

January 4, 2013

"How long can the world's biggest borrower remain the world's biggest power?"
-LARRY SUMMERS, FORMER US SECRETARY OF THE TREASURY

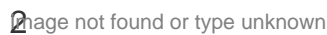
1. The US is presently trapped in the vise-grip of political paralysis irrespective of a less than impressive resolution of the fiscal cliff. Fortunately, despite the utter lack of leadership from our elected officials, America's innate desire to innovate continues to soar. (See *Figure 1*)

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2. Last year, the Fed engaged in an interest rate manipulation process it called "Operation Twist." Essentially, it sold short-term Treasury debt while simultaneously buying longer dated issues, hoping to drive down long-term interest rates. The Fed's problem is that it has now sold almost all of its near-term maturities. As a result, the world's most important central bank will simply create the money needed to purchase \$500 billion of extended-maturity Treasuries.

3. Despite enjoying a 12-year bull market, gold represents a mere 0.05% of global household net worth. Thus, it's difficult to contend that bullion deserves the dreaded "bubble" designation.

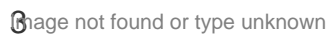
4. New oil-rich basins like North Dakota's Baaken region have gained the majority of attention with regard to America's improbable energy boom. Yet, the venerable oil-producing state of Texas is also enjoying a remarkable renaissance due to new exploration and production techniques. (See *Figure 2*)

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5. California's political ruling class, which has presided over one of the worst fiscal disasters in American history, is euphoric over the recent passage of Proposition 30. This initiative raises the highest state income tax to 13%. Governor Jerry Brown (of Governor Moonbeam fame) has boasted that this tax hike should be a model for achieving a balanced budget at the national level.

6. Ignoring the potential to drive high earners out of California, Prop 30 also makes the state much more reliant on the top 1% of taxpayers, whose incomes fluctuate dramatically with the economic cycle. The top 1% will now pay more than 50% of taxes, up from 41% (while making just 20% of income). Assuming federal tax rates rise to around 40%, high-income, Californians will now be paying close to a 60% marginal rate, including the 3.8% Obamacare surtax.

7. Much has been made of improving US consumer confidence. Yet, the reality is that even prior to the recent swoon, it has been at recession-like levels. (See *Figure 3*)

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8. China has been routinely criticized for an over-reliance on capital spending to spur economic growth. America is the polar opposite of China in that regard. As US confidence has ebbed in recent years, the overall stock of private fixed assets has nosedived. Once confidence returns, however, capital expenditures are likely to be a powerful economic catalyst. (See *Figure 4*)

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9. Although China's upper classes have flourished during its development boom of the last 30 years, roughly 70% of its 1.3 billion populace remain too poor to represent meaningful sources of consumption.

10. If carbon dioxide emissions are truly a leading contributor to global warming, the US is not the culprit, despite popular opinion to the contrary. (See *Figure 5*)

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11. Notwithstanding a slowing economy, Chinese wage growth is still running in excess of 15%. This is almost double China's productivity gains, meaning that its labor cost advantage continues to narrow.

12. It's understandable that US exports to the eurozone have fallen out of bed. What is more alarming is that the same has occurred with shipments to Asia. (See *Figure 6*)

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13. China and India are often seen as very similar countries. Yet, the size of China's foreign currency reserves is more than 10 times India's. (See *Figure 7*)

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14. Despite the charade-like nature of Europe's various dike-plugging efforts, there is no question they have lowered Spanish and Italian financing costs. Spanish 10-year bond yields have come down from 7.5% in the summer to 5.5% recently, while Italian government bond rates have tumbled from 6.5% to 4.5%.

15. It's hard to overstate the degree to which the eurozone banking system is reliant on—or addicted to—European Central Bank (ECB) support. (See *Figure 8*)

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Beyond the noise. While most of the investment world was fixated on fiscal cliff negotiations, I've been ruminating on other topics. The first involves a meeting I had in early December that keeps echoing in my mind.

Simon Mikhailovich was 19 when he came to the US from the former USSR in 1978 with only \$100 to his name. He was, and is, a grateful beneficiary of legislation passed in the 1970s by Washington State's own Henry "Scoop" Jackson, which required Soviet Russia to release tens of thousands of Jews in return for US grain. Had he not bolted when he did, the Russian invasion of Afghanistan in 1980, triggering an embargo by Jimmy Carter, would have shut his escape hatch for more than a decade.

Despite his destitute beginnings, Simon has amassed a tidy fortune over the years, primarily due to his acquired expertise in distressed debt. Undoubtedly, his former country's proclivity to

default on its sovereign obligations taught him a great deal about this dark, but lucrative, niche of the investment world.

Simon swung by our Bellevue office a few weeks back on a West Coast tour away from his New York City home base of the last three decades. My team and I had invited him to visit us so that we could learn more about a unique offshore gold vehicle he is offering to high net worth investors. Given Mr. Bernanke's relentless desire to make the US dollar resemble the Zimbabwe dollar, we have become increasingly interested in such options.

It's unfair to attempt to boil down his spirited and highly intelligent comments into a few sound bites, but alas that's the truncated nature of "Points to Ponder" EVAs. In essence, Simon says that the fiscal film he is now watching play out in the US reminds him very much of what Russia has done repeatedly over the last roughly 50 years.

He realizes that Americans have what he (and behavioral finance experts) calls a "normalcy bias." Thus, the current generation of US citizens has never known its government to repudiate its obligations, and this leads these citizens to believe it cannot, or at least will not, happen. Basically, this would be out of the range of their normal experience. Yet, there is little doubt in Simon's mind that such an endgame is looming in the not-too-distant future for our country. Unlike many of a similar mind-set, though, he has an unabashedly sunny view of America's long-term future.

Despite our appallingly inept government, he thinks Americans should avoid apocalyptic scenarios and realize the country itself will survive and even flourish. After all, we are still the richest country in the world and our private sector remains incredibly vibrant. It's just that, on top of a superb foundation, we have overlaid excessive debts, unaffordable entitlements, and a governmental structure that would make Rube Goldberg jealous.

As Simon points out, a decade hence people will still be buying Nike shoes, GM cars, Boeing planes, Starbuck's lattes, Exxon gas, and the latest Apple i-whatevers. Just as with Russia, Argentina, Greece, Iceland, and a host of countries that have had to restructure their debts, the economy, once it goes through the inevitable convulsion of an extreme currency crisis, will snap back. What will take the punishment is our money, the once formidable greenback.

In Russia, this amounted to a series of overnight "re-sets" of the value of the ruble. For those who held smaller bank deposits in rubles, the damage was slight to nil. However, if you had a lot of rubles or ruble-denominated bonds, safely tucked away at your local Moscow S&L, or even in a mattress, you wound up taking a massive haircut. Thus, 1 million rubles became 100,000 overnight or, as happened in 1998, virtually worthless.

Of course, this could never happen in America, right?

Avoiding the money illusion. Let's think back to the 1970s. US government finances were in infinitely better shape than today, yet the Fed nonetheless allowed inflation to erode half of the dollar's intrinsic value over that decade, as the CPI more than doubled.

There was no official restructuring, just an inexorable erosion of real purchasing power. Given the magnitude of the government's present fiscal cavern—and the Fed's potential to inflate its already monstrous balance sheet with trillions more of fabricated funds—a far more precipitous drop in the real value of the dollar is most probable.

One of the most compelling motivations for this from our government's standpoint is to inflate away its IOUs. If it can basically extinguish a large percentage of what it owes, particularly shafting foreign investors who have loaded up on Treasuries denominated in dollars, it can start the giveaway game all over again. Naturally, there will be terrible consequences of such actions, especially for those with considerable assets in US dollars, but it may be the least disastrous alternative.

Of course, we still have time to get our act together and behave like a real super power, or even junior power. However, the experiences with the debt ceiling in 2010 and the current fiscal cliff dive are not encouraging.

Offering a similar message, but from a completely different source, is a recent essay I read from Evergreen GaveKal's esteemed economist-on-retainer, Woody Brock. The main point of his paper was to address when the once-infamous bond market vigilantes might ride again, driving up US Treasury rates.

Woody cites the work of Lacy Hunt and Van Hoisington who have shown that post-credit bubble periods, such as the US after the 1920s and Japan in the wake of the 1980s, saw interest rates stay subdued for many years. Last May, I had the privilege of listening to Lacy Hunt make this case at an investment conference and I can attest that he does so most convincingly.

While Woody challenges their thesis for several reasons, he ultimately comes to the same conclusion: The Fed is likely to be successful in keeping US long-term interest rates at low levels for years to come. In other words, the era of "financial repression" has much further to run.

Yet, as our partners at GaveKal Research have repeatedly pointed out, a country can control either its interest rate or its currency, but not both. To this point, Woody believes the US dollar will be the victim of the Fed's interest rate suppression. In his words: "The dollar will bear almost all of the adjustment required when foreign investors become disenchanted with US bonds and demand higher (returns), whereas bond yields will bear almost none of the adjustment. Thus, interest rates will not rise."

Therefore, in Woody's view, it will be a cheaper dollar, potentially significantly cheaper, that will lure overseas investors into US debt securities. If so, although investors holding US bonds are likely to experience positive returns in nominal dollars, when compared to stronger currencies or, implicitly, stores of real value like gold, the results are likely to be woefully inferior.

Consequently, what might be the biggest asset allocation decision investors need to make is not whether to hold stocks or bonds but rather in which currency to hold them. Because the central banks in Europe, the UK, and Japan are also in full debasement mode, many of the obvious alternatives to the dollar don't solve the inherent problem. In fact, the euro and the yen may perform even worse.

In my opinion, most investors seem oblivious to the importance of the currency in which their investments are denominated. Some clients who share my abhorrence of current US policies have suggested going into cash but that doesn't solve the currency problem. It is also guaranteed to lose money even at today's controlled inflation level. There are far superior vehicles available to protect against the Fed's determined dollar degradation intentions.

If the end of that last sentence seems a bit over the top, consider that the Fed has now conveyed that it will rev up its money manufacturing to a \$1 trillion annual rate until unemployment recedes to 6.5%. With the world precipitously perched on the edge of another recession (and some regions are clearly already contracting), simply avoiding another rise in US unemployment won't be a cinch.

It certainly isn't a stretch to envision unemployment taking several years to reach the Fed's 6.5% target level. Actually, this is the forecast of the estimable David Rosenberg, who sees the Fed adding trillions more to its balance sheet in the next few years. Maybe it's no coincidence that, like us, David sees tremendous protection value in bonds denominated in his home country of Canada.

A 3% cash flow yield paid in a currency that is likely to be heading north rather than south. Sounds appealing, eh? That's why we are increasingly going north to Canada—and east to Asia—to protect our clients from Mr. Bernanke's frenetic efforts to "rescue" our economy.

David_Hay_Signature

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