The BOECKH INVESTMENT LETTER
Volume 1.2
February 23, 2009

The Coming U.S. Fiscal Crisis

When national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having being fairly and completely paid. The liberation of the public revenue, if it has ever been brought about at all, has always been brought about by bankruptcy; sometimes by an avowed one, but always by a real one, though frequently by a pretended payment.

Adam Smith
An Inquiry into the Nature and Causes of the Wealth of Nations, 1776

Economic and financial events since the last note, including the breakdown of stock markets to new lows in the U.S. and most developed countries, indicate that the downward spiral remains intact. Virtually open-ended financial rescue in the U.S. has failed to gain traction so far. It is clearly recognized that conventional remedies won't turn things around and a return to 'normal' is not in the cards. We are undergoing a policy experiment that does not have much credibility yet. One of its consequences will be an explosion in U.S. Government debt both in absolute terms and relative to GDP. Below we take a look at that.

The Debt Picture

In the past 25 years, total private debt in the U.S. (and some other important countries) expanded way past the point where it could be supported by incomes and underlying asset values. This occurred because lenders relaxed standards and created new, complex products that brought into the credit system a vast new cohort of uncreditworthy borrowers. They also encouraged and even pushed previously creditworthy borrowers to over-extend themselves with such things as home equity loans. Artificially low interest rates, driven by a combination of Alan Greenspan's poor judgment and excess savings in China and other parts of the world, pushed financial institutions into such speculative, leveraged lending practices. This enabled these institutions to generate artificially enhanced returns for shareholders and option holders. A massive mismatch between the illiquid, unsound long-term loans of the lenders and the highly mobile short-term deposits they used to fund those loans was a powder keg ready to explode.

The economic and credit meltdown won't be over until a good part of the debt overhang is liquidated. There are only three ways to do this. Increased savings and debt default are two possibilities and both are deflationary. They drive the economy, employment and prices down. The third way is inflation, which reduces the real value of debt and hence makes it easier for debtors to service.

Each of these ways of reducing debt triggers painful, but different problems for different social classes. Hence the most likely adjustment outcome will see a combination of all three. Below, we make crude estimates that suggest private sector debt will have to be liquidated to the tune of about $7 ½ trillion.

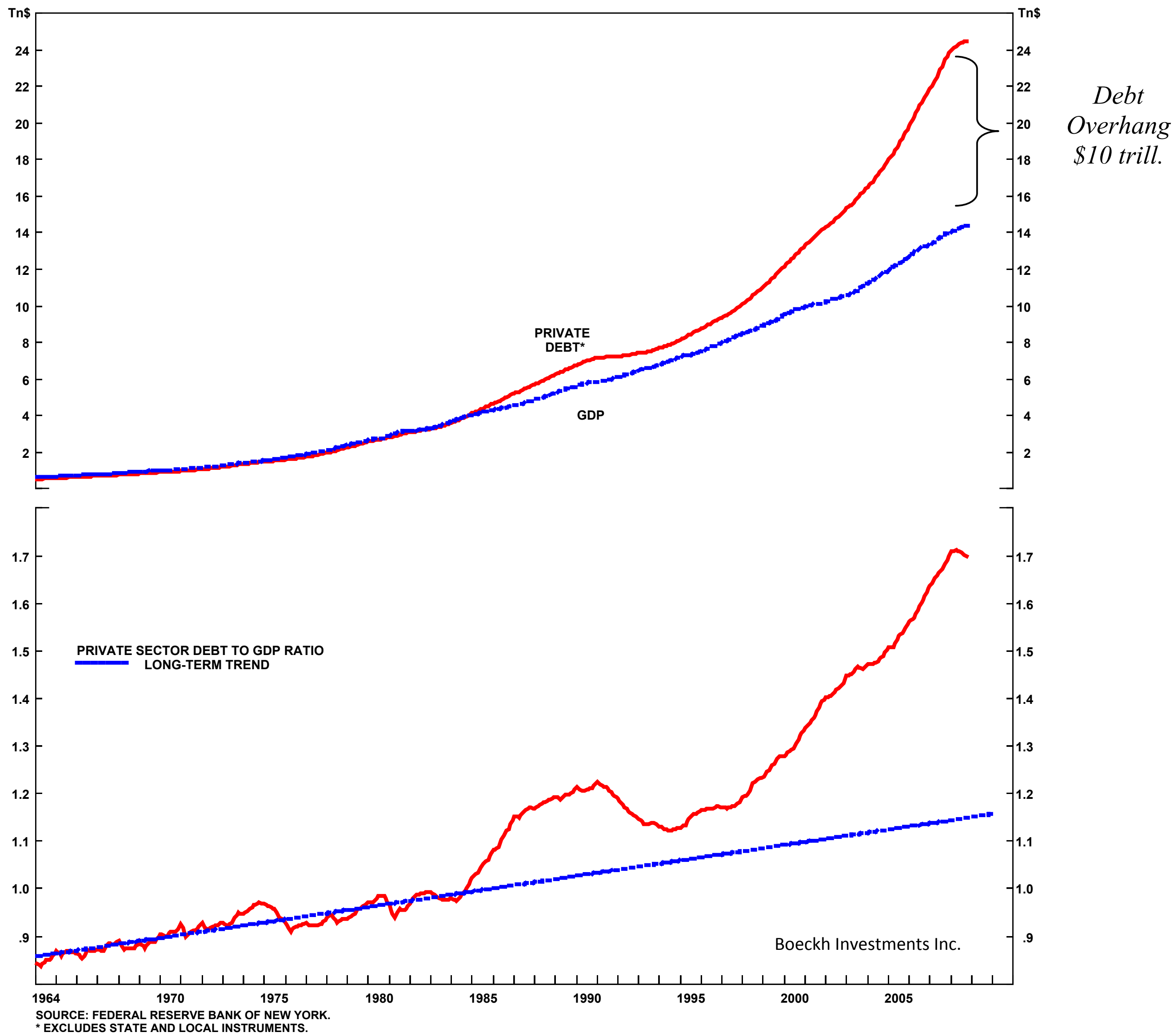
The previous and new Administration, through the various stimulus and bailout packages, have done much to reduce the sick patient's symptoms but they have yet to face the real issue of debt liquidation and what needs to be done to prevent it from triggering a more substantial collapse than we have already seen. The only way this can be done is for the Federal Government to facilitate a transformation of the private sector debt overhang into public sector debt. One way or another this must happen if we are to avoid a prolonged depression.

The authorities continue to make up the playbook as they go along for the basic reason that they don't yet understand what they are dealing with. It is pretty clear that they still remain behind the curve and do not have a proper grasp of the complexity and magnitude of the meltdown, the momentum behind it and where it is going. Thus uncertainty remains very high. Having said that, however, it is crucial to keep in mind that the authorities are committed to doing whatever it takes to prevent a 1930s depression. The extreme pessimists, looking for a total collapse, may be proved right but it is a low probability scenario. The contribution of massive and unlimited bailouts and a stimulus of 5 1/2 % of GDP and more, if necessary, will do plenty to cut off the downside for the time being.

However, there remain many dangers. These interventions do not guarantee sustainable and full recovery of GDP and employment nor do they address the problem of private sector debt liquidation. The vast magnitude of U.S. Government debt that is going to be created, and the amount of time required to take us through and out the other side of this crisis is making a lot of people very uneasy, even terrified. Gold, a barometer of fear, has risen dramatically in absolute terms and relative to other assets since the crisis began. Congressional concern over bailouts and budget deficits is acute and could block further packages if the economy does not recover. Protectionism is on the rise everywhere and could increase sharply over time as unemployment spirals toward or above 10%. Potential implications of the Federal Reserve's ballooning balance sheet are causing Congressional pressure to reexamine the Fed's authority. This potentially calls into questions whether the Fed will be able to continue being the buyer of first and last resort of private sector assets that the market doesn't want. This, of course, would be critical if the Treasury has trouble selling its debt, and already we are seeing that Sovereign Wealth Funds in the Middle East are re-examining their exposure to U.S. Treasury bonds. And, finally, the looming spectre of nationalizations and a greatly increased role of the state in the economy are raising a host of other questions.

Debt: Getting a Handle on Magnitudes

CHART 1: The Debt Overhang

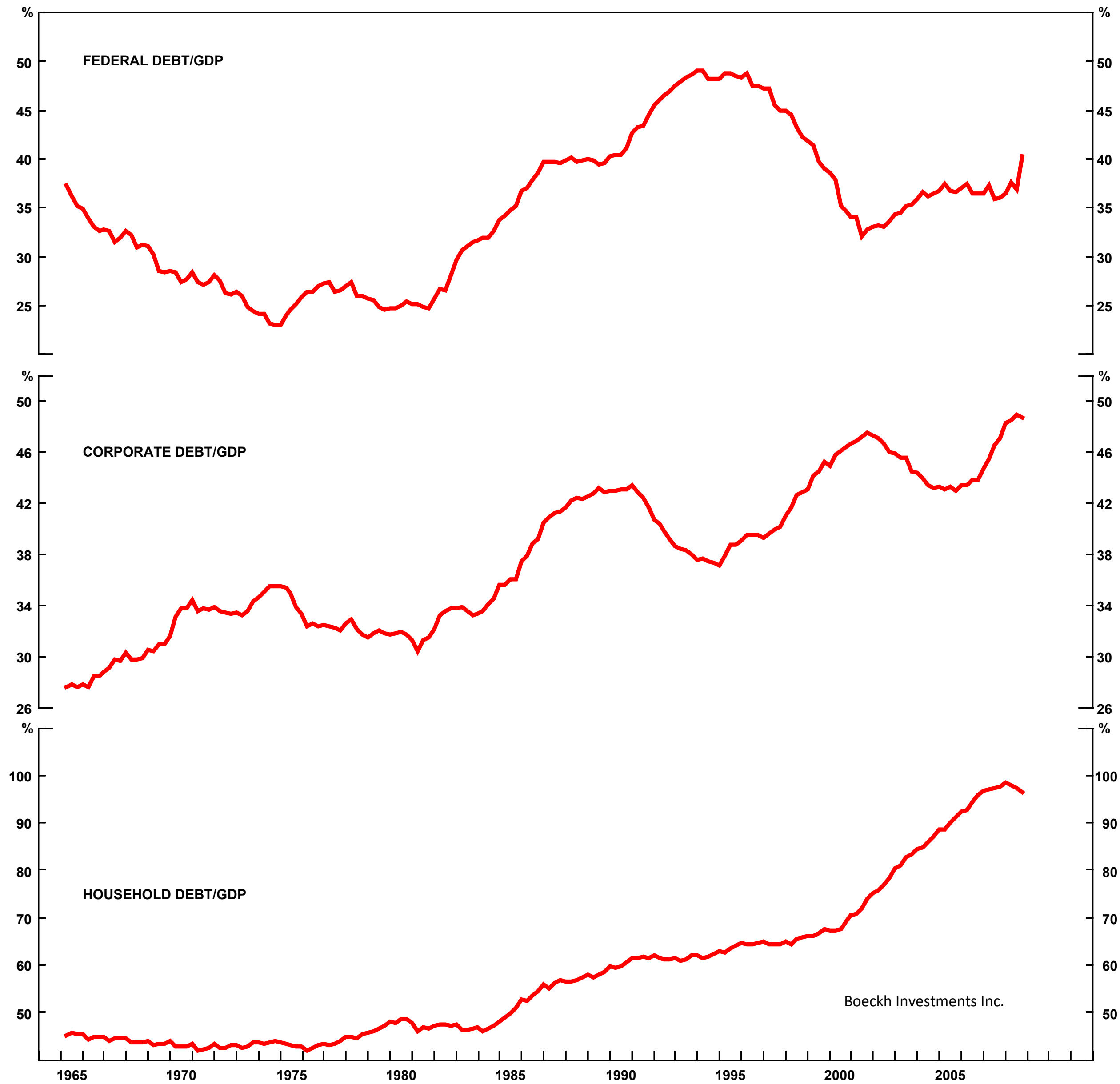


It is important to get a handle on the size of the potential Government debt explosion, given the catastrophic nature of the crisis and its potential to spin out other crises. Below, we take a broad-brush approach to avoid getting caught up in too many details that might obscure the bigger picture. Chart 1 above shows the relationship between the growth in GDP and the growth in the private sector debt since 1964. Up until about 1984, there was a close and stable relationship. Then debt began to accelerate much faster than GDP. There are a variety of reasons for this - a decline in savings and a sharp deterioration in personal responsibility would certainly be on the list. But it could never have occurred without the complicity of Government and a progressive slackening of lending standards by financial institutions and their entrepreneurial creation of new products that hid the risks inherent in over-lending.

There was a sharp correction in the private sector debt ratio after the 1990 recession as debt got liquidated close to the trend line. Interestingly, during and after the 2000-02 recession, there was no debt liquidation so that by the start of the current downturn, the debt overhang – the amount of private debt in existence relative to what it would have been to maintain the earlier stable relationship with GDP – reached a little over $10 trillion or 70% of GDP. While this measure of excess debt may appear somewhat arbitrary, it does have a certain logic, particularly given the negative dynamic in today's financial markets and economy. Our sense is that there needs to be a massive reduction. Even if we just go back to the levels of the early 1990s in both household and corporate debt relative to GDP, the amount of liquidation would be approximately $7.3 trillion – see Chart 2 on the following page. For that to happen in a relatively orderly way so as to avoid a 1930s debt deflation collapse, the Government will have to transform this private debt reduction into additional public debt. The current level of Federal Government debt is about $6 ½ trillion. Thus the new total would move into the $14 trillion area, roughly equal to GDP.

In addition, we have to add in new debt that will be created by the enlarged fiscal deficits now and in the future. The deficit was running at a rate of $455 billion prior to the September-October collapse. With the stimulus plan of $800 billion, the collapse in tax revenues and increase in non-discretionary outlays for unemployment insurance, welfare, Medicaid, etc. the new deficit could approach $2 trillion and average around $1.5 trillion for the next three years, perhaps dropping into a range of $750 billion to $1 trillion for the following three years.

CHART 2: U.S. Debt as a % of GDP



*SOURCE: FLOW OF FUNDS.

We would thus be looking at adding another $7 trillion to the stock of Government debt outstanding in the next few years. Obviously there is some double counting. For example, the ongoing budget deficits will help to prop up personal income and profits, some of which will be used to pay down private sector debt. So, to be conservative, we cut the increase in Government debt in half or roughly $7 trillion and we generously assume some modest growth in the economy in 2010 and beyond to follow the sharp plunge in GDP in the 2nd half of 2008 and 2009. GDP could be 6% higher in 2014 compared to 2008 but perhaps flat in per capita terms. The result of these rough but probably optimistic calculations would see the Government debt: GDP ratio move into the 90% area in five to six years. Under a more bearish scenario of a weaker economy, higher budget deficits and a larger decline in private sector debt, the U.S. Government debt ratio would move far beyond the 100% level.

However, this is not the end of the Government debt story. There are two other components that must be included to properly assess overall U.S. fiscal fragility. First, state and local governments currently have debt outstanding of about 16% of GDP. Most are running large deficits driven by revenue losses from the depression in housing. CBPP estimate cumulative state deficits could reach $350 billion by the end of fiscal 2011. Their deficits will ultimately have to be financed by Washington because they cannot raise funds in the capital markets. Thus, we will see even more upward pressure on Federal Government debt ratios.

The second additional component is contingent liabilities of the Federal government. At present, the net present value of these liabilities, principally for Medicare and Social Security for federal employees, veterans and the general public total about $43 trillion (yes trillion) or about three times GDP *. There are, of course, other contingent liabilities that arise, for example, from

*Source: Government Accounting Office

the FDIC's guarantee of $4 trillion of bank deposits with only $52 billion of assets they hold. There are also potential liabilities that arise from the guarantees of Fannie Mae and Freddie Mac.

In short, the U.S. total Government fiscal position is precarious and will get much worse. The balance sheet of the nation has been used to make promises that artificially inflate perceived/expected living standards. These promises will not be kept and credibility in Government could erode rapidly, causing people to wonder what other promises won't be kept, raising questions over the Government's ability to finance ongoing cash requirements in a non-inflationary way.

How much Government debt is too much? That is always an excellent public finance question and there is no right or wrong answer. Much depends on credibility and confidence in the Government, the size of the ongoing deficit, the domestic tax base, the level and direction of interest rates, the domestic savings rate, etc. Aside from the massive direct financial costs of the crisis, it has illuminated some embarrassing truths about the U.S. financial and political models that may do more damage to confidence. The complete failure of regulatory systems to prevent spectacular fraud (e.g. Madoff, Stanford) and shocking inaction on transparency and accountability for hedge funds and CDS markets points to a level of political corruption that may well be Obama's greatest challenge. The largest foreign holders of Treasuries (China, Japan, UK and the Mid East) are not holding them because they are an attractive option. They are doing so grudgingly, because they have no reasonable alternatives.

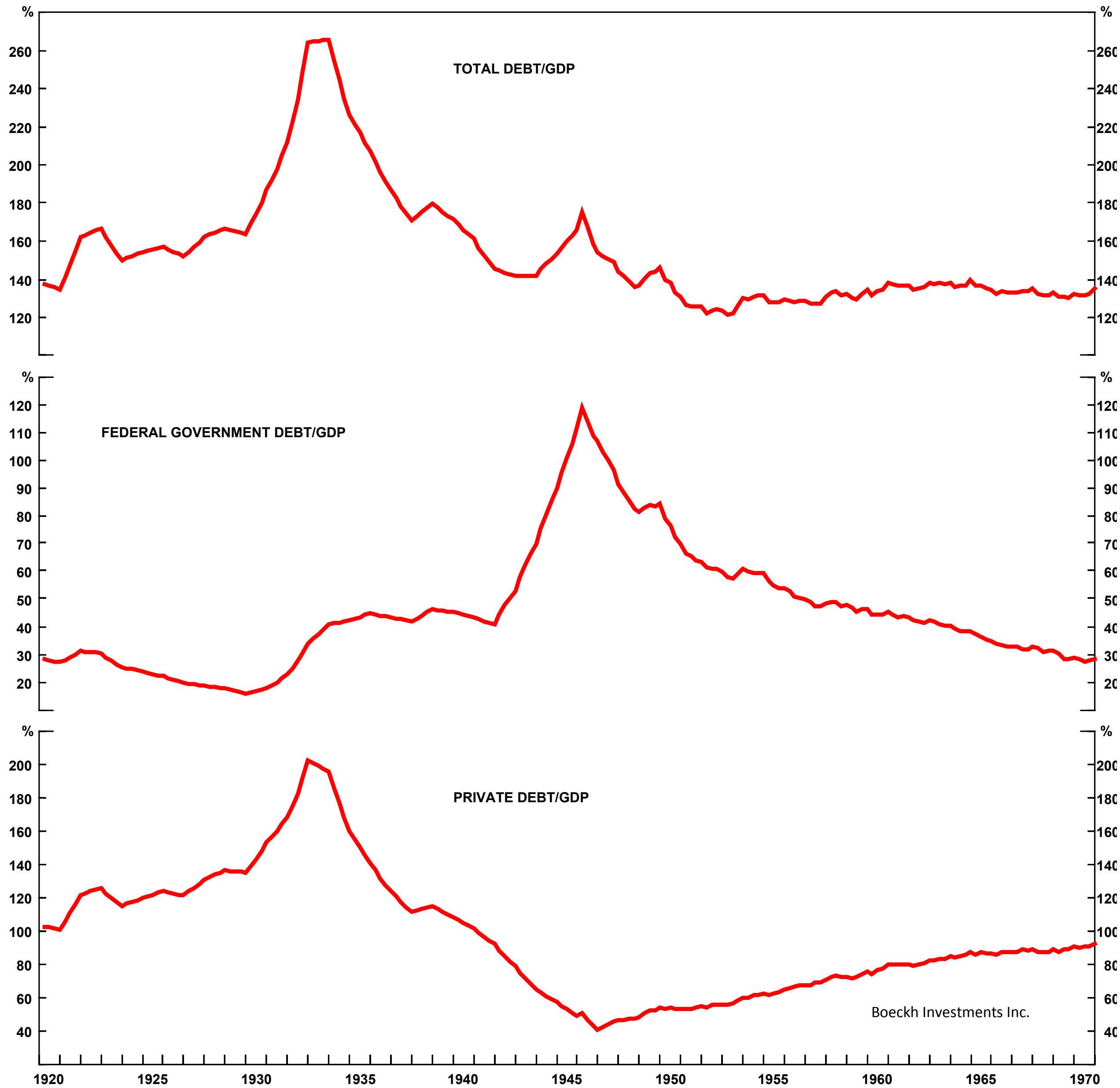
The experience of other countries is useful in trying to get a handle on appropriate levels of Government debt. In general terms, we can say that countries with Government debt: GDP ratios under 40%, and expectations that it will stay below, can maintain stability. Countries that push the ratio up to 80% and beyond move into the arena of instability and are, of course, seriously handicapped if the economy implodes. They have little or no room to stimulate and bail out banks and others. Currently, we can think of Italy, Greece, Ireland, Iceland and much of Eastern Europe in this camp. This is where the U.S. is rapidly heading.

In the past 20 years, Japan appeared to be the exception to the stability rule. It pushed its debt ratio to close to 200% of GDP but managed to maintain confidence in its currency, finance cash requirements at very low interest rates and avoid fears of inflation. The cost may have been sluggish growth for years but the fact is that Japan, following its post-bubble crash, avoided a depression. Presumably its very high savings rate was a key factor in enabling the Government to increase its debt so dramatically without instability. The U.S., in contrast, has experienced a collapse in its savings rate until recently.

The U.S., post WWII, is another example worth looking at as shown in Chart 3. In 1946, the U.S. Government debt to GDP ratio was over 120% and it was worked back down rather painlessly to the stable area of 30% by 1970. However, in 1946 there were virtually no contingent liabilities of the U.S. Government, private sector debt had been reduced to about 60% of GDP compared with 170% today, and the savings rate was high.

It is also instructional to look at what happened to debt in the 1930s. Then, attempts by the private sector to liquidate debt by selling assets, saving more, bankruptcies, etc. had the effect of driving asset prices, commodity prices and incomes down faster than the debt got liquidated and hence the real burden of debt actually rose for most of the 1930s. Chart 3 shows private debt to GDP from 1920 to 1970. Going into the Great Depression, the ratio was about 140%. However, by 1932, the ratio actually increased to 230% as a result of the deflationary collapse in the economy. The Government effectively stood aside and let this happen.

CHART 3: U.S. Debt as a % of GDP (1920-1970)



By comparison, the increase in the Government debt ratio was small, going from 20% of GDP to 40%. It was not until WWII that the Government debt ratio really expanded and the depression ended.

Washington has learned from the 1930s, which is why the U.S. Government and Federal Reserve are rightly committed to avoiding a 1930s private sector debt deflation spiral. To do that, the Government must and will facilitate private sector debt reduction by transforming it into public sector debt no matter how distasteful to many.

President Obama's weekend statement addresses this concern and it is obviously important that he try to maintain fiscal credibility. But he talked of the *should be* world about cutting deficits. Today's *real world*, however, is one of financial and economic calamity. In the latter, deficits and Government debt will be exploding upwards.

Markets

Since the stock market crash began in the second half of September, the ideal portfolio has been gold and Treasury bonds. Both are up sharply in absolute terms and dramatically so relative to all other assets. But that was then – what about the future?

Gold is basically an inflation hedge and is bought as an insurance policy against chaos. Treasury bonds are a deflation hedge. Both are unlikely to be right, or at least right over the same time horizon. It is most probable that we will experience deflation in the near term and inflation in the longer term. There is no case for inflation returning anytime soon. The only issue is how deep and prolonged deflation will be. Japan may be an extreme case but 20 years after the bubble broke, they are still struggling with deflation.

It is also important to note that jewelry demand for gold, like other luxury items, has collapsed. Therefore, the gold market has been propelled upwards by portfolio demand. The danger is that this demand is driven by momentum speculators and not by those genuinely buying insurance. Gold buyers betting on a dollar collapse are also premature. If gold does top out soon, it will have formed a classic double top and be set for significant correction. The real support for gold is likely to come when the U.S. economy starts to recover, inflation fears heat up and the dollar comes under pressure.

There is a case for high-grade investment quality bonds slightly further out on the risk spectrum than Treasuries. But with the default rate on corporate bonds set to soar and the recovery rate for investors very likely to be below past experience, it is premature to commit to high-yield bonds.

Deleveraging, as discussed above, is obviously better for bonds than stocks. Equities are even further out on the risk spectrum than high-yield bonds with earnings set to plunge much further. Dividend yields and P/E's may not have fully adjusted to the new crisis reality. The Dow Jones and S&P indexes have broken below their November lows and the benefit of the doubt must be given to the underlying trend, which remains down.

However, with all the pessimism out there, it is important to remember that the U.S. market is at the same level at early 1997, and some 50% below its high of almost nine years ago, so a pretty major bear market has already occurred.

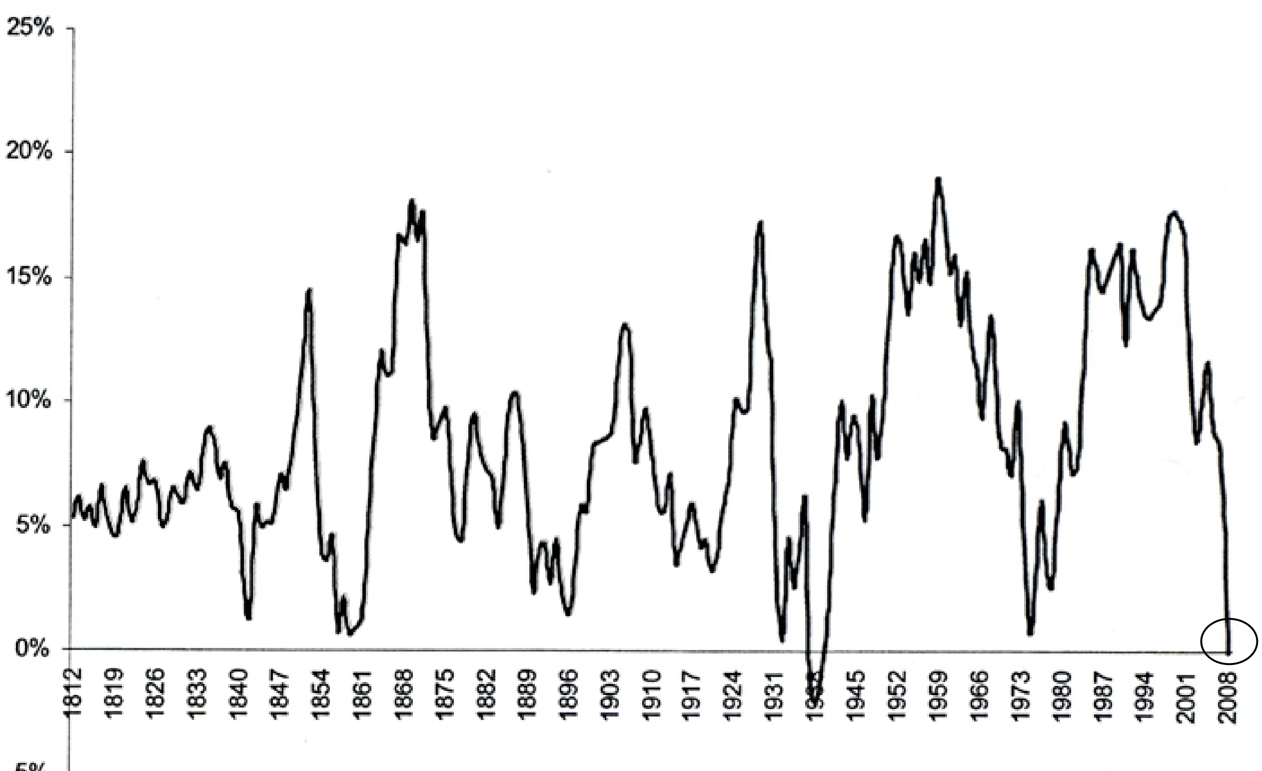
Moreover, if we look at 10-year annualized rolling returns back to 1812 (see chart 4 on the next page), there were only seven times when the zero line was approached or penetrated. This is one of those times. Markets are forecasting a depression or something close to it. So if the

Obama and previous packages do work to cut off the downside - and this is very likely - then the equity markets may well be through the bulk of the bear cycle.

As for currencies, it is hard to make a fundamental case for any of them, which is why gold is so appealing to many. The yen, in particular is very vulnerable, having risen sharply against a background of collapsing exports and a dramatic decline in the economy as a whole. When economic recovery comes, the commodity currencies backed by relatively sound financial systems (e.g. Canada) will do well.

As for equities, the best candidates for an early recovery are China and the other Asian surplus nations. In particular, this crisis will force China to turn towards domestic markets for future growth. The combination of massive stimulus and unleashing huge domestic savings promises to transform the country once again over the next decade.

CHART 4: Rolling 10-Year Returns from Large-Capitalization Stocks



Source: Jeremy Siegel; Bloomberg; LMCM estimates.

Conclusion

Clearly, we are heading for a major fiscal crisis in the U.S. In future letters, we will explore some of the implications. However, for now, it is unlikely that the Treasury will have a problem financing the deficits because the dramatic increase in domestic savings - the counterpart to the collapse in spending – means that deflation will be the main concern and surplus funds will be adequate to finance Treasury deficits. The risk will come when/ if the economy starts to recover.

Other countries will have fiscal crises as well. For many of them the markets for their debt and currency will not be so patient.

How much exposure to risk assets is a question on everyone's mind. Millions of investors had become far too complacent before the crash and found that their exposure to risk was far too high. Paring this back at seemingly depressed price levels is painful. But the overriding consideration for investors must continue to be adequate liquidity for survival. Pension fund assets have fallen sharply - jeopardizing future retirement payments, taxes will increase dramatically in the years ahead, and returns on non-risk assets are far too low for most people to live off. Unemployment will be higher for years. Investment opportunities are plentiful but staying power is more important.

Tony Boeckh

February 23, 2009