The Equus Report

—BY BARNABY LEVIN

A MEAN REVERTING MECHANISM

September 15, 2011

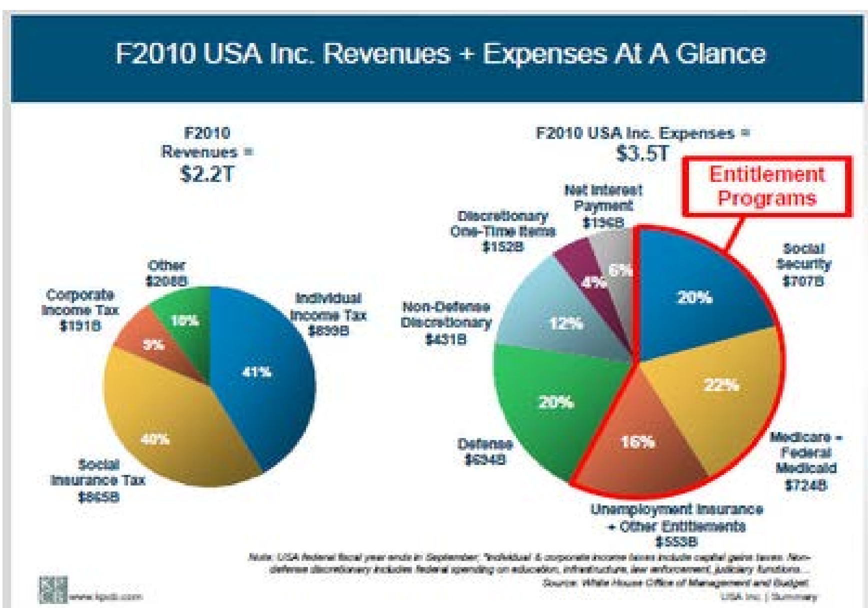
A Mean Reverting Mechanism

Nobody likes hearing bad news, which is why – despite the size, number and magnitude of issues facing us on a global basis today – I think so many people still believe that we'll somehow muddle through like we always do. I think this because, when I ask questions, there are a lot of things they just can't answer. They have notions of what *should* be done – but can't offer decent odds that enough other people will agree with them to reach a consensus and take decisive action. This is why I keep quoting Jean Monnet, who said that "people only accept change in necessity and see necessity only in crisis."

So here's the question: what if we *don't* just "muddle" through? What if things are so out of whack that they get worse before they get better? Wouldn't you want to have been proactive and protected? My high school wrestling coach died recently and there are a lot of people whose lives he touched deeply, including my own. I know there is no man who I admire more and Coach Parks used to say that the worst words one could ever utter are "I wish I hadda." It means that there are things you know you could have done but chose to ignore and, because we knew better or could have done more, we live with that regret for the rest of our lives.

Let me tell you, then, why my clients and I believe what we believe.

To begin with, our country continues to spend substantially more than it makes, which is why we recently had to raise our Debt Ceiling:



As a result, we have amassed $14.6 Trillion[1] in outstanding, federal debt which, according to the government's Office of Management and Budget, is growing every day from interest on that debt alone:

The Debt to the Penny and Who Holds It

Current	Debt Held by the Public	Intragovernmental Holdings	Total Public Debt Outstanding
09/01/2011	10,058,384,678,037.32	4,639,030,111,526.08	14,697,414,789,563.40

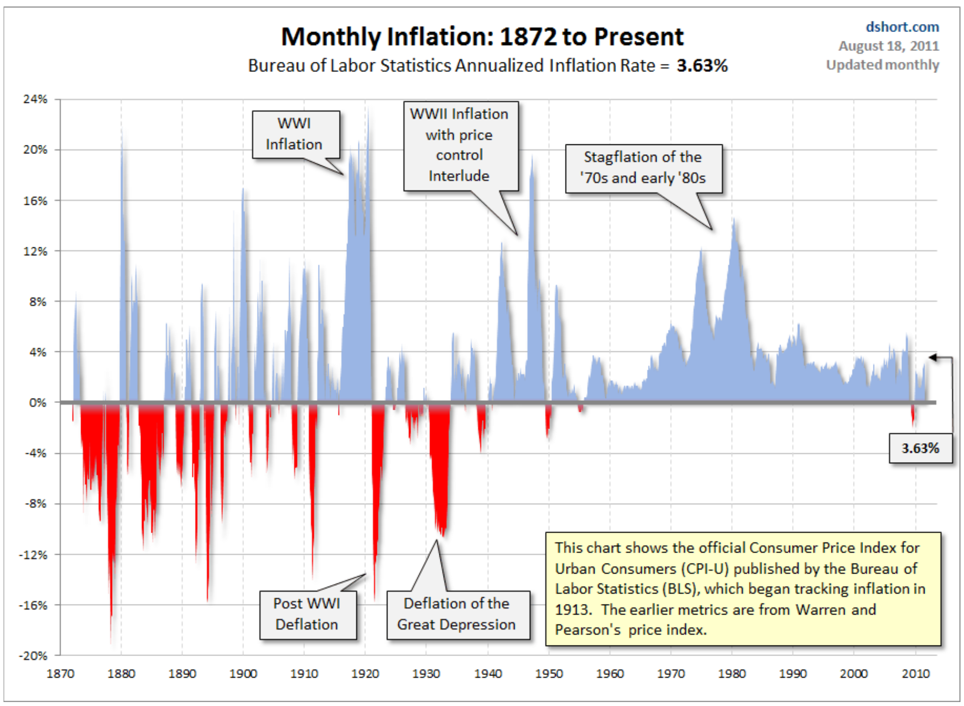
Find History

This debt already equals the total output of goods and services (GDP) of the United States but, because of The Mandrake Mechanism, it gets worse. The Mandrake Mechanism is a term coined by Edward Griffin in his book, "The Creature from Jekyll Island," to explain the way in which the Federal Reserve creates money out of nothing. It does so through its Open Market Operations and, in coordination with Fractional Reserve Banking, this leads to an exponential increase in the nation's money supply. When the U.S. Government needs money, for example, they issue notes or bills to the Federal Reserve in the form of an IOU. The Fed then issues the government a check for the loan amount and the government deposits this check into one of 12 Federal Reserve Banks spread throughout the country. The Treasury uses these funds to pay expenses like employee salaries and outside contractors for military equipment and the checks received by these individuals and organizations are deposited into commercials banks. These commercial banks are required to keep 10% of the deposits in "reserve" – on which the Fed pays them interest – which means that they are allowed to treat the other 90% as "excess" that can be used for their own lending purposes. The dollar from the savings account is still "there" and can be spent by each individual or entity in full – but when the recipient puts this money into another bank, that bank can, in turn, loan 81 cents (90 cents x 90%) for each dollar it receives. This cycle repeats again and again until every dollar issued by the government reaches its mathematical limit of $10 dollars which, of course, is the nature of all "fiat" currencies. In simple terms, it means 1) that we are far more leveraged than we think and 2) the supply of US Dollars – which has basically been unsecured since Nixon took us off the Gold Standard in 1971 – is constantly increasing through the ongoing issuance of more debt.

[1] This number does not include unfunded, off-balance sheet liabilities like Medicare, Medicaid and Social Security. Under the (rather generous) assumption that our GDP grows 3.5 to 4% per annum, our debt will exceed 140% of GDP by 2030. "USA Inc: A Basic Summary of America's Financial Statements," Mary Meeker, KPCB, February 2011

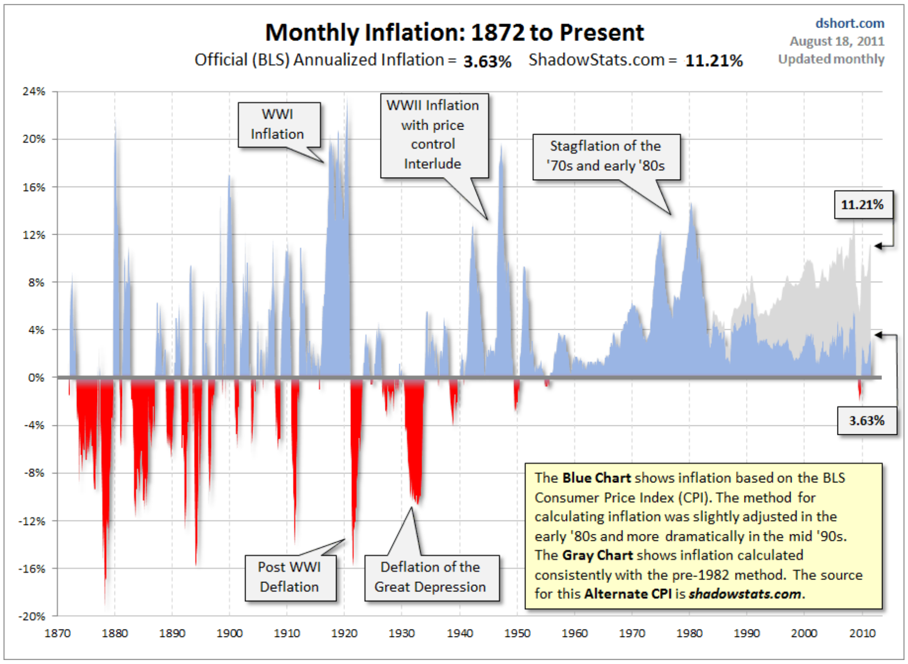
This is only exacerbated by ultimately ineffective programs like “QE2” under which the Federal Reserve printed $600 Billion to be held on its own balance sheet to cover the Treasury’s $92 Billion in monthly deficit spending during the first six months of 2011. Who are they kidding? The creation and leverage of all this unsecured, paper money throughout our system is by definition “inflationary” and, by causing all outstanding dollars to be worth less, this is how governments for thousands of years have sought to pay off excessive debt at their citizen’s expense. The problem, according to Michael Maloney, is that this has always backfired and their currencies became worthless.[2]

Nevertheless – with inflation officially running at 3.63% – it is not, they say, a “problem”:



[2] “Guide to Investing in Silver and Gold,” Michael Maloney, August 2008

Yet, if CPI were still calculated the way it was when first created by the Bureau of Labor Statistics in 1919, it would be considerably higher[3]:

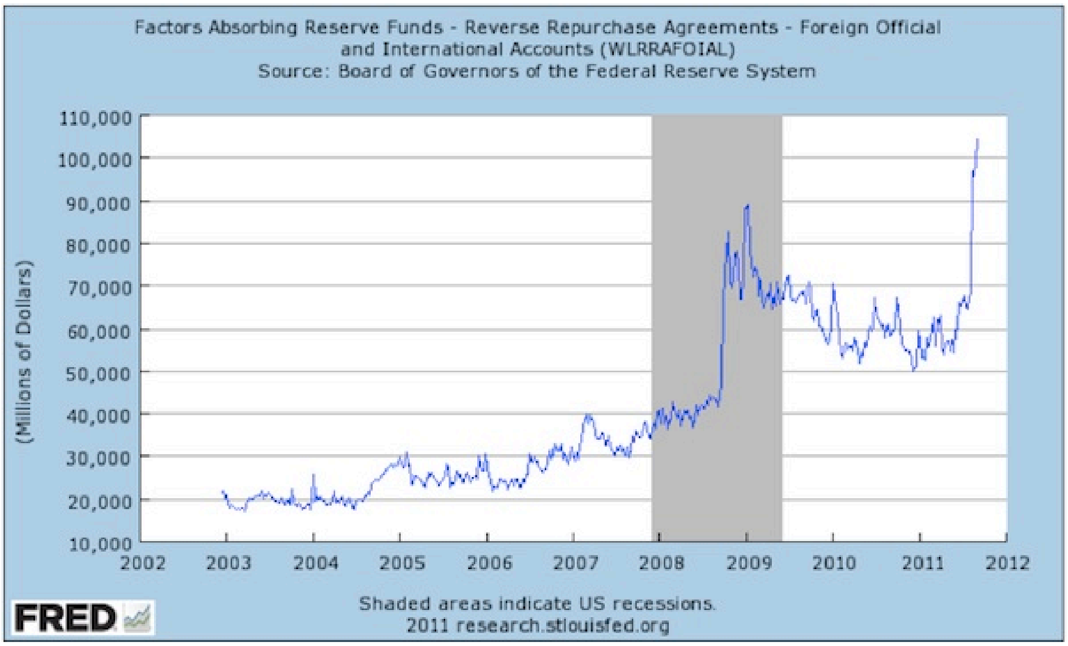


In the face of this, I have one mea culpa. Despite numerous predictions that are coming true, I have also believed that foreigners – who already own 46% of our debt – would have said “enough!” by now and stopped buying our bonds. Along with people like Bill Gross, Julian Robertson and Byron Wien, I believed this would be reflected in the yield on 30-year Treasuries once QE2 ended and the primary buyer of our government’s new debt exited the market at the end of June. I had thought that long-term rates would have risen and stayed far higher than the current 3.25%, creating a “hockey stick” yield curve and I was wrong.

This may partly be due to the even more imminent threats of default by Greece, Portugal, Ireland, Italy and Spain. Any one of these could make our problems pale in comparison and I doubt anyone really knows what repercussions there will be if and when this happens. Or perhaps it’s because of the European Union who, like us, is printing money to buy bonds to keep their interest rates low as well and who will have an even harder time than us getting seventeen countries to agree on fiscal discipline and a course of action before it is too late. This time, the US was not really at risk of default, so the bottom line is that, after long-term rates rose to 4.80% in April, the world has been beating a path to the relative “safe haven” of

[3] Shadowstats

US Treasuries of all maturities since the beginning of August and, who knows, may continue doing so for a long time to come. The graph below shows the amount of deposits at the US Fed from foreign official and international accounts at rates that are next to nothing and, as John Mauldin asks, "What do they know that we don't":[4]

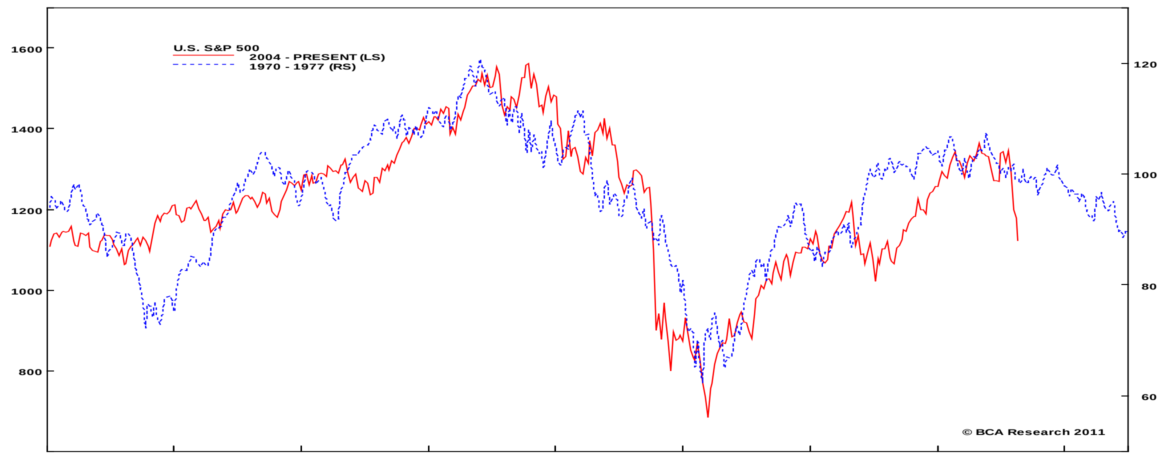


As I have said in other articles, I expected that unemployment would remain high until states downsized substantially and companies saw a meaningful increase in domestic demand; that domestic consumption (of anything other than iPads and iPhones) would remain low as Boomers continued to deleverage and had reason to feel more confident about the future; and that our economy would be vulnerable because of its overwhelming dependence on overseas demand should foreign growth slow. I'm not surprised that we remain in a low interest rate environment for maturities under five years because most institutions and, as indicated above, countries now seem to consider shorter maturities the same as "cash." While not a conspiracy theorist, it has also dawned on me that, with so many instruments like mortgages priced off the 10-year Treasury, the Fed has a vested interest to make sure that 10-year yields stay low as well in order to stimulate demand and to keep the cost of servicing our debt from spiraling out of control – and I am beginning to hear terms like "Operation Twist" to describe what the Fed might do next with its $17 Billion in monthly cash flow from current holdings. But I must admit that I still remain mystified that the markets aren't demanding more for the long-end given that the cost of food, energy and healthcare are all rising by double digits – and that inflation is running *somewhere* between 3.63% and 11.21%. I'm not quite sure what to do about this because I don't understand how buyers of a 30-year treasury at 3.25% aren't, ultimately, assured of losing money over time and how this would be okay. Or how countries like China,

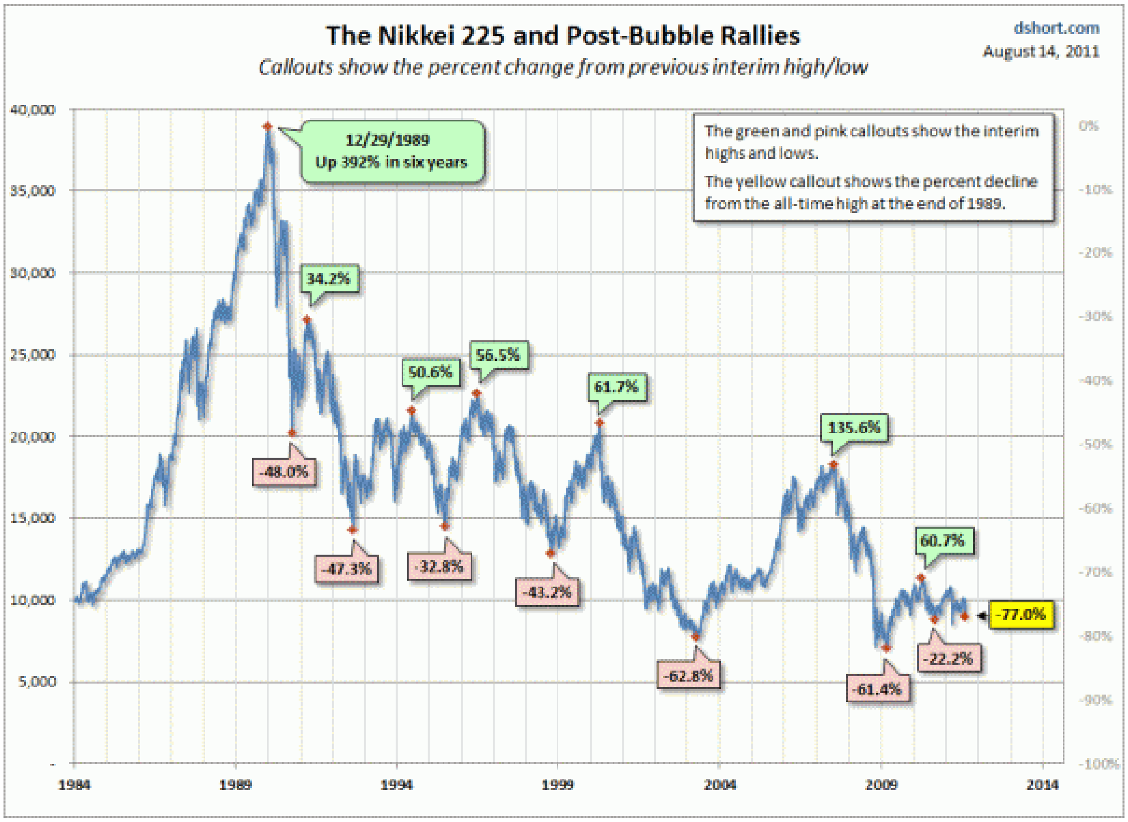
[4] "Preparing for a Credit Crisis," John Mauldin, September 10, 2011

Japan, Brazil – and all oil-exporting nations from Saudi Arabia to the UAE – are willing to accept losses they are taking as their currencies strengthen relative to ours, rendering their goods less competitive. Last week, Switzerland pegged their Franc to the Euro because of this.

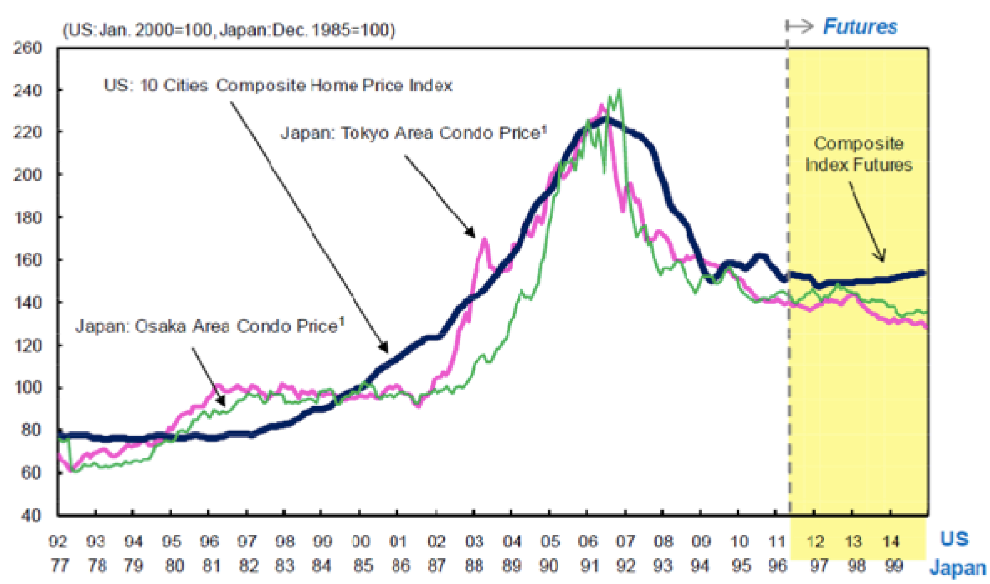
The fact is that recent evidence increasingly suggests we are heading into a double-dip recession, and *any* yield clearly seems better than zero to whoever is buying and, as things stand, I am no longer sure if our markets this decade will more-closely resemble **the 1970's**:



or **<u>Japan</u>?**!



US House Prices Are Moving Along Japanese Experience



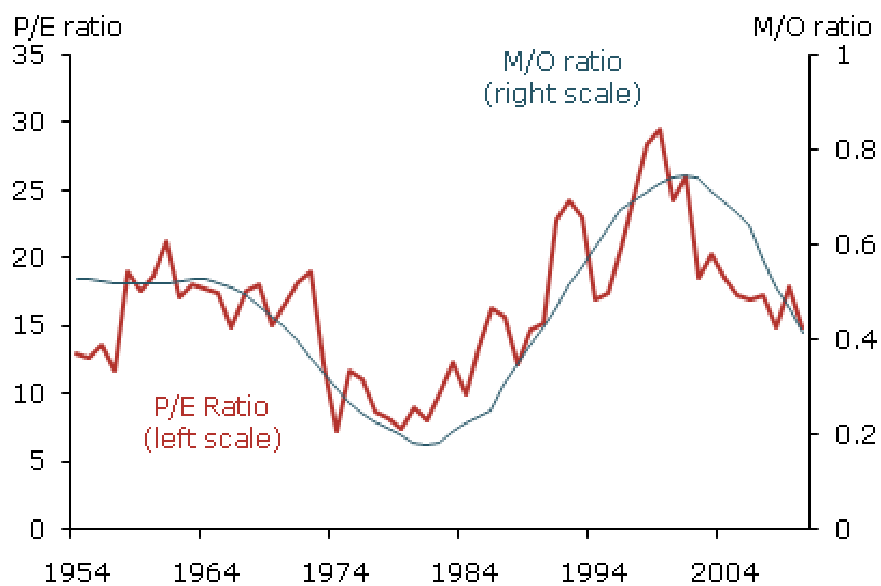
Note: per m^2, 5-month moving average
Source: Bloomberg, Real Estate Economic Institute, Japan, S&P/Case-Schiller Home Price Indices as of August 9, 2011,

Nomura Research Institute 1

At this point, equity markets are down year-to-date; 30-year yields have fallen to 3.25%; and even real estate trends seem eerily similar to Japan. So, what else? At the deepest, most intransigent level, an article by the Federal Reserve Bank of San Francisco recently echoed my own Demographic argument: [5]

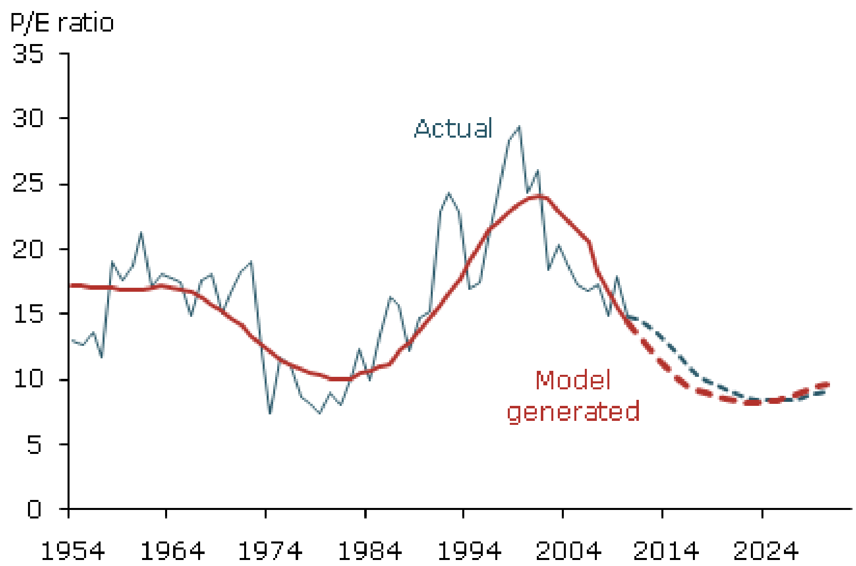
> "The baby boom generation born between 1946 and 1964 has had a large impact on the U.S. economy and will continue to do so as baby boomers gradually phase from work into retirement over the next two decades. To finance retirement, they are likely to sell off acquired assets, especially risky equities. A looming concern is that this massive sell-off might depress equity values."[6]

The FRB examined the historical relationship between demographic trends and stock prices using a statistical model that measures the inflation-adjusted, equity price/earnings ratio of the Standard & Poor's 500 and a ratio of Middle- to Older-aged people (M/O) in the U.S.[7]



[5] "Demographics," Barnaby Levin, HighTower Advisors LLC, 2003
[6] "Boomer Retirement: Headwinds for U.S. Equity Markets?" Zheng Liu and Mark M. Spiegel, FRBSF Economic Letter, August 22, 2011
[7] Middle-aged, ages 40-49, divided by the "old"-aged, ages 60-69, who may shift their portfolios as their financial needs and attitudes toward risk change.

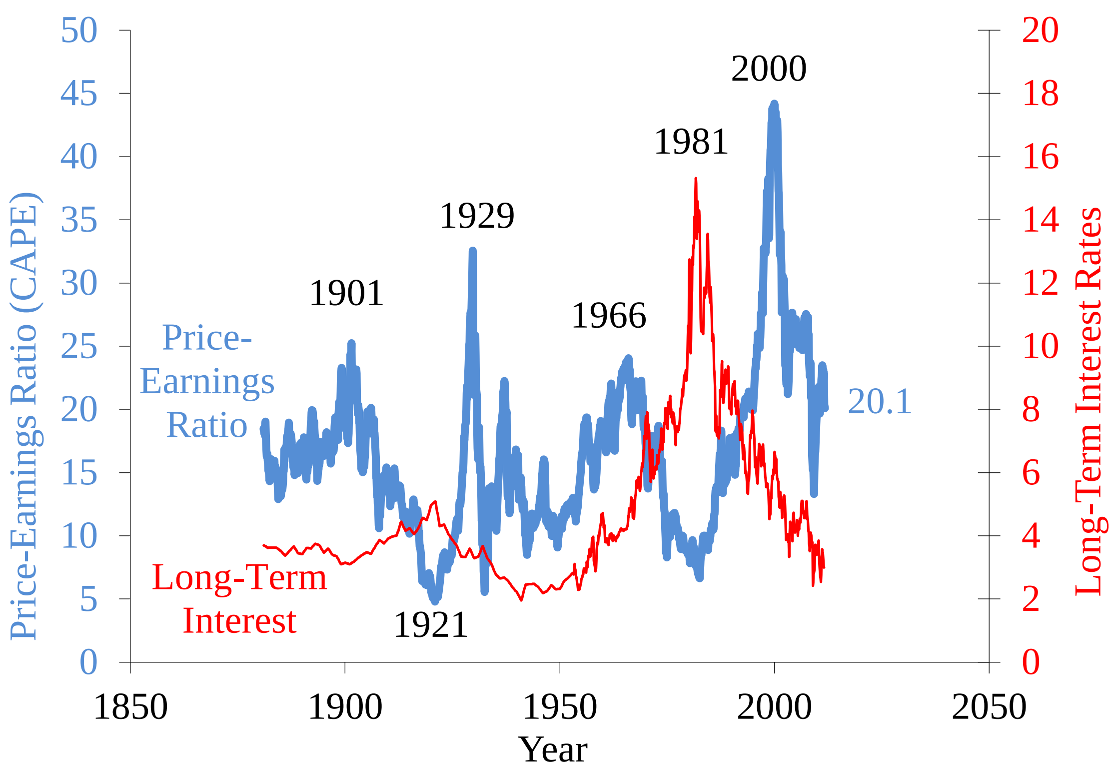
They estimate that this M/O ratio explains about 61% of the movements in the P/E ratio between 1954 and 2010 and – because demographic trends are largely predictable – they believe it can be used to reliably forecast long-run trends going forward:[8]



This second chart suggests that P/Es will decline from about 15 in 2010 to about 8.4 by 2025 before beginning to recover which, clearly, would be a bearish outlook for U.S. stocks. Seconding this in his book, "Irrational Exuberance," Robert Shiller stated that, when attempting to put things into an historical context, corporate profits should be averaged over an extended period in order to smooth out the effects of economic cycles and that, over the course of booms and busts, P/E ratios revert to a mean. As the charts below illustrate, we still aren't anywhere near "undervalued."

[8] To read their full analysis, http://www.frbsf.org/economics/


So are valuations
2
United States, cyclically-adjusted
price-earnings ratio
1976
50
40
30
20
10
0
1881 1900 25 50 75 2000 11
Source: Robert Shiller, irrationalexuberance.com


Price-Earnings Ratio (CAPE)
Long-Term Interest Rates
Price-
Earnings
Ratio
Long-Term
Interest
1901
1921
1929
1966
1981
2000
20.1
Year
1850
1900
1950
2000
2050
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Together, these perspectives help refute any notions of what constitutes true "value" according to most, long-only equity managers, who claim that – based on "historical norms" -- equities should be bought.

One final headwind to highlight is our country's low level of savings. This is something that actually makes our situation even more precarious than that of Japan thirty years ago when they began their demographic transition – or the U.S. after the end of World War II. When Japan entered their post-crisis decline in 1989, they had a high personal savings rate which initially helped to sustain their economy. And we *won* World War II. As James Rickards says, "We got something for our money. We were not just the most powerful country on the planet – we were *by far* the most powerful with over 50% of global GDP." [9] But as Lance Roberts points out, 56% of American workers today have less than one year's salary saved, with less than $25,000; 76% have less than $100,000; and 90%, less than $250,000. For those already retired, it's not much better. [10] If we then assume, as he suggests, that "the average retired couple will need today's average annual salary of $40,000 to live through their 'golden years,' they will need roughly $1 million dollars generating 4% a year to make ends meet." That's a problem and I have no idea how we resolve it as a nation.

Individually, however, there are things that we can do. In order for us to invest and, in the process, protect ourselves from the tumult we foresee, it is my contention that successful investors will need to grow adept at managing on both a "long" and "short" basis. As we discovered in 2008, a "Buy and Hold" approach can be costly and it will be critical that we protect our portfolios against downside risk using instruments that, until recently, have not been available to the general public. These instruments fall within the "alternative investment" category and are often referred to as "hedges." By and large, they are designed to move inversely to a given index in order to balance out the volatility of markets as the markets move up and down.

Next, it is my contention that investors should own a substantial amount of Gold and Silver, which have continued to rise because endowments, institutions – and, most importantly, countries – have been seeking a more reliable store of value to defend against long-term inflation, budget deficits, "fiat" currencies, and for simple diversification through owning tangible assets. According to recent studies, the amount of gold in sovereign treasuries is quite low as a percent of their reserves and, because sovereigns tend to take these reserves out of circulation, it should provide an ongoing source of demand and price support.[11]

[9] "Gold, Geopolitics and the Gold Standard," James Rickards, April 30, 2011
[10] "Boomers Are Going to Be A Real Drag," Lance Roberts, Streettalk Live, August 25, 2011. For those already retired, 54% have less than $25,000; 71%, less than $100,000; and 83%, less than $250,000.
[11] "Gold, Geopolitics and the Gold Standard," James Rickards, April 30, 2011

Finally, people should reduce their equity exposure and raise a meaningful amount of cash. For much of this decade, I expect that "adding alpha" will be more about return *of* principal than return *on* principal and, when it comes to one's balance sheet, I encourage people to look at things more skeptically.

This is not about loss of hope, or doubting mankind's incredible ability to innovate and overcome any challenge or, in the face of loss and adversity, to create something even more spectacular. Like the phoenix, we will rise again. It is simply the hand that we must now play after more than forty years of growth and prosperity. This is an outcome that we have been preparing for ever since I left the wire-house world to become a Partner at HighTower. It is a time to act and the only thing that has changed in my outlook is what may happen to long-term interest rates in the short term. In that regard, I simply suggest that all of those bondholders and managers who are feeling so pleased with themselves – and who are gleefully casting aspersions at people like Bill Gross for his ill-timed call on treasuries[12] – not get too carried away. *Everything* ultimately reverts to the mean. This is the purpose of the markets: to correct imbalances. And, given the fact that there is a lot more debt outstanding than gold, I still think that the bigger bubble to worry about is bonds.

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The Mandrake Mechanism

[12] "PIMCO Missed The Trade Of The Year In The Treasury Market," Econmatters, August 29, 2011