March 31, 2011

The Tipping Point

Recent events in Japan remind us of some of the faults in human nature: our overconfidence in safety systems and inadequate risk assessment skills.

The 9.0 magnitude Tohoku earthquake and resulting tsunami of March 11, 2011, is both a natural catastrophe and a human tragedy of massive proportions. The cause of the earthquake was the incomprehensible pressures of two colliding tectonic plates 19.9 miles below the ocean's surface and 80 miles east of the northeast Japanese shoreline. Seismologists had predicted that the area was prone to massive quakes and that one was likely to happen at some future date but the **tipping point** of the tectonic pressure was unknown, as was the power of the ensuing tsunami.

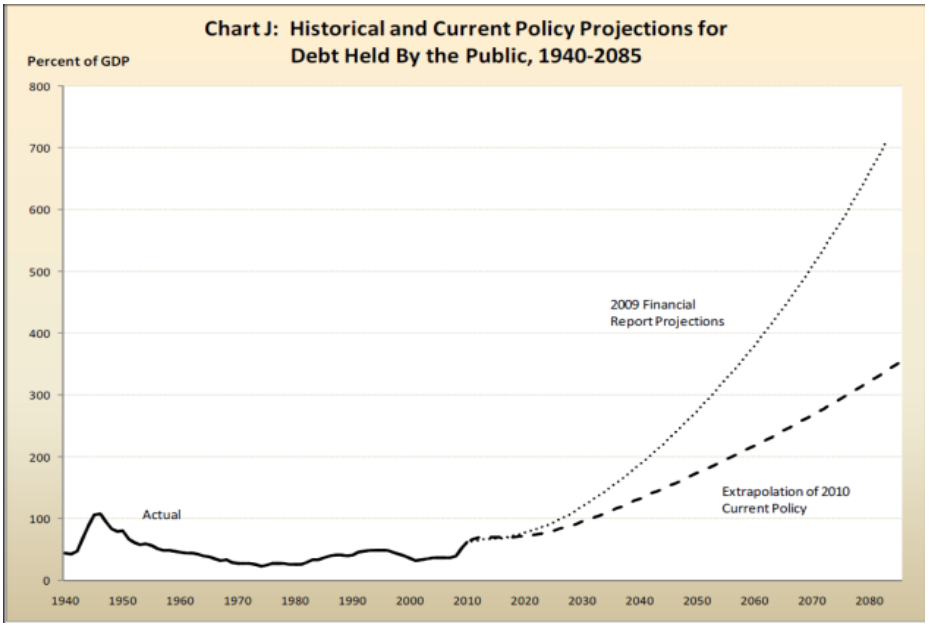
Thankfully the seismologists' warnings did not go *completely* ignored. The Japanese people constructed massive sea walls to protect low lying areas and reinforced many buildings to withstand a massive earthquake, including the Fukushima Dai-ichi Nuclear Plant and reactors. Unfortunately, in part because of these precautions, residents seemed confident that they were adequately protected. They were not.

The unprecedented pervasiveness of recording technology allowed the whole world to watch as the sixth largest earthquake ever documented hit Japan and then to witness the variety of behaviors exhibited by individuals during the brief period between the earthquake and the tsunami. In this respite, people were seen casually riding bikes and driving cars and trucks along the sea wall, ignoring the tsunami siren's warnings, while other, less trusting individuals, rushed to get out of harm's way. Those individuals who believed they were safe at 40 feet above sea level were swept away by the gigantic swell of water. Here, in no uncertain terms, we saw that it is the nature of many individuals to trust that things will work out in the future as they have in the past. They have faith that the systems in place will continue to provide protection and safety. In short, people found it impossible to believe in the possibility or magnitude of this disaster because it was outside their experience or expectations.

> *…markets and the economy are threatened by the government's tardiness in addressing fiscal reform.*
> Rodriguez, FPA Capital

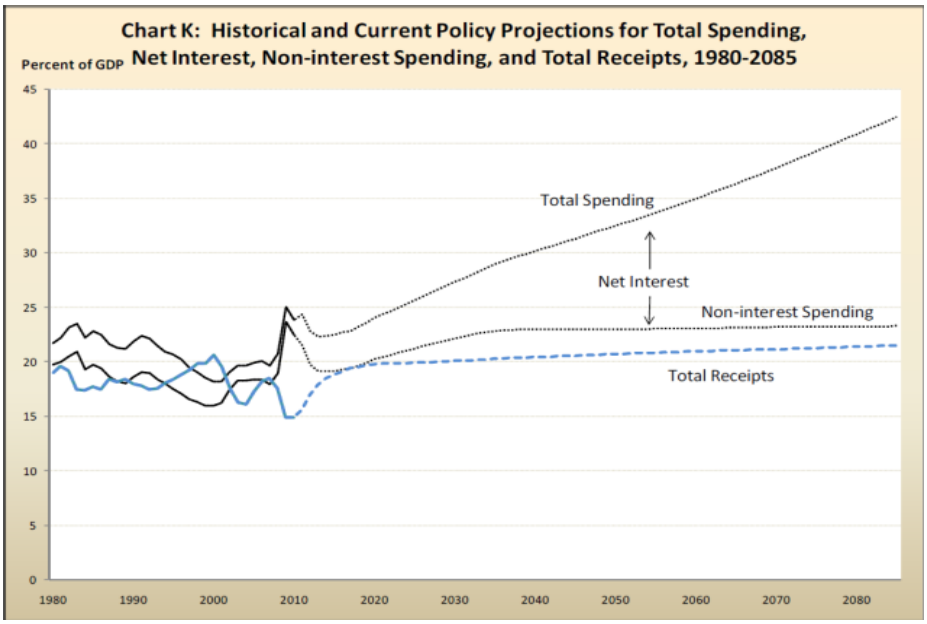
There are many behavioral parallels between the reactions to the possibility of an event like the Tohoku earthquake, and investor's behavior towards the current plight of the world's financial markets. In the case of the Tohoku earthquake, a number of leading scientists and engineers had given warning of the dangers of constructing the Dai-ichi nuclear reactors near the Okhotsk Plate fault line. They were labeled as alarmists and all but ignored in favor of safety precautions that proved to be inadequate. Similarly, a number of highly regarded economists and professional investors have been warning of an impending financial crisis if the U.S. Congress does not meaningfully address the massive debt increases in the U.S. economy in the very near future. Congress, thus far, has ignored the warnings in favor of using the Federal Reserve and a low interest rate policy to keep the debt problem at bay. This is, at best, a stopgap measure.

In the United States, which represents 24% of the total world GDP, there is a tremendous pressure of debt building in the financial markets. Specifically, current U.S. government debt held by the public[1] is approaching 100% of GDP (See Chart J).



Source: http://www.fms.treas.gov/fr/10frusg/10frusg.pdf

The policy projections for the substantial increase in national debt and subsequent spending on entitlements are unsustainable when considered in light of future tax receipts (Chart K).



Source: http://www.fms.treas.gov/fr/10frusg/10frusg.pdf

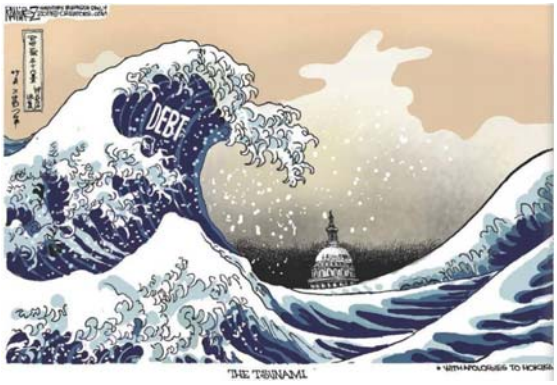
[1] Federal debt securities held by the public outside the Government are held by individuals, corporations, State or local governments, FRBs, foreign governments, and central banks.

Bill Gross, manager of the PIMCO Total Return Fund, says that "Unless entitlements are substantially reformed, the U.S. will likely default on its debt; not in conventional ways, but via inflation, currency devaluation and low to negative real interest rates."[2] The National Inflation Association calculated that at year end 2010, "our real debt to GDP in the U.S. today is already north of 500% of GDP when you include unfunded liabilities for entitlement programs, as well as other commitments like the backing of Fannie Mae and Freddie Mac."[3]

To make matters worse, the recent financial reform bill contained no meaningful reduction of the national debt. Equally, in 2011, the U.S. ranked 28th out of 34 nations in the Sovereign Fiscal Responsibility Index[4]. Our credit-addicted and government-fueled economy has created little real wealth. Economic growth, and resulting governmental revenues, must pick up and spending must be cut. If no progress can be made on either front, the government will need to print money in order to pay back their creditors inexorably resulting in inflation. Action must be taken to pay down the debt *before* it comes due[5].

In Gross' opinion "the only way out of the dilemma, absent very large entitlement cuts, is to default in one (or a combination) of four ways: 1) outright via contractual abrogation – surely unthinkable, 2) surreptitiously via accelerating and unexpectedly higher inflation – likely but not significant in its impact, 3) deceptively via a declining dollar– currently taking place right in front of our noses, and 4) stealthily via policy rates and Treasury yields far below historical levels – paying savers less on their money and hoping they won't complain."[6]

U. S. investors must recognize that the nation's massive debt is rapidly approaching a **tipping point**. At some future time, the tectonic pressures of debt will set off a horrendous monetary debt crisis. **The resulting shock and government reaction to that may create an inflationary tsunami, collapse the dollar, and cause financial devastation to many investors, especially the uninformed and the unprepared.** Those who naively trust that the Congress and Federal Reserve will provide financial walls of protection will see their purchasing power swept away. Now is the time for investors to take early action and to structure their investment portfolios to avoid the fiscal debt crisis that is unfolding. It is time to seek the high ground.



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[2] http://www.pimco.com/EN/Insights/Pages/Skunked.aspx
[3] http://inflation.us/harvardeconomics.html
[4] http://www.tcalii.org/pdfs/SFRI_Final_Report_Executive_Summary.pdf
[5] For more on this topic see Bob Rodriguez's February 9th, 2011 AdvisorOne interview with Jane Wollman Rusoff: www.advisorone.com/article/fpa-capital-s-bob-rodriguez-says-economic-meltdown-looming-advisorone-interview?page=0,0
[6] http://www.pimco.com/EN/Insights/Pages/Skunked.aspx