimes it’s hard to see what’s happening when our point of reference makes everything seem like it’s on the decline, but the declines are a natural part of the ebb and flow that make for a stronger future.