December 21, 2012

"The US can pay any debt it has because we can always print the money to do that."
-ALAN GREENSPAN

POINTS TO PONDER

Special message: First of all, my Evergreen colleagues and I would like to wish all EVA readers a joyous Holiday Season. The heartbreaking shooting last week in Connecticut is a reminder of how fortunate we are to have our loved ones safe and, hopefully, together with us at this time of the year. And thanks to the wonders of technology, especially Skype, I'm sure many of you will be able to connect almost face-to-face with your distant family members. As the kids used to say, way cool.

Second, I am mixing up the usual order of the Points to Ponder version of EVA. Instead of starting out with the US, I thought I would begin overseas and then work my way back to our country.

1. German stocks, similar to those in the US, have been remarkably ebullient in 2012, rising 29.4% (versus a 13.7% increase in the S&P 500). This is even more surprising given that German industrial production has fallen 3.8% in the last year, a more severe contraction than experienced by beleaguered Spain and, most incredibly, even Greece. (*See Figure 1*)

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2. A decade ago, Germany faced an existential crisis similar to France's today. As is often the case, a left of center politician, Gerhard Schroder, put in place a series of labor and entitlement reforms that once more established Germany as Europe's economic locomotive, rather than its sick man.

3. Although the consensus view is that the worst of Europe's latest recession is behind it, the prestigious forecasting firm, Capital Economics, disagrees. It sees the eurozone downturn intensifying in 2013. (*See Figure 2*)

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4. Vividly illustrating how moribund France's private sector has been for nearly three decades, no entirely new company has joined its main stock index in the last 25 years.

5. Despite myriad remaining challenges, Italy has been making quiet progress under technocratic Prime Minister Mario Monti. In addition to running a primary budget surplus (where government revenues exceed expenditures before debt service costs are considered), Italy has also experienced a hockey stick increase in its manufacturing trade surplus. (*See Figure 3*)

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6. One of the lurking threats to global stability is the reality that European banks are brimming with debt issued by their increasingly risky home governments. But the eurozone is not unique in this regard. The IMF recently warned of the high risk to Japan's banks, if interest rates begin to rise. This tocsin ignores the peril should Japan's massive debt require restructuring, otherwise known as a default.

7. Unlike in most Western economies (plus Japan), China's aggregate government debt is relatively modest. It has also begun to fall a bit lately relative to the size of its economy (GDP). (*See Figure 4*)

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8. Despite China's effort to reduce its reliance on heavy industry for growth, its economy remains skewed toward fixed-asset investment. Similarly, consumer spending continues at a subdued level. (*See Figure 5*)

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9. Past EVAs have highlighted Canada's elevated consumer debt. On the corporate front, however, financial conditions are exceptionally robust. (*See Figure 6*)

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10. One of the most controversial EVA views ever was our belief, back in the deep gloom of late 2008, that the federal government would turn a profit on its bailout of AIG. The final chapter on that saga has now been finalized. Between the Treasury and the Fed, their combined investments have produced a net profit of nearly $23 billion. Moreover, the value provided by

preventing the implosion of the global financial system is incalculable.

11. Microsoft has become the ultimate Rodney Dangerfield stock despite its prodigious cash flow and growing dividend yield. The knock on the company is that it is almost exclusively tied to an eroding PC market. However, most investors are likely unaware that MSFT collects license fees on more than half of all Android phones sold.

12. Should the US stock market rally next year as a result of the Fed’s decision to manufacture another $1 trillion, it might be best to focus on depressed sectors. Tech, healthcare, and energy all appear relatively attractive, especially versus ostensibly defensive sectors like REITs and telecom stocks. (*See Figures 7 and 8*)

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13. Since the global financial crisis, spikes in the Fed’s balance sheet, as it fabricates reserves to buy government debt, have had an 86% correlation to the direction of stock prices. (Prior to 2007, this linkage was less than 20%.) Thus, the Fed’s "Great Levitation" has been effective in propping up stock prices. It does beg the question, though, of what happens when it is forced to sell its $2 trillion of excess holdings (which, by the end of 2013, will be near $3 trillion).

14. Gold has been stuck in the $1,600 to $1,700 range for an extended time. With global central banks now in a decided buying mode—and the Fed’s pace of money creation set to double next month—bullion might be poised for another leg up. Even gold mining stocks may rise up from seemingly interminable lethargy. (*See Figure 9*)

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15. Although financial markets are likely to react very negatively should the fiscal cliff become a reality, the Congressional Budget Office projects much better long-term economic growth beyond 2013, if the US economy does go off the ledge. Moreover, total debt-to-GDP would be 73% by 2022, assuming mandatory tax hikes and spending cuts occur, compared to 104% if "sequestration" does not kick in. (*See Figure 10*)

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What the world needs now… One of my favorite sports quotes, which I've relayed on at least one previous occasion, is that winning is a great deodorant. Of course, if John Madden's famous quip is true, then the logical reciprocal is also valid: Losing really stinks.

For many years, the US economy was like a great sports franchise. It would encounter a losing season here or there but, overwhelmingly, it was a growth juggernaut. There is simply no question that over the last 150 years, and particularly after WWII, America experienced prosperity never before seen in the annals of history.

Additionally, thanks to the brilliance of George Marshall's global revival plan that bears his name, the rest of the world also enjoyed unparalleled economic success in the post-war period. Then, once the emerging nations, notably China and India, decided that capitalism worked a lot better than socialism, what was once condescendingly known as the Third World embarked on a growth trajectory that put the "rich" world to shame.

If you think there is a "but" in the offing, you are most perceptive. As conveyed in prior EVAs, the planet's five major economic blocs—Europe, the US, Japan, China, and the rest of the developing countries—are all witnessing a breakdown in their business models. Even the most dynamic, China and its emerging market peers, are witnessing a disconcerting slide in their exports—the lifeblood of these economies.

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Consequently, what the world desperately needs right now is a twist on those lyrics sung almost 50 years ago by Dionne Warwick.

…is growth, sweet growth… Back when Ms. Warwick was crooning Hal David's catchy words, with music by his more famous partner, Burt Bacharach, growth seemed so easy to come by, at least in the US. In the 1960s, America's economy routinely grew between 4% and 5% annually. We were the world's flywheel and the envy of nearly all nations, especially those enfeebled by arch-socialism or outright communism.

But by the 1970s, Japan and the other "Asian tigers" were the growth superstars. The US and Europe were caught up in a grand experiment based on the theories of John Maynard Keynes, underscored by President Richard Nixon's 1971 proclamation: "I am now a Keynesian in economics" (popularly remembered as "We're all Keynesians now").

As was typical of Nixon's grasp of things economic, this was just as Keynes' traditional nostrum to kick-start growth and mitigate recessions with massive government spending was poised to flop. In a few short years, "stagflation" would become the buzzword of the era.

By the late 1970s, America was being told that its best times were behind it and its days of rapid economic growth were just a stardust memory. In Europe, hard-left governments had encroached into almost all critical areas of business activity with predictably disastrous results. The world was coping with its first growth crisis since the 1930s.

Fortunately, new policies came to the rescue in the 1980s and not just in the US and Europe. In China, a former hardline communist named Deng Xiaoping, decided to embrace free enterprise. Instead of "to work is glorious," the new mantra became "to get rich is glorious." In the developed world, Ronald Reagan and Margaret Thatcher unshackled their respective economies and a new boom was underway.

Yet, when I survey the landscape today, it feels more like the early 1970s than the early 1980s. Capitalism is once again under siege and voters, at least in the West, seem to believe that more government is the solution instead of the problem.

As a result, the wonderful, sweet-smelling deodorant of growth is no longer in the air.

…that's the only thing… Actually, it's utterly wrong to say that the world has a growth shortage. In many ways, we are seeing a growth acceleration unlike anything the world has ever produced. Let's just consider government debt. It is growing at a rate that would make the cell proliferation in the Andromeda Strain look plodding.

Or take the exponential growth rate in government regulations and, while you're at it, don't forget the explosion in student loans that promises to indenture the younger generations for decades to come.

Last but not least, think of the quantum leaps in jobless benefits, long-term disability payments (the new long-term unemployment program), and food stamps. Let's face it: We've gone from bailout nation to handout nation in four short years. At least with TARP, and the other reviled Wall Street bailouts, there was a return on taxpayer dollars.

The problem, of course, is that the growth is in all the wrong places. Most disturbingly, the more things like government debt and regulations grow, the more difficult it is to generate the kind of growth that actually pays the bills. Perhaps worst of all, a country gone "ex-growth" also tends to go "ex-hope." And without hope for a better, more prosperous future, the entire social fabric begins to tear.

One of my vivid junior high school recollections (yes, I really can remember back almost 50 years—for now) is of my history teacher, Mr. Hood. He would constantly remind my classmates and I that the reason that we didn't have pitchfork wielding mobs marching down Bellevue Way was that the have-nots believed they would someday become haves. In other words, they had hope, and I was certainly one of those who did, even though my prospects weren't very impressive back in 1968.

Without growth, difficult societal problems become unsolvable. Dividing up a shrinking pie, at least on a per capita basis as the economy expands more slowly than the population, becomes a zero sum game—perhaps even a negative sum game. Belief in the ultimate American dream of upward mobility begins to die out and in its place arises an abiding resentment toward those at the top. Increasingly, the affluent come to be viewed as effluent—at least according to the class war mongers like Paul Krugman (who recently wrote an op-ed piece calling successful entrepreneurs "robber barons").

This, in turn, leads to exceedingly unproductive measures on the part of those who have capital to move their funds into hard assets and even offshore. The result is that the vicious circle grows larger with less investing in areas that produce jobs and real wealth, further strangling economic vitality, otherwise known as growth.

So, the government can spend a trillion more than it takes in, as far as the eye can see, and the Federal Reserve can wave its magic wand to create a trillion in pseudo money annually to buy the government's IOUs, but neither of those produces real economic growth. However, it can create a transitory illusion of prosperity by inflating corporate earnings and stock prices, what we call the Great Levitation. Yet, as anyone with a moderate degree of common sense realizes, there will be an extremely painful price to pay once the twin trillion dollar props are removed, as someday they must be.

Unfortunately, as the latest charade plays out in Washington over the fiscal cliff, there is no discernible movement to revive that precious commodity which is in such short supply these days.

…there's just too little of. Growth, like winning in sports, covers up a multitude of sins. When it stops, or shifts into reverse, it's like Buffett's story of the tide going out—you find out who was swimming in the buff. Based on current global economic trends, it's pretty clear there are a lot of nudists around the world. Even in once booming China, double-digit growth appears to ebbing, likely permanently.

While I can't prescribe remedies for the rest of the world, recent events have reinforced my conviction that the US has one extreme growth retardant: our tax code. In fact, *code*, as in mind-numbingly cryptic, is an excellent word for it. All the time, energy, and, of course, fees, that are going into dancing to the tune of the latest tax code changes, both from an income and estate tax standpoint, as this year comes to a close are simply staggering. My team and I have spent a considerable amount of the last quarter trying to manipulate portfolios for tax reasons rather than focusing on traditional investment analysis.

Extrapolate our experience across the country with all the CPAs, law firms, investment advisers, and brokers, not to mention the cost in time and money to the underlying clients, and you realize what a massive waste of resources this has been. Of course, in a few more years, we will probably be reversing much of what we've spent months putting in place this year.

In this regard, I was pleased to read a *Financial Times* article earlier this week by Larry Summers, former treasury secretary in the first Obama term. In this op-ed piece, Mr. Summers makes a persuasive case for closing loopholes and simplifying the tax code. As Jeff Eulberg so competently outlined in last week's EVA, that's an essential goal of the Simpson Bowles reform plan. (Mr. Summers also notes that the US collects just $12 billion per year in estate taxes due to the myriad loopholes that exist in that code.)

As I've gotten older, I've come to realize the world is made up of constructors and obstructers. The former are those intrepid souls who actually make things, create ideas, come up with inventions, make risky investments, start businesses, and generally drive the arc of civilization upward in what used to be known as progress.

The latter, the obstructers, are all the rule makers and enforcers. They are, though they don't like to admit it, overhead. They are certainly needed—in appropriate quantities. But over the last three decades or so, they have been breeding like rabbits on Viagra and so have all their rules and regulations. The tax code is certainly one very tangible—and costly—example of that but, shock of shocks, there is a lot more obstruction in the legislative pipeline.

Just since the election, the Department of Health and Human Services (HHS) has spewed out 13,000 pages of regulations and "clarifications" on Obamacare (I wonder if Nancy Pelosi has read all of those so she can now tell us what's in them). Yet, those who have to actually implement them, like the states, seem more confused than they were before the latest HHS information carpet bombing.

While it's the time of the year when we are supposed to be joyous, I'm having a hard time getting in the holiday spirit when it is becoming increasingly clear that the obstructers are winning the war. If we want to rekindle growth in this country, we've got some serious de-obstructing to do. The solutions are out there. The question is: will we embrace them before we destroy the greatest growth franchise the world has ever known? If we don't, all the deodorant in the world won't cover up the stench.

David_Hay_Signature

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