The Equus Report

—BY BARNABY LEVIN

WHERE YOU STAND DEPENDS ON WHERE YOU SIT

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Where You Stand Depends on Where You Sit

For some time, I have been concerned about the growing dangers posed by

- stealth inflation
- rising, long-term interest rates
- the intermediate, principal risk to longer-term Treasury and Municipal debt

The Federal Reserve has not. They believe that inflation is not a threat because the Consumer Price Index – which excludes “volatile” components like food and energy and is heavily weighted toward housing – showed a mere 1.5% increase in 2010.[1] So strong, in fact, is their conviction that, as Fed Chairman Ben Bernanke suggested on CNBC’s “60 Minutes” last December, they felt free to expand their “mandate” from merely promoting “maximum employment, stable prices and moderate long-term interest rates” to include “higher asset prices.” Asked how his second, $600 billion round of quantitative easing could be considered a success when interest rates and commodity prices had actually risen since the Fed’s purchases began, he deadpanned: “our policies have contributed to a stronger stock market.” Leaving questions of cause and effect aside, the Chairman’s theory (according to James Saft of Reuters News) was that, by (attempting) to keep longer-term rates low through open-market purchases, money would flow from bonds into stock and “that higher asset prices would help to restore confidence and entice greater investment and consumption. Consumers, feeling a bit richer, would spend a bit more and businesses would respond by committing to investment in new capacity to meet this new demand. Money parked on the sidelines would go from feeling smart to feeling stupid and move into riskier assets like stocks or high yield bonds.” [2] In other words, given money’s tendency to go where it’s treated best, he felt the Fed had plenty of leeway to give the market another “nudge.”

While I don’t disagree with his basic premise regarding flow of funds, I do with the long-term benefits and sustainability of the Fed’s actions, especially on top of our already massive state and federal deficits. And, given the chart below, I completely disagree that inflation is not a problem, especially on a global basis.

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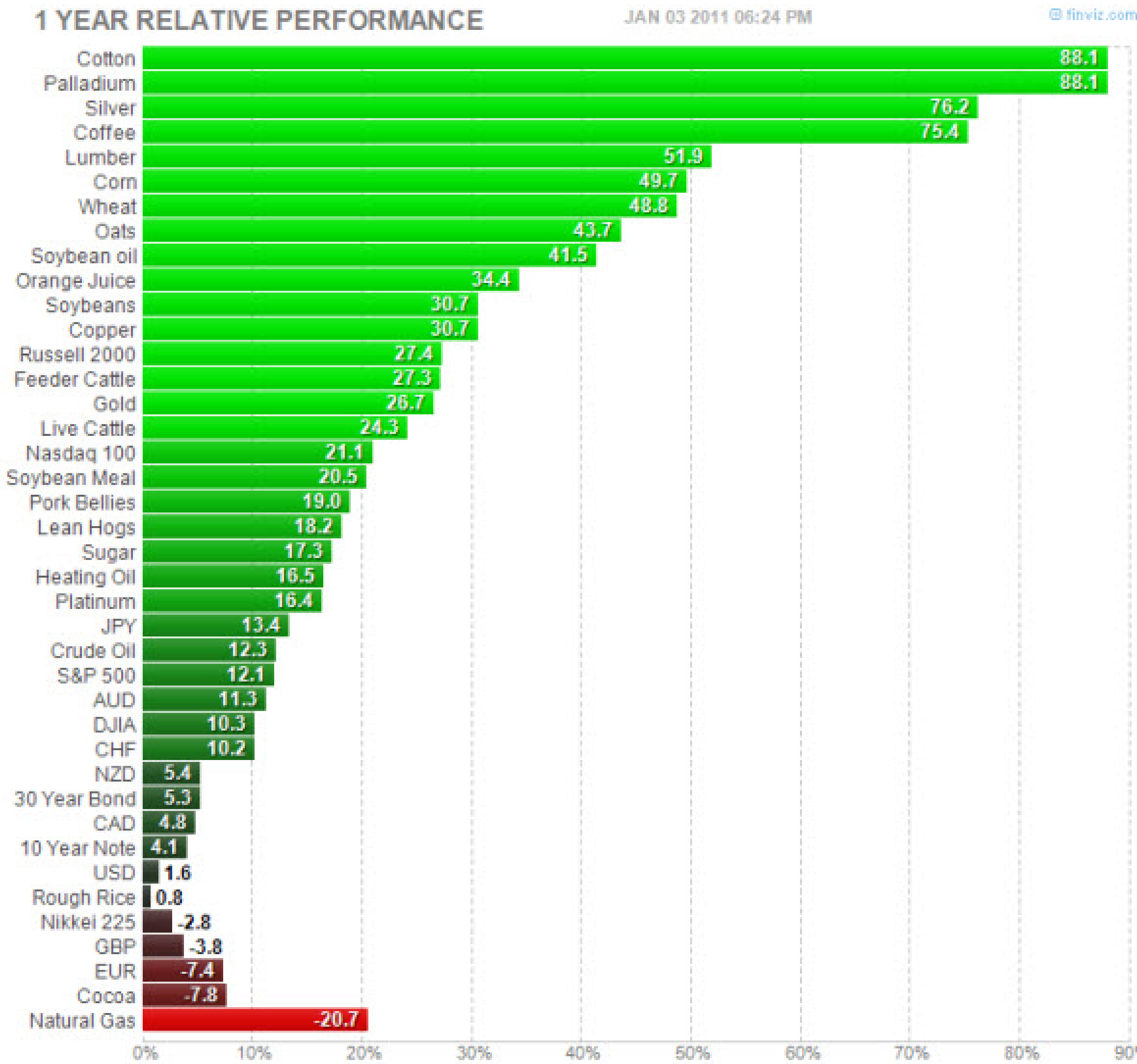
[1] U.S. Bureau of Labor Statistics
[2] “Fed hits its 3rd mandate,” James Saft, Reuters, January 18, 2011



While it may be true that many prices fluctuate due to the natural forces of supply and demand, this chart suggests that the Fed's focus on "sustained" increases – based on the current calculation for CPI – is somehow flawed. How many years ago did the Bureau of Labor Statistics create that index and establish a more or less fixed basket of goods and services that it still believes are typical to this day? That index now consists of 40% goods and 60% services and housing-related expenses account for 42% of the consumer budget.[3]

[3] Bureau of Labor Statistics: "housing expenses" include Rent, Rental Equivalence, Utilities, Furnishings and Upkeep

Yet we now live in a truly global, interconnected world and most people acknowledge that global growth, for many years to come, will be driven – not by the U.S. or Europe – but by high-population countries like China, India and Brazil. We accept that these populations and their consumer classes will only increase over the next ten years, and that competition with these and other developing nations for food, energy and many of our most basic resources – because their supply cannot be rapidly expanded in the short term – will only increase as a result. So, how can the BLS continue to "cross off" roughly a quarter of consumer spending if these price increases are now more likely than ever to become (no pun intended) ingrained? Yet U.S. and European central bankers are aggressively printing money (which devalues their currency and is, itself, inflationary) to support their markets and industries, while the faster-growing BRIC and CIVET countries[4] are struggling with the need to raise rates to curb speculation and prevent their economies from overheating. It seems inevitable that these actions by our biggest trading partners will (continue to) bleed over into our own economy.

At the same time, didn't Japan already prove – when unemployment is high and persistent; new, private sector jobs are scarce; and the consumer's balance sheet is already under attack – a government's ability to stimulate demand for any meaningful duration through its own, increased spending is, ultimately, futile? As Nicolas Oudin said in his "GaveKal Daily" dated July 28, 2010: "What matters in economics is not the quantity of production but the creation of value. If we produce a lot of worthless goods that have no value, nobody is better off, even if some people have been paid to build them." It's all smoke and mirrors and "pushing against a string." And, in the absence of sustained, underlying demand, we cannot expect the private sector to be so unwise as to increase lending, spending or hiring except on a temporary basis or to the strongest credits no matter how much cash they might have on their balance sheets. The only thing increased government spending will do, then, is add to the country's budget deficit, which is only a postponed tax that, one day, needs to be paid by the taxpayers who already have enough of a burden to bear.

Again, with regard to economic or tax policies, they can and do have an influence, for better or for worse. But, as I demonstrated in 2003, they are subordinate to the greater influence of the ultimate, underlying driver of supply and demand, which is "Demographics." [5] It is the spending and saving patterns of each generation as they advance through life that lead to expansions and contractions in an economy. And it is the 80 million Baby Boomers born

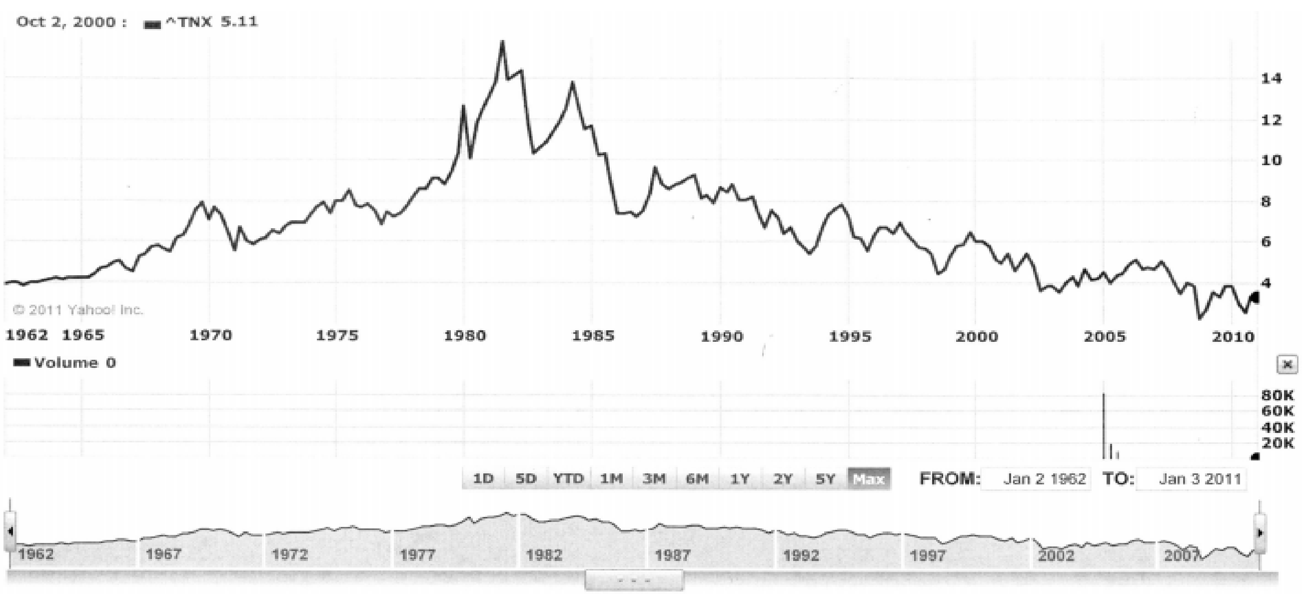
[4] BRIC: Brazil, Russia, India, China. CIVET: Columbia, Indonesia, Vietnam, Egypt, Turkey
[5] "Demographics," Barnaby Levin, HighTower Advisors LLC, April 16, 2003

between 1946 and 1964 – who, two years ago, began their transition to a "saving" mode – who will continue to dictate the direction of the U.S. economy for many years to come. After a nice relief bounce in consumer spending last year – while we may continue to offset some of the decline in domestic demand through increased exports going forward – we'll be competing with every country in the world for the same piece of the pie. And in those developing countries upon whom we'll be increasingly dependent, this competition will include their own domestic companies which, of course, will have advantages and protection from foreign imports. These protections will most likely make matters worse, leading other countries to, first, complain and, then, retaliate with their own tariffs and trade barriers in an effort to protect their own jobs and companies by making their products more "competitive" with those cheaper imports. But we all do it. And, whether "they" did it first or not, there are consequences of this policy that are often worse than the problem they were meant to resolve – including the fact that increased tariffs increase consumer prices which, by definition, is inflationary. We refer to this as "The Law of Unintended Consequences."[6]

Inflation is a problem and these other forces will only make things worse. But at any moment, given our ballooning deficits on both a federal and state level and our inflated Fed balance sheet, I fear that – however remote the possibility might seem today – there will be a "tipping point" in which holders become sellers and the buyers of our debt go on "strike" and, seemingly overnight, will demand a significantly higher rate of interest to compensate them for the double whammies of devaluation and default. As you can see from the charts of the 10-year U.S. Treasury below, this run-up in rates can happen very fast; it can be very dramatic; and there's a lot more room to move up than down, especially when viewed with the perspective of a fifty-year timeframe.

[6] "The Law of Unintended Consequences," Barnaby Levin, HighTower Advisors LLC, August 31, 2004


$TNX (10 Year Treasury Note Yield) INDX
© StockCharts.com
21-Jan-2011
Open 32.88 High 34.74 Low 32.81 Close 34.16 Chg +0.83 (+2.49%)
RSI(14) 65.32
$TNX (Weekly) 34.16
MA(50) 31.55
MA(200) 36.17
Volume undef
MACD(12,26,9) 1.067, 0.170, 0.897


Oct 2, 2000 : ^TNX 5.11
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Volume 0
1D 5D YTD 1M 3M 6M 1Y 2Y 5Y Max
FROM: Jan 2 1962 TO: Jan 3 2011

If this were to occur as it did a generation ago in the late 70s, it could lead again to a "stag-flationary" environment of simultaneously higher prices, rising interest rates and a weak domestic economy with devastating effect. Also, as these inflationary pressures continue to build and become embedded in ways that can no longer be absorbed by productivity improvements at the producer level, they will be more and more difficult to reverse and, in today's low interest-rate environment, there simply isn't enough yield to compensate for the principal risks to an asset class whose primary purpose is preservation of capital.

The bottom line is that we need to be proactive and to protect ourselves now against the risk of inflation and rapidly rising rates. Bond holdings should be hedged by keeping maturities short and their quality high and all portfolios should include some assets that can be expected to rise with inflation, including gold, materials and their producers.

With regard to problems in the municipal debt market, Meredith Whitney clearly struck a nerve on "60 Minutes" when, on December 19th, she suggested that there may be "hundreds of billions of dollars" in municipal defaults in coming years. At the end of Q1 2010 – not even counting all of their unfunded pension liabilities – state and local governments had $2.8 trillion in outstanding debt, or 20% of U.S. GDP.[7] And, judging from the chorus of outcries from bond managers and trading desks around the country, it surely begs the question: "**Where You Stand Depends on Where You Sit**." We must remember that, well-intentioned or not, there are no unbiased opinions; that anyone who makes a living by issuing, rating or selling municipal bonds has a lot to lose if she is right; and, as Steven Covey said in "The Seven Habits of Highly Effective People": "As clearly and objectively as we think we see things, we begin to realize that others see them differently from their own apparently equally clear and objective point of view. Each of us tends to think we see things as they are – and that we are *objective.* But this is not the case. We see the world, not as *it* is, but as *we* are – or, as we are conditioned to see it."[8]

To be fair and balanced, I refer clients to a widely disseminated and lengthy report from the "Center on Budget and Policy Priorities" that seeks to refute each of Whitney's concerns.[9] But I also note that its authors make a significant number of assumptions regarding GDP growth, projected receipts and rates of return. They say that defaults have been rare which, in my opinion, has nothing to do with what may or may not take place going forward. They suggest it may be easier – certainly than I think it will be – to change

[7] http://www.federalreserve.gov/releases/z1/current/
[8] "The Seven Habits of Highly Effective People," Steven Covey, page 28
[9] "Misunderstandings Regarding State Debt, Pensions, And Retiree Health Costs Create Unnecessary Alarm," by Iris J. Lav and Elizabeth McNichol, Center on Budget and Policy Priorities, January 20, 2011

pension provisions or terminate health benefits to state retirees. They cite "out-of-date tax systems," meaning we need to raise taxes more progressively on higher earners who, as I have noted in other articles, already pay more than 75% of all income tax receipts and who are the primary holders of the state's debt.[10] They downplay the downward spiral that could impact state income taxes, local sales and excise taxes, property taxes and housing prices when, as part of their need to slash expenses, states are forced to further reduce inflated payrolls. And they pray that health care and education costs won't *continue* to rise faster than GDP and state revenue going forward. All in all, it seems like a lot of hoping to me.

But this much is certain: from January 2008 through July 2010, when private sector employment declined 6.8%, Federal employment rose 10%.[11] And, contrary to popular belief, when comparing the compensation of federal and private employees, while it used to be true that a federal government job paid less but was more secure, now – while still more secure – it pays about 44% more on average (35% higher wages and 69% higher benefits).[12] As these facts become more widely known, there will be increasing pressure on politicians to deal with the burdens of entitlement spending and – given the country's mood regarding bailouts – it will be difficult to convince Congress to come to the aid of states that have refused to put their own fiscal houses in order. As John Taylor and John Cogan pointed out, of the $173 billion in ARRA funds issued to states under President Obama's 2009 $862 Billion Stimulus – funds whose "principal purpose was to provide state and local governments with additional funds to enable them to boost their purchases of goods and services" to stimulate economic growth – the actual impact on consumption was "negligible."[13] Instead, "most of it went to reduce borrowing" and to finance states current expenditures. Also, while Chairman Bernanke recently "ruled out a central bank bailout of state and local governments strapped with big municipal debt burdens,"[14] there is (behind the scenes so they don't cause a panic) a growing movement among policy makers to "come up with a way to let states declare

[10] "Boston Tea Party," Barnaby Levin, HighTower Advisors LLC, January 8, 2003: In California, according to the Governor's Budget Summary, "the top 10% -- taxpayers reporting an income more than $100,000 – paid 75% of the state's personal income tax." The point I was making at the time was, not that one should necessarily feel sorry for taxes paid by the country's top earners – but that those who depend on their success should hope they stay wealthy and Californians. Because, if pushed too far to the point where they leave, all the services their tax dollars pay for – from public schools, to maintaining our infrastructure, to our police and fire departments, to health and welfare programs for the poor – will suffer along with them. Also, as John Mauldin points out in his "Thoughts from the Frontline" dated January 22, 2011: "Higher taxes are hardly a cure. When Oregon decided, for example, to tax the wealthiest 2% of its citizens, they collected 40% less than they projected, and over 255 of the people they expected to tax somehow 'disappeared.' At some point, the 'rich' get tired of being in the crosshairs of politicians and repair to more favorable climes."
[11] U.S. Department of Labor, Bureau of Labor Statistics
[12] U.S. Bureau of Economic Analysis, USA Today analysis http://www.usatoday.com/news/nation/2010-03-04-federal-pay

[13] "Where Did the Stimulus Go," John F. Cogan and John B. Taylor, commentarymagazine.com, January 2011
[14] "Bernanke Rejects Bailouts," Jon Hilsenrath and Neil King Jr., The Wall Street Journal, January 8, 2011

bankruptcy and get out from under their crushing debts."[15] If passed, such a change would permit a state to alter its contractual promises to retirees who are currently protected by state constitutions, and to reduce investors in a state's General Obligation and other bonds to the status of unsecured creditors. I believe that, where there's smoke, there's fire and while, like Peter Orzag,[16] "I hope it does not ultimately require a crisis to restore fiscal sustainability, I fear it will."[17]

In conclusion, we must think and prepare for "the unthinkable," like Noah did with his Ark. We don't need to throw the baby out with the bathwater and the recent, widespread spike in municipal yields might even, selectively, be offering some good buying opportunities in certain issues. But, in general, it seems prudent to only own bonds issued by the highest-rated states which, of course, excludes California and Illinois. And we should only hold their General Obligation and strongest, most essential-service Revenue Bonds, like the Department of Water & Power, because – if and when these bankruptcies occur – it will most likely impact individual cities and counties first and I assure you that, as in musical chairs, you won't want to be the last one standing.

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[15] "A Path is Sought for States to Escape Their Debt Burdens," Mary Williams Walsh, The New York Times, Jan. 20, 2011
[16] Former Director of the Office of Management and Budget under President Obama
[17] "Balancing the budget will prove difficult task," Krishna Guha, Financial Times, January 25, 2007