

November 16, 2012

"By a continuing process of inflation, Governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens...Lenin was certainly right. There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency."

-JOHN MAYNARD KEYNES

The original Volcker Rule. The year was 1979 and I had decided to become a broker. When I told my friends of my decision, they assumed I meant a real estate broker and their assumption was entirely reasonable. Inflation was running wild and real estate was in the late stages of a long bull market. But I meant "stock broker," a career move that also surprised my father. In fact, he was sure I was committing the kind of mistake 23-year olds seem to be able to make so frequently and effortlessly.

Dear old dad, who truly possessed what Bush (the Elder) called "the vision thing," felt the recent innovation of discount brokerage was going to drive my new employer, Dean Witter, out of business. He may have been right—just a few decades early, and for the wrong reason—considering that Dean Witter eventually disappeared into Morgan Stanley. And had it not been for the Troubled Asset Relief Program, aka TARP, Morgan Stanley might have gone the way of all flesh—or at least Washington Mutual.

Slightly more momentous than my decision to become a "Witter Critter" was the appointment in August 1979 of Paul Volcker as chairman of the Federal Reserve Board. Those readers with a keen memory realize that this date means he was appointed by the much-maligned Jimmy Carter, not Ronald Reagan, as I believe most now assume.

It's plausible, if not more than a little ironic, to believe that it was Volcker's vicious assault on inflation, driving interest rates up to levels never before seen, that cost Carter the 1980 election. Though many EVA readers were too young to appreciate the convulsions of that era, I suspect almost all who are at least my age will never forget what it was like. If you were a small business owner or real estate investor, borrowing money at that time was even more painful than watching the recent and interminable presidential campaign ads. (See Figure 1)

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Mr. Volcker's gambit to throttle inflation, which we all now know was spectacularly successful, had a pronounced impact on my early career. For one thing, I came to associate December with two things: 1. Christmas and 2. Selling whatever bonds you had bought for clients earlier in the year at a loss. Brokers like Dean Witter did a brisk business doing tax swaps where bonds with a below-market interest rate were sold and others with similar characteristics were bought at an equivalently depressed price.

As a young and somewhat naïve broker, this all seemed a bit odd to me. After all, the bonds I had acquired for clients on the buy-side of the prior year's tax swap needed to be sold for losses a mere 12 months later. It was during these years that bonds became known as "certificates of confiscation" and other than for the dubious purpose of producing tax losses this was a fair description.

After this went on for a few years, it was naturally harder to get clients to buy bonds.Â This was despite the fact that I was generally trafficking in municipal debt and the highest tax rate on "unearned income" in those days was 70% (at least until the Reagan tax cuts kicked in).

Fortunately, however, most clients did stick with the program and thanks to Mr. Volcker bonds were about to become something they hadn't been since the 1930s: "certificates of appreciation."Â Instead of the interest income offsetting a portion of the depreciation, it now became bond investor nirvana:Â double-digit cash flow plus rapidly rising market values.Â And to complete the trifecta, falling inflation made the real return even better.

As I admitted in a recent presentation to a small group of Evergreen clients, it took me awhile back in those days, as it did for most investors, to appreciate that Volcker was totally committed to breaking inflation.Â It's hard to realize now how much skepticism there was at the time that inflation could ever be contained.Â It had basically been on an irregularly rising curve (temporarily inhibited by recessions) since the early 1960s.Â But somewhere in 1982, I woke up to the fact that it was time to move out of money funds, then yielding in the mid-teens, and buy longer term bonds even though the yields were often lower (the classic "inverted yield curve".)

That was a tough sell, especially for a relatively inexperienced broker.Â One of my vivid recollections is of a client asking me why he would want to go out five years on a CD that was "only" yielding 14%.Â But, fortunately, an increasing number of clients, and those I was "prospecting," began to do just that.Â By the end of 1982, the growth of my business started to look like the stock market, which was also going vertical as rates did a cliff dive.

Consequently, when I look back at my career I realize what a debt of gratitude I owe to Paul Volker and I don't think it's an exaggeration to say the entire country does as well.Â He had the courage to take the heat for triggering a deep recession and the benefits reverberated for decades.

Now, some 30 years later, inflation remains exceedingly subdued, but a radically different Fed chairman is at the helm.

The brave new Fed. In the wake of last week's presidential election, financial markets appear to be coming to terms with its implications.Â Yet, as they focus on threats like the fiscal cliff, there doesn't seem to be much reflection on what the outcome means for the Fed. In my opinion, the impact on the Fed is vitally important from an investor perspective. Now that Mitt Romney is no longer poised to send current Fed Chairman Ben Bernanke packing off into premature academic repose, the future course of monetary policy is coming into sharper relief.Â And it's my contention that bond markets should feel far from relieved, at least looking out a few years.Â

As I wrote in the October 12th EVA, in which I attempted to outline post-election scenarios, Mr. Obama returning to office is likely to be less bond market destabilizing, on a short-term basis, than if Mr. Romney won.Â Thus far, based on the fall in government bond yields since the election, that seems to be the case.Â Mr. Bernanke will almost certainly serve out his term through next year and he'll also plausibly have a considerable influence on the choice of his successor.Â Just as logically, his replacement will share his conviction that the Fed needs to continue to drench the financial system with half a trillion dollars annually that the Fed simply wills into existence.

Consequently, in the near term, the bond market is anesthetized by the belief that the Fed will

remain the buyer of 100% of Treasury issuance with maturities five years or longer to facilitate the funding of its trillion dollar deficits. (See *Figure 2*)

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But the crucial words above are "near term." In the fullness of time, the continuation of current monetary policies has to be as big a negative for the US bond market as the appointment of Paul Volcker was a positive in 1979. Yet, as previously noted, it took a few years for bond investors to catch on to how dramatically the atmospheric conditions were about to change.

For me, this is a poignant point in time. A master strategy that has guided me so well and benefited my clients for so long is coming to the end of its useful life. As you can see above, it's been an amazing ride. (See *Figure 3*)

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Now, however, with 10-year Treasury note rates at 1.6%, below even today's quiescent inflation rate (instead of 10% or more above as in the early to mid-1980s), future returns are certain to be paltry at best, and certificate of confiscation-like at worst. This outlook assumes we avoid a Japan-like bout of deflation. However, given that Mr. Bernanke has made it LCD clear that his printing will know no bounds to avoid deflation, a persistently contracting CPI seems to be a most unlikely outcome.

As I have repeatedly admitted in print and innumerable conversations, the timing of when the great bond bull market meets its maker is highly debatable. It's true that our economy

continues to be burdened by the lingering deflationary effects of the bursting of the real estate and lending bubble. It's also valid to say that with the Fed overtly suppressing interest rates, and announcing its intention to do so for years to come, income investors have almost no choice but to play along with the game economists call "financial repression." The key word here is *almost*.

Go east, young (and old) man! Let's assume for a moment that all of the Fed's machinations don't actually trigger an inflation resurgence due to excess slack in the system, deleveraging, non-existent money velocity, etc. Even so, its efforts are likely to achieve one of the Fed's not-so-overt goals: weakening the dollar. Admittedly, that's not an easy feat presently when the Fed's peers in Europe and Japan are chasing the same inglorious prize. But not all countries are intent on trashing their currency. Actually, one country seems to be pursuing a very different course.

Our partners at GaveKal Research in Hong Kong have been making the case for some time that China is positioning its currency, the renminbi, to be the world's reserve currency-in-waiting (and based on present Fed policies it may not need to wait very long). China has been feverishly inking deals with its trading partners to settle their trade claims in renminbi versus dollars. After the dislocations caused by the dollar shortage during the global financial crisis, it is finding willing participants among countries like Korea and Brazil.

In addition to desiring to burnish its currency status, China also is in immeasurably better financial shape than the US government. Further, it is sitting on more than \$3.2 trillion of foreign currency reserves, much of it in the form of IOUs from the US. Lately, though, China has been showing a reduced appetite for adding to its already massive trove of Treasuries, leaving American households—and, of course, the Fed—to pick up the slack. (See *Figures 4 and 5*)

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Evergreen and our partners at GaveKal believe there is a rising new asset class that will likely be moving to the top of the menu of appetizing investment options for yield-famished investors: dim-sum bonds. This is the slightly whimsical name for debt issued in Hong Kong and denominated in renminbi. Louis Gave, in a research note last week, pointed out that you can now buy a three-year Ford Motor dim-sum bond at 3.7% versus just 1.9% from Ford in US dollars. In other words, you can invest in the same credit but with almost double the yield and, remarkably, in a currency with much sounder underpinnings.

As many of you are aware, GaveKal and Evergreen have been striving to bring out an Asian income mutual fund accessible to US investors for the past nine months. We've encountered some delays, which is fairly typical in launching a new fund, but it is definitely still in the works. In light of the recent election, and the clarity it provides about future US monetary policy, we realize this is an even more timely vehicle to be able to offer our clients.

Beyond dim-sum bonds, Asian equity income securities also look appealing with some of the strongest companies trading at P/E ratios in the 10 to 11 range and offering 3.5% to 4% yields. One Hong Kong bank, which survived the financial crisis in excellent shape, has the largest deposit base on the planet. It yields 4.25% and is enviably positioned to benefit from the financial deregulation now underway in China. In the non-financial realm, Evergreen has recently bought, for income portfolios, one of China's premier infrastructure operators with extensive holdings around the world. In addition to a dividend of 3.4%, projected to rise to 4% soon, it has a credible growth rate of 15%.

It goes without saying, but I will anyway, that we're not giving up on the US. In fact, there are numerous attractive places to invest domestically, even assuming we are close to the reversal point for the mega bull market in bonds.

Defenseless no more. During the 1970s when bonds were investment sinkholes, there weren't many places for a yield-oriented investor to hide. Even money funds were relatively unknown until the end of the decade. Today, however, there is an extensive assortment of tools a professional money manager can use to craft portfolios that are relatively immune to rising inflation and interest rates. Floating-rate bonds are one tangible example that we have been using more extensively of late. Royalty trusts, where the payout is linked to a commodity price like oil, are another.

An even more recent entry in this regard is exchange-traded funds (ETFs) that hold floating-rate bank debt. While these are certainly not riskless (what is anymore?), we believe they are considerably safer than their more volatile cousins in the below-investment-grade world, junk

bonds. This is due to the fact that they are higher up in the capital structure and have historically had superior recovery rates should the issuer default. And, as their name implies, the yield floats with short-term interest rates.

Master limited partnerships (MLPs), a long-running EVA favorite, also provide inflation-protected cash flows. Even with the CPI increasing at a mere 2% for many years, the healthier MLPs have been able to bump their distributions at an annual clip of 5% to 6%. In the event inflation breaks free of its moorings, distribution growth rates should rise more or less commensurately.

Yet, even though there are more ways to protect income portfolios from a 1970s flashback, the reality is that a replay of that downbeat decade would be exceptionally challenging for domestically focused investors. That's why we believe shifting assets into countries with better fundamentals is increasingly essential, with Canada being the nearest example of a nation with a healthy balance sheet—not to mention a central bank run by a committed Volckerite rather than a man whose favorite keystroke combination is *control+print*.

For many years, the Fed was very proud of having achieved what it called the Great Moderation, basically, steady but not spectacular growth with controlled inflation. But the edifice of the Great Moderation came crashing down in 2008, exposing a fatally flawed foundation of excessive leverage. As noted in a recent EVA, the Fed is now engaging in what we have called the "Great Levitation" whereby it blatantly seeks to inflate stock prices. Unapologetically, the Bernanke Fed is trying to force stocks higher to create a greater wealth effect and, hopefully, stimulate the economy. Though Paul Volcker has been circumspect in his public remarks, other than to rightly say he doesn't think it will work very well, he must be gnashing his teeth like Karl Rove on election night.

Ironically, the man who has the power to hire and fire him, President Obama, is preparing to make Mr. Bernanke's Great Levitation considerably harder. Should the tax rate on dividends nearly triple from their current 15% level to 44% (assuming they are once again taxed at ordinary income rates and those go to roughly 40% with another 4% added for good measure due to the Affordable Care Act), that can't help the market. Frankly, I think a jump of that magnitude is unlikely, but it is possible and it would neutralize much of Mr. Bernanke's considerable powers of temporary levitation.

In fact, it's hard to comprehend how the number one problem inhibiting the economy—a crisis of confidence in the future of our country—has been rectified by the election. Therefore, it's likely Mr. Bernanke will keep brewing up hundreds of billions of dollars from his cauldron of alchemy, raising the risk that he will eventually create his version of "That '70s Show." If so, it's important to remember what that decade meant for US-based investors: Bonds and stocks both tanked.

Yet, from the Volcker era on, stocks and bonds have been negatively correlated, at least during bear markets. Thus, bonds have risen in value whenever stocks have been thumped, providing a nice counterbalance for blended stock/bond portfolios. But those days could well be coming to an end, with enormous implications for the traditional balanced investor. This once again highlights the need to be allocating a healthy portion of your bond investments to countries where there is a combination of an undervalued currency (like the renminbi) and a responsible monetary policy. According to Charles Gave, whom I spent several hours with last week, German bonds (known as bunds) outperformed almost all major stock markets from 1972 to 1982. We think there is a distinct possibility that dim-sum bonds are the new bunds, with

the renminbi the latter day "D-mark." (The folks at GaveKal deserve full credit for this concept, by the way.)

Now, could it be that US policies aren't destined to reprise the decade when double-digit inflation and unemployment rates gave birth to the aptly named Misery Index?

The California contagion! It's been a recurring EVA refrain that the fiscal reform package known as Simpson-Bowles still has a pulse. It was my hope that if Mr. Obama won the election, the race would be close enough that he wouldn't conclude he has a mandate to move the country deeper into big government territory. Despite his small margin of victory in the popular vote, he won easily at the electoral level and from listening to some of his post-election comments he doesn't sound to be in a mood to compromise, at least very much.

Yet, it's still early and I continue to believe there's a decent chance he won't want to be held accountable for four more years of the same combination of lackluster growth, trillion dollar annual deficits, and Banana Republic-like monetary policies. The fact is Simpson-Bowles was designed to raise tax revenue. It would do so with lower tax brackets but the overall burden on "the rich" will go up given the elimination of many deductions and higher taxes on both dividends and capital gains. In other words, it accomplishes his constantly avowed goal of having the 1% pay more.

If we somehow get a burst of bipartisan rationality in D.C., that would certainly change our outlook for the better. But I have to admit I worry about my beloved second home state of California and what its long-running modus operandi could mean for the US as a whole.

Back around that fateful year of 1979, there was a trend of Californians moving up to Washington State to escape pollution, steep taxes, and lofty home prices. The influx became so pronounced, upsetting many "native" Washingtonians, that it was quite common in those days to see bumper stickers with these words: "Don't Californicate Washington!"

Lately, I've been increasingly concerned we are beginning to Californicate America and it wouldn't be the first time. Over the years, the now tarnished Golden State has often been a trendsetter for the rest of the country. And never has there been a more perfect laboratory to test out how well it works to keep raising taxes, enacting more crippling regulations, and allowing public employee unions to have their way with taxpayers than in California. Basically, the legislative process has been dominated by one party for the last 40 years and it truly transcends politics to simply observe that it is bankrupting the state.

Lost in the ruckus over the national elections is that California just passed another massive tax increase. The top rate is now 13.3% and that is in addition to a sales tax that often amounts to 9% (with local levies included.) Indicating that the grand experiment has much further to go, the Democratic party now has a supermajority in the legislature meaning it is nearly impossible for the Republicans to restrain spending or taxes (not that they've been very effective in the past). To complete the circle, a ballot initiative that would have banned automatic payroll deductions to fund political ads by unions was defeated.

To say that the government of California is in disastrous financial condition is merely to convey the facts. It has more than \$200 billion in unfunded public employee retirement benefits. Even for a state as large as California this is an overwhelming sum. The sad irony is that there is no other state in our union that is as naturally blessed as California given its enviable climate, sheer land mass, enormous energy reserves, prolific agricultural sector, and flourishing

entertainment and high-tech industries. It's not easy to go broke when you have all these God-given advantages but the government of California is proving it can be done.

California's experience, particularly over the last 20 years, makes it abundantly clear that solving a chronic spending problem with higher taxes simply doesn't work. Of course, France, Canada, Sweden, Australia, Germany, and New Zealand have proved the same thing. While France never seems to learn, the other countries listed above all did mend their ways with the "liberal party" often blazing the trail back to solvency.

One of the great tragedies of the currently polarized US political situation is that labels transcend logic. Voters and their elected representatives are "liberal" or "conservative" (where did all the moderates go?) and the policies they propose are based on the stereotypes of these dueling ideologies. To resolve our differences, and deal with the existential threat current policies pose to our country's survival, we need to think rational vs irrational, rather than left vs right.

Paul Martin, the finance minister who drove Canada's amazing fiscal turnaround, said this during the worst days of its debt crisis: "The deficit is not an invention of ideology; it is a fact of arithmetic." By the way, Mr. Martin was a leader of Canada's *Liberal* party. Starting in the mid-1990s, Canada enacted a series of very rational reforms and within a few short years it was running surpluses. Its federal debt-to-GDP ratio is now around 35% versus over 80% in the US (and including the social security "trust fund" debt we are over 100%).

Simpson-Bowles is our best shot at imitating the Canadian experience and avoiding the Californication of America. If it gains momentum, we will be able to take a more constructive stance on the US financial markets. If not, we are almost certainly looking at serial downgrades for the US. Prudent and realistic fiduciaries will need to protect their clients' assets from the unavoidable future fallout of today's radioactive fiscal and monetary policies. Yet, even assuming Simpson-Bowles becomes law, the outlook for fixed income is not stellar. The confidence revival caused by credible reforms would rekindle the desire to hire, borrow, and invest, igniting the long dormant velocity of money and causing interest rates to begin normalizing.

Shakespeare once wrote that it is better to be three hours early than one minute late. When it comes to preparing for the demise of Paul Volcker's 30-year bull market in bonds, those centuries-old words are very much worth remembering.

Correction notification:

November 2nd EVA - For those who were quick to open this EVA, there was a typo in PTP 2. We mistakenly printed "0.7%" instead of the correct "9.7%". The sentence should have read: "Backing out a 9.7% jump in defense spending, hardly an area to rely on for future robustness, the economy would have expanded by roughly 1.4%."

November 9th EVA - On page 3 of last week's EVA in the subheading of "Bull Market's Extension" should have read, "Bull Market Extension No. 1 was in 1961". (1981 was originally printed.)

David_Hay_Signature

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