The Quarterly Report

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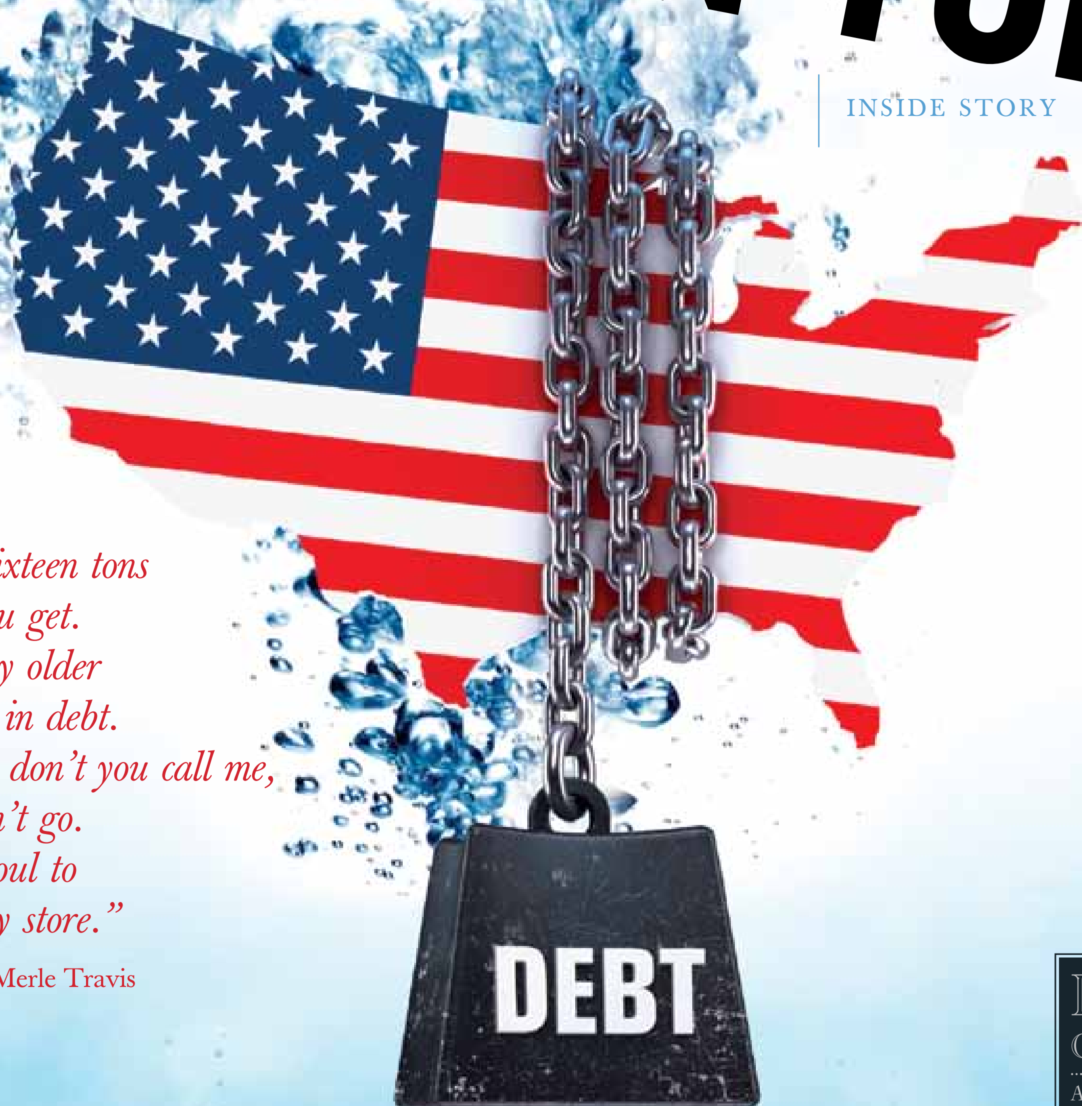
SIXTEEN TONS

INSIDE STORY



"You load sixteen tons
what do you get.
Another day older
and deeper in debt.
Saint Peter don't you call me,
'cause I can't go.
I owe my soul to
the company store."

–Merle Travis

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Sixteen Tons

GROWING UP, I'm sure my father's car had a radio in it, but I don't know why – he never listened to the radio as he drove us around town because it would interrupt his singing. My father is not a good singer – Mom has the musical talent in our family – and he seemed to know only two songs, but that didn't stop him. The first song was the bluegrass classic, "Mountain Dew," and the other was "Sixteen Tons," originally recorded by Merle Travis and later made popular by Tennessee Ernie Ford.

I don't know that there are any financial lessons in "Mountain Dew," although leaving your money in an old hollow tree is probably not the wisest investment in the world, even if it is mysteriously replaced with a jug of "mountain dew" (aka moonshine for those not versed in Bluegrass tradition). "Sixteen Tons", on the other hand, seems very appropriate for our times.

We are awash with debt, and no one seems to have a really good plan to deal with it. As Lacy Hunt, Ph.D., of Hoisington Investment Management puts it, we have not only too much debt, but also too much unproductive debt, and too much counterproductive debt. Hunt should know, since he is a disciple of Yale economist Irving Fisher, who argued that the Great Depression was caused not by a lack of demand as John Maynard Keynes theorized, or by poor monetary policy as Milton Freidman theorized, but by excessive debt. Consensus leans towards Friedman being the one who was correct about the Depression, but Hunt may be on to something now. After all Anna Swartz, Friedman's co-author, famously criticized policy makers in 2008 for responding to the wrong crisis. This was surprising because they were basically following the play book she and Friedman wrote. Swartz argued that the 2008 crisis was different because in the 1930s banks faced cash crunches but were otherwise in good shape, while this time they had made numerous bad loans.

This fits nicely into Hunt's theory. He argues that there are three types of debt. First there is productive debt, which is good. Productive debt pays for itself and then some. For example an entrepreneur may borrow money to start a business. This is debt, but this debt has the potential to not only be paid back to the lender but also add to society in terms of jobs, new products and services, etc.

Productive debt does not have to be private sector debt. If a government borrows money to build a bridge, that can be very productive. Toll revenue and/or taxes can pay the loan back, and the new bridge may create new economic opportunities.

The next level is unproductive debt, which is debt that will be paid back but does not add anything else to society. Refinancing is the best example. It works out for the lender and the borrower but nothing new is being built. No other economic activity is created.

Finally there is counterproductive debt, which not only does not produce economic benefit beyond its cost, but also has a high probability of not being paid back. Sub-prime mortgages come to mind, as do student loans. Richard Vedder, an Ohio University economist, writes in the Chronicle of Higher Education that as many people and perhaps more have student loans as have college degrees. In 2010 the New York Times reported on Cortney Munna, then 26, a New York University graduate with almost $100,000 in debt. If her repayments were not then being deferred because she was enrolled in night school, she would have been paying $700 monthly from her $2,300 per month after-tax income as a photographer's assistant. She says she is toiling "to pay for an education I got for four years and would happily give back." Her degree is in religious and women's studies.

There is nothing wrong with getting a degree in religious and women's studies or with buying a house. There is something wrong with borrowing money that you have no real way to pay back. There is also something wrong with lending money to people when it is almost certain that they will not be able to pay it back. This behavior is, as Hunt puts it, counterproductive, and weighs our economy down.

Unfortunately in most economic circles – the very circles tapped to help guide us out of this mess – debt is completely ignored. Hunt points out that debt is simply not in their models. It is not part of Keynes' model or those of any of the post-Keynes improvements from his followers. It is also not in Friedman's models. Traditional policy tools, both fiscal and monetary, simply are not having an impact because of the debt overhang.

This certainly seems to fit our current situation: Large fiscal stimulus packages that are completely ineffective. Interest rates near zero and two rounds of quantitative easing, and the economy is still not going anywhere. It would also explain the awful recent record of some of the most notable economists. For example, in January 11, 2010 – just a few months before Greece imploded and the European debt crisis began – Paul Krugman published a glowing op-ed in the New York Times where he wrote, "Europe is an economic success, and that success shows that social democracy works."

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This was very unfortunate timing for the Nobel laureate which, quite honestly, makes him look foolish.

Paul Krugman may be a lot of things and many people, including myself, disagree with him most of the time. However, he is not foolish; he is a very bright man and a respected economist. Obviously, in his analysis Krugman was and still is ignoring the debt. Why would one ignore the debt?

Krugman is not alone. Ben Bernanke, in his *Essays on the Great Depression,* makes the following statement that is indicative of mainstream economists of all political hues: "Beginning with Irving Fisher (1933) and A. G. Hart (1938), there is literature on the macroeconomic role of inside debt. Hyman Minsky (1977) and Charles Kindleberger (1978) have in several places argued for the inherent instability of the financial system, but in doing so have had to depart from the assumption of rational economic behavior. Footnote: I do not deny the possible importance of irrationality in economic life; however, it seems that the best research strategy is to push the rationality postulate as far as it will go."

In plain English this means that economic models from just about every school of thought rely on the assumption that people behave rationally, or at least rationally as defined by economists. In the case of debt loads, this economically rational person would not change his behavior because of debt until the market began to demand higher interest payments. From a classic economics standpoint, if one can continue to borrow at low interest rates than one does not have a debt problem.

Recent studies have shown that this theory does not work out so well in real life. In a paper published in the National Bureau of Economic Research, Carmen Reinhart, Vincent Reinhart, and Kenneth Rogoff studied the effect on GDP growth of excessive public debt. They defined these public debt overhangs as periods of time where all public debt equaled 90 percent or more of GDP for at least five years. They found 26 such episodes globally post-1800. Their research indicates that public debt overhang episodes are associated with growth over one percent lower than during normal periods. In addition, the "…duration of the average debt overhang episode across all 26 episodes lasted an average

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REVIEW *of* ECONOMY

Our already sluggish growth is slowing further. The first quarter GDP growth came in at 1.9% and we expect second quarter to be worse. The previously mixed economic signals have taken a turn for the worse and while far from a certainty, the risk of falling into recession has risen dramatically.

The improvements in unemployment have ceased and the rate has leveled off at 8.2%. Many economists are now projecting it to rise by year end. It looks like the positive momentum in the first quarter was, as feared, just a seasonal blip.

The situation in Europe has worsened and even as there seems to be some progress towards more consolidated help for banks, the continent has slipped into recession and we fear that their downturn could be much worse than the current consensus view. +

REVIEW *of* MARKET

The S&P 500 finished the quarter down 2.75%. It spent most of the quarter down more, but rallied 4.12% in June, 2.49% of which occurred on the very last day. That rally is already disappearing in early July. Small-caps were worse, with the Russell 2000 finishing down 3.47%. With all that happened economically, it is a surprise that the markets did as well as they did.

Bonds rallied in the quarter with the Barclays U.S. Aggregate index up 2.06%. The fear of European collapse may not have spooked the stock market as much as it should, but bond investors are always smarter. The flight to quality helped domestic bonds.

International markets continue to be the worst place to be for the quarter, although the June rally was stronger overseas. The MSCI EAFE was down 6.85% for the quarter. We believe international markets will continue to underperform in both up and down markets even if crisis is averted; the medicine is likely to cause a severe recession. +

MARKET *forecast*

Our outlook remains negative. In fact, the rally in June has only made us more concerned about a potential shock to come. The poor economic situation seemingly has not registered with equity investors. We believe that will correct itself when corporate earnings are reported. Our best prediction continues to be that the markets end the year flat with more extreme volatility. We see the correction getting worse through the summer with some possible relief this fall.

U.S. large-cap stocks remain the most attractive asset for the long term. We still like large dividend-paying stocks.

Bonds look troubling over the long haul but will likely remain a safe haven during times of crisis. Commodities have dropped dramatically and may be near a bottom.

The biggest risk to our outlook has been that Europe does somehow muddle through. That is looking less likely as at this point, even if they avoid catastrophe they are still in a deep recession.

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of 23 years… Growth effects are significant even in the many episodes where debtor countries were able to secure continual access to capital markets at relatively low interest rates." They go on to say, "Contrary to popular perception, we find that in 11 of 26 debt overhang cases, real interest rates were either lower or about the same as during the lower debt/GDP years. Those waiting for the financial markets to send the warning signal through higher interest rates that government policy will be detrimental to economic performance may be waiting a long time."

Again, in English this means people do not wait for high interest rates to change behavior and reduce economic activity. Once debt levels reach 90 percent of GDP the debt turns cancerous, to use Hunt's term, and begins to deteriorate economic growth. In the U.S. today total government debt (Federal, state and local) is 99 percent of GDP, according to data from the McKinsey Global Institute. This concurs with our sluggish recovery.

So how do we get out of it? Hunt points out that there are only four ways out: first, belt-tightening, or austerity;

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second, inflation; third, massive default; and the final way is to grow out of it. The second and third methods have only occurred in relatively small, emerging economies. The final method only occurred once, and that was the U.S. post-World War II. The circumstances that led to that recovery – the U.S. being the only industrial power in the world not in ashes – are not likely to recur. Hunt makes another interesting point: During World War II the U.S. economy experienced an export boom, because our industrial capabilities were not being bombed. At the same time those who were still at home were under-consuming due to war time rationing. The savings rate spiked to more than 26 percent. That is some pretty severe austerity and may cast a little doubt on the theory of the U.S. simply growing out of its debt post-World War II.

The bottom line is that we are going to have to learn to live within our means, not just as individuals, but as a nation. Debt can be a double-edged sword. It can be productive and finance businesses, roads, schools, etc.; but in excess it becomes ruinous. Debt is like the main character in Merle Travis' famous song:

"If you see me coming better step aside/ A lotta men didn't, a lotta men died/ One fist of iron, the other of steel/If the right one don't get you/The left one will.

We load sixteen tons, what do we get/ Another day older and deeper in debt/ Saint Peter don't you call us 'cause we can't go/*We* owe our soul to the company store."

Chuck Osborne, CFA
Managing Director