March 31, 2009

Humpty Dumpty

The current fiscal crisis has created a new paradigm for investors. Forty years of growing the economy on credit and leverage has resulted in an economic meltdown and stock market crash. The investment strategy of the past two generations needs to be reassessed as the economy de-leverages, savings rates increase, and the massive federal and personal debts are confronted. A new strategy should be considered.

The past year has been the most trying period for investors since the Great Depression. The collapse in asset values worldwide was an unavoidable consequence of years of economic expansion and one which history teaches us should have been expected. Unfortunately, human behavior is consistent and the lessons of the past are often ignored or forgotten. Short term success often leads to a lack of caution and, in this case – as in the Great Depression – the perversion of those systems that had safeguarded the economy. In the end, governmental, corporate, and personal abuse of leverage created a "**Humpty Dumpty**" economy.

The United States ***wall of debt***, upon which the economy was precariously perched, began to develop in the 1960's. The debt-ridden economy started with the "Great Society" spending of Lyndon Johnson and the contiguous decade of the Vietnam War debts. Ronald Reagan's attempt to grow the economy was based on supply-side free market economic theory. The theory calls for reduced taxes and reduced spending to stimulate economic growth. The Reagan economic growth strategy, which should have short-circuited the growth of American debt, was offset by Cold War spending in an effort to bring down the Soviet Union. The result was a rapid growth in the national debt along with a reduction in federal regulations.

Throughout the 1980's and 1990's, government and personal spending spiraled upward. The Federal Reserve, under Chairman Greenspan, stimulated economic growth by excessively increasing the money supply, setting artificially low interest rates, permitting low margin requirements, and encouraging very high rates of leverage. Governmental rules and regulations were further undermined. Off balance sheet accounting, unregulated bundled products, hedge funds, and derivatives, became popular with Wall Street and were encouraged by the politicians, rating agencies, and regulators.

Not since the Gilded Age (1890's) and the Roaring Twenties (1920's) has the greed, political corruption, misrepresentation, and personal lack of responsibility been so rampant. Some examples:

- The top 1% of wealthy individuals now own 25% of our nation's assets.
- Hedge Fund managers, earning hundreds of millions of dollars per year, lobbied Congress to pass a bill that taxed the hedge fund owners at a 15% capital gains rate vs. the 25%+ income tax rate that the general public must pay. This law was passed by "our" Congress and signed by "our" President.
- The statistical method our government created for reporting unemployment understates significantly the actual number of unemployed individuals. Individuals off the

unemployment rolls are not counted in the statistics. Barron's estimates the rate of unemployment to be 16%+ vs. the 9% being reported.

- The rate of monetary inflation is also significantly understated by the government's pro forma "hedonic" method of calculation.

  Julius Baer, a German money manager, estimated last year the true rate of inflation in the US at 8%+ vs. the 3.8% being reported. Because benefit payments and interest payments on the federal debt are indexed to the inflation rate, the Federal Government saves an estimated 750 billion dollars per year in Social Security payments, federal employee and military retirement benefits, entitlement payments and interest paid on U.S. Treasuries.

There is reason for public distrust and concern.

The 21st century witnessed a continuation of the previous decade's economic policies. Politicians and modern day Wall Street ***robber barons*** supported even greater deregulation and leverage. The nation's ***wall of debt*** grew to an estimated 50 trillion dollars. These policies helped create the greatest over-valuation bubble in human history. The current housing bubble was created by an economic system (quasi unregulated free market capitalism) out of control. As suggested, the Greenspan FED held interest rates at artificially low levels for a number of years helping create the fertile ground for excess leverage and speculation. Financial lending institutions, empowered by Congressional and Presidential action, encouraged the bending or ignoring of rules to allow unqualified buyers to take out loans that could never be repaid. These were our elected politicians and regulators changing or ignoring, for ideological reason or personal gain, laws which had been earlier enacted with the interest of the general public in mind.

"**Humpty Dumpty,**" the US economy, began to fall off the wall in March 2008 when Bear Stearns went bankrupt due to massive leverage, and the inability to make payments on their credit default swap book. Many of our nation's largest banks, foreign banks, and investment banks were suddenly bankrupt. As the massive leverage unwound, a number of financial companies dropped below their net capital requirements and a Federal bailout of many of our largest banks and investment banks became necessary. As the crisis unfolded, bank credit dried up and lending came to almost a stand still. Capitalism, due to inadequate regulation, had become ***Capitalism Rex***: an untamable beast which attempts to devour most everything in its path.

Businesses throughout the world economy are being impacted, to varying degrees, by the loss of available credit. AIG, the world's largest insurance company, and a massive investor of leveraged CDO's (collateralized debt obligations) now bankrupt, was forced to apply for a government bailout. Other industries were immediately impacted. The leveraged US automotive industry is once again on life-support. Unemployment in Detroit, MI, is at the Great Depression levels of 25%, and home prices are down 50-75% in some areas of the city.

The economy continues to have numerous pressure points. Small business and individuals will continue to be impacted. During the first quarter of 2009, consumer prices posted their first annual decline since 1955, and industrial capacity slid to 69.3%. The 'officially reported' unemployment is currently over 8% and is forecast to rise to 12%. Unemployment in Oregon is now over 12%. There is also concern that commercial real estate is starting to collapse, with increasing corporate credit defaults likely. Residential real estate values are expected to continue to decline for the next 6 to 12 months. After being down over

50% the stock market is currently down 44% from the market high of October 2007. The S&P 500 Index was down 11% for the Q1 period. Economic and stock market risk will remain until the credit market regains its footing.

Gary Shilling, Nouriel Roubini , and other economists who anticipated this economic downturn, believe that GDP will fall to a 2% annual rate for the next decade. The US economy will most probably experience economic deflation for a number of months along with slow economic growth. Given the massive 15 trillion dollar fiscal stimulus package now being added to the 50+ trillion dollar long term national debt, and a current negative balance of payment debt in the hundreds of billions of dollars annually, one must conclude that higher monetary inflation is on the horizon.

The 1974 stock market crash and subsequent stock market bottom provided exceptional investment opportunities and valuations unseen since the 1930's. Investors benefited greatly as they purchased companies at compelling values. The current stock market decline provides similar investment opportunities. A number of the world's best managed businesses are once again trading at compelling valuations. The emerging markets now represent the most likely sector for rapid GDP growth, and trade at decade low price earnings ratios. These investments will provide a hedge against a declining dollar. Natural resource and infrastructure businesses will provide investment protection from monetary inflation. Exceptional opportunities often present themselves after economic and market meltdowns.

The lessons of history, especially those of the last forty years, dictate an investment approach that anticipates short term deflation followed by higher monetary inflation. Astute money managers and individuals must position portfolios and allocate assets to reflect this new investment paradigm.

Let us hope that "all of the king's horses and all of the king's men will soon put '**Humpty Dumpty**' together again!"

Roger L. Johnson