Prepared Comments from 8/11/2011 Conference Call

Wow—what a difference four weeks makes! My last conference call was on July 15th. US stocks have since fallen about 10%. The magnitude of the decline this summer is similar to last summer's, however it took several weeks for that decline to build—this decline has only taken a few days. Last summer's decline was attributed to concerns over a possible double-dip recession—concerns which proved groundless. What has been causing the stock market decline this summer?

I see four causes of this summer's (and this month's) volatility, most of which has been downward. We have the debt ceiling/budget deficit mess, the European government debt crisis, the seemingly stalled US (and global) economic recovery, and, well, the volatility itself.

First, we had several weeks of drama in Washington DC as Congress and the President developed a plan to raise the debt ceiling and reduce future annual budget deficits, culminating in the Budget Control Act of 2011. There was drama, for the actors took until the 11th hour to finalize a plan which could garner enough votes and the President's signature. There were many false starts, and temporary impasses.

As is often the case with Washington DC, the final chapter was not the final chapter. There is a sequel, and probably many. The law established some initial (broad, not very specific) spending decreases over the next decade, and then defined a committee to come up with additional plans for future savings. They have a deadline of this Thanksgiving, at which point Congress and the President have the opportunity to approve or reject. If the proposal is rejected, then there are some (broad, not very specific) spending decreases which will be made in the future (without the need for a subsequent vote), again over the next decade. Together, the 'savings' comes to about $2 trillion.

This painful process led rating agency Standard and Poors (S&P) to downgrade long-term US treasury bonds from AAA to AA+, with a downward bias. Their move was 'well telegraphed;' they made clear that they felt that a clean $4 trillion deal would be necessary to convince them and the markets that the US government had a credible plan to prevent the debt from rising to a dangerous level, versus the country's economy, as measured by our GDP. Their report placed more blame on the **process** than the **result**—they noted that the process showed that the two houses of Congress (each held by a different political party) seems incapable of putting their ideological differences behind them for a higher cause, putting the country's finances in order this year, and beyond.

The second factor causing the recent volatility is the European debt. The European countries with troubled government debt have the unfortunate abbreviation of PIIGS: Portugal, Ireland, Italy, Greece, and Spain. These countries have debt:GDP ratios ranging from 52% (Spain) to 152% (Greece). As members of the European Union and unlike the United States, they have previously exchanged their own currency for the Euro, and they therefore are not able to print more currency and in this manner devalue it, a typical step for a country with too much debt. So what can they do?

The best approach is for the countries to grow their way out, magically expanding their economic activity and in this manner boosting its tax revenues and therefore its ability to meet all of the obligations of its bonds. The challenge is that, for many reasons (including the austerity measures forced on most of these countries), these countries are seeing economic shrinkage rather than growth, and therefore a worsening of the situation.

The governments can default, refusing to live up to their obligation to pay the interest and principal on their outstanding debt (Congress incredibly dabbled with this possibility last month). This would 'solve' the situation in many ways from the specific country's perspective (since they are no longer responsible for the bonds), however the country would likely be unable to borrow any money for years and years, as it would be deemed a 'deadbeat,' and this would have severe ramifications to their future government operations.

Alternatively, the lenders and governments can work together to restructure the debts. This could mean reducing the interest rates that each bond pays, extending the due date of each bond, and/or reducing the face amount of each bond. This requires a borrower (government in this case) willing to have their debt written down, which shouldn't be a problem, and a lender (actually, EVERY lender) being willing to write down the bonds they hold on their balance sheets. This second piece is likely VERY DIFFICULT to accomplish. In the case of a personal or corporate bankruptcy, a court is involved to ensure that the deal is the best that can be struck, and to compel both parties to accept the deal's terms. Thus far there is no party who can assume this role.

It seems to me that the most likely path is for the European Central bank to issue long-term bonds, and offer to exchange them for outstanding bonds from each troubled government. This approach was used in the late 1980s, creating what became known as Brady Bonds. This EU central bank might set a different exchange rate for each country and each maturity (say 25 cents on the dollar for long-term Greek debt, and 50 cents on the dollar for long-term Italian debt). This enables lenders, including European banks and insurers, to remove the uncertainty that has been plaguing them for over a year. As the EU central bank in this manner holds more and more of a country's bonds, they can then calmly negotiate a fair, sustainable restructure of each bond.

The problem this year is that the stronger European countries are unwilling to publicly support such a plan, as it would anger many of their citizens, and as it could cause a rating agency to downgrade that country's credit score (sound familiar?), and could necessitate higher tax rates. Furthermore, there is a bit of the game of chicken going on, with no single party wanting to offer to compromise first (again, sound familiar)?

The third factor responsible for the current downward volatility is the extremely weak US and global economic recovery. US unemployment remains stubbornly above 9%, and consumer confidence is at depressed levels, close to those at the depth of the 2008/2009 financial meltdown. Investors have a hard time holding onto their stocks in such a dismal environment.

The final factor responsible for the current downward volatility is the media. Throughout the media's coverage of the debt ceiling/budget negotiations, all of their attention was placed on the political ramifications. They failed miserably to cover the economic ramifications, which in some cases were fairly minor and unexciting. The same failure was seen in their coverage of the S&P credit rating change. Investors need to recognize that the media is about the last place you should look for useful analysis of the economic meaning of events, and economic meaning is needed to make good investment decisions.

So let's start examining the economics of recent events.

We will begin on the US debt/GDP ratio. This rose to 50% in the mid-1990s, at which point it fell towards 32% or so. From this point it marched upward, to about 68% now. Without the Budget Control Act, it would have continued to march upward, towards 100%, clearly a critical level. With the deal, and the scheduled end of the Bush-era tax rates for upper income individuals, the ratio should top out at less than 75%, and should remain at that level. That is deemed manageable for our country—not good, but manageable.

This is accomplished by gradually reducing the annual deficit, from the current 8.6% of GDP currently, perhaps to 4% or less by 2013, and to fall to about 3% annually by the end of this decade. This cannot and should not be accomplished all at once, as the cure would be worse than the disease. You cannot eliminate 39% of this year's budget (the current level of the annual deficit) without leading to incredibly serious consequences.

Cutting government expenditures sharply all at once would lead to an immediate drop in the economy. Changes of this sort are best done with advance notice, and gradually. This is the reason that the approach to the budget deficit negotiations was focused on changes over ten years.

The consumer makes up 70% of our economy. However in the 2008/2009 meltdown, the consumer left the stage, as did corporations, and our government was the last man standing. This led policy makers to initiate substantial stimulus spending, with their resulting deficits.

Well, the government is ready to take three steps back, leaving consumers and corporations to pick up the slack.

Both are able, but neither is especially willing.

Consumer savings rates have jumped, to over 5% from a pre-meltdown level of under 2%. How did this happen, given that the unemployment rate is over 9%? By cutting back non-essential spending, including autos and housing, and due to the results of government action, including lower mortgage interest rates and unemployment benefits.

Corporations are sitting on a massive amount of cash, built up over the past three years. How did they accomplish this? By laying off much of their staff in 2008 and 2009, and running a lean, mean, skeleton staff ever since. Companies have been able to make and grow their profits despite a VERY low rate of economic growth, due to this lean-ness.

So what will it take for corporations to spend money and push the economy forward? They would love to see an increase in demand for their goods and services. In the meantime, they are considering buying back stock, boosting dividends, and making strategic acquisitions.

What will it take for consumers to spend money and push the economy forward? At some point the American consumer will get fed up with pinching pennies, worried about losing their job, and recognize that if they haven't been laid off yet, they likely won't. They will then cut back their savings rate and release some of the pent up demand that has developed for the past three years. When this will start is anyone's guess, however many of the news headlines over the past several weeks aren't bringing that start time any closer.

Note further that this will not be a 'turned on switch' moment. This will start very slowly, an inverse Chinese water torture experience. Our employment and unemployment news has been positive, but not positive enough to turn heads. Over time, the news will be more convincing, which will help to thaw the wallets of consumers and corporations. This is how our economy will move forward, and will adapt to a shrinking role of the federal government in the next few years.

This brings us to investments. My theme this year has been that cash pays near zero, much less than inflation. Bond prices are high and yields are low, making likely future returns disappointing. Stock prices, however, are low on many measures. There are many large US stocks that yield more in dividends than 10 year treasury bonds. As one analyst noted—there are too many people on the bond side of the boat. Bond prices are too high and yields are too low to provide reasonable future returns. The result of this is that stock prices are too low and dividend yields are too high to NOT provide reasonable future returns.

Therefore, my broken record continues. We have suffered a correction this summer, similar in some ways to last summer's correction. Corrections happen, as do bear markets. Investors need to have a plan to withstand both. You don't know when they will begin or end, so the best plans can naturally adjust to both. At this time, there are concerns about the US and global economy, however it is quite possible that these concerns are fully reflected in the low prices for stocks. If this is the case, investors will be well compensated for holding onto their stocks at this time, or even boosting them. For when investors rush off the bond side of the boat towards stocks, there will be a very strong tailwind, benefiting those who own stocks now.