Memo to: Oaktree Clients

From: Howard Marks

Re: It's Greek to Me

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In the early part of this decade, I reviewed a few books for the *Sunday Los Angeles Times*. Here's how I began my assessment of Pete Peterson's *Running on Empty* in 2004:

> Consider Sam. He's always been regarded as the brightest guy in town, and maybe the handsomest. He has the best job and lives in the best house. He spends aggressively – detractors would say hedonistically – to support a lifestyle that many others envy, but he shows good character by providing generously for his sick and elderly relatives.
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> There are, however, a few problems. In recent years, he's been spending more than he makes, and his expenditures appear likely to grow faster than his income. He covers each year's shortfall by borrowing from other members of the community. (They've always been glad to lend him money because of his good standing in town.) But this adds increasingly to his debt, and thus to the next year's interest (and shortfall). In other words, he seems to follow Winston Churchill's dictum: "It saves a lot of trouble if, instead of having to earn money and save it, you can just go and borrow it."
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> Finally, with the number of family members Sam cares for increasing, with him promising each of them an increasing stipend, and with his relatives – even the sick ones – living longer, it seems clear that in the future, the cost of supporting them will grow considerably faster than his income.
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> An annual deficit. Attachment to a lavish lifestyle. Growing indebtedness and related increases in interest costs. Dependence on others to finance the shortfall and the risk that those lenders will withdraw their loans or charge higher interest rates. A commitment to pay for the welfare of others that threatens to grow out of control.

Pete's book focused on the tendency of the United States to ignore the cost of its social programs, run deficits and expand debt, and the "Sam" in my analogy was, of course, Uncle Sam. But now other nations have jumped the line and usurped the above description. Like most of Western civilization, it started with Greece.

Because I was in London much of the time since Greece burst into prominence, I may be able to add some insight from a European vantage point. This period in London was unusual for me, in that with this topic in the headlines I was far more a student than a teacher. Most Americans don't start off sensitized to international economics and, especially, currency matters. It's been challenging to organize all I've learned and boil it down for a memo, but here it is.

Strange Bedfellows

"Shared values" is one of the things I credit for Oaktree's success over the years. All of Oaktree's senior managers are conservative, cautious people; we all agree that risk control and consistency hold the keys to long-term investment success; and we all put clients' account performance ahead of our company's profit. Shared values make it easy to run an organization and particularly easy to reach agreement on policies and tactics.

Now imagine what it would be like to run an enterprise where (a) some of the constituents believed much more in thrift, discipline and transparency than others and (b) there was no mechanism for making sure everyone played according to the agreed-upon rules. Welcome to Europe.

In the 1950s Belgium, France, Italy, Luxembourg, the Netherlands and West Germany came together to form the European Coal and Steel Community, European Atomic Energy Community and European Economic Community, which in 1967 combined as the European Community. Denmark, Ireland and the U.K. joined in 1973, and Greece, Spain and Portugal joined in the 1980s. Membership has since expanded to 27 nations, and the name "European Union" (E.U.) was adopted in 1993. In 1999, eleven nations (since expanded to 16) agreed to form the euro zone and replace their individual currencies with the euro. Europe seemed to have accomplished the daunting task of pulling together its nations and adopting a single currency. This was a delicate balancing act, but for years it seemed to go quite well.

It was a requirement for success that all the nations share fiscal policy. However, as in most economic alliances, there were incentives to nibble at the rules. And, believing more is better, the E.U. admitted nations with less uniform values. The desire to create a common currency and expand the reach of the union – to achieve a scale more comparable to economic powers like the United States – colored decisions regarding expansion and ultimately led to trouble.

To get a feeling for what happened, let's say you and I are such good friends that we decide to combine our economic strength to apply together for a credit card with better terms and a higher limit. We agree we'll each (a) refrain from spending more than we earn and (b) receive and pay that part of the bill that relates to our own charges. All goes well, and eventually we agree to admit a third member to our association. But the new member doesn't share our commitment to thrift and integrity, wants to live a better life than he can afford, and thus charges more on the card than he earns. Our strong combined credit rating enables him to do so, and his balance on the credit card starts to swell. When it comes out that our association is heavily indebted, we chip in to pay off the unpaid balance, even though only one of us ran it up. In fact, since the prodigal third member spent more than he made, he has nothing to contribute to paying off the debt; thus you and I – despite having behaved more responsibly – are stuck with the burden.

Greece is that new member of the arrangement, and it (like a number of other countries) wanted to give its people a better life than they can afford, financed from the public treasury. Without membership in the E.U. – or if the rules on deficits had been enforced – Greece's economic reality would have limited what it could do for its citizens. But E.U. membership enabled it to borrow and spend to excess. Here's what the Bank of Spain's governor said in April 2007: "The single monetary policy has meant that excessively loose conditions for our economy have been almost continuous" (*Telegraph.co.uk*, May 30). The same was true of Greece.

My English friend Rodney Leach is a Member of Parliament and a committed leader of the "Eurosceptics" who have campaigned to improve the E.U. and prevent Britain from adopting the euro in place of sterling. His draft of a coming paper influenced my understanding of the situation: "Once inside the Club," he writes, " . . . the Mediterraneans resumed their old habits. The temptation was irresistible to borrow at the low interest rates bestowed on them by Germany's participation. Greece in particular indulged itself by completely abandoning financial discipline."

Greece was able to violate the agreed-upon 3% cap on E.U. members' deficits, abetted by generous capital markets and the failure to enforce the limit, and it engaged in financial transactions designed to hide its growing debt. It bears noting that much of what's true today about Greece has been true for years. But people didn't understand its significance to the extent they do today, or didn't find it worrisome, and short-term-oriented politicians had every incentive to ignore the problem rather than confront it and admit that their noble experiment was fraying.

Thus it emerged in early April that Greece and Greek companies had run up substantial debts that would be hard to repay. It didn't take long for people to figure out that the same was true about the rest of the "PIIGS": Portugal, Italy, Ireland, Greece and Spain. In May, some unfortunate remarks by Hungary's Finance Minister made it a candidate for similar treatment. Then Estonia came under the spotlight, and the process seemed to cascade non-stop.

## A Problem of Substance

The real problem in Greece and the other countries – especially what Rodney calls the "Mediterraneans" – isn't one of deficits and debt. Those are merely the results and the symptoms. And if the problem were Greece alone, the smallness of its economy and financial system would render it easily fixable. The problems are more substantial, structural and widespread. (I looked at 17 European nations; they all ran deficits in 2009, and only two of those deficits were below the E.U.'s target of 3% of GDP. In ascending order, the deficits in Belgium, Cyprus, Slovakia, France, Portugal, Spain, the United Kingdom, Greece and Ireland were all between 6% and 14%.)

The ingredients that contributed to the European crisis are many:

- Slow-growing, unproductive and uncompetitive economies.
- Low birthrates and aging populations. ("In the 1950s there were seven workers for every retiree in advanced economies. By 2050, the ratio in the European Union will drop to 1.3 to 1." – *New York Times*, May 23)
- Generous benefits and social services; cradle-to-grave safety nets.
- Extensive vacations and strict limits on the work week.
- Early retirement.
- Artificially high debt ratings and resultant low interest rates.

In “What Worries Me” (August 28, 2008), I expressed concern about the fact that Americans expect the world’s highest standard of living even though the U.S. is no longer a leader in manufacturing output and global competitiveness. Certainly this is the case in spades for Greece, whose economy is largely irrelevant but which wanted to meet its people’s demands.

In April, as the problem began to unfold, I heard a Greek taxi driver express his worry on the radio: “I might not be able to retire at 53,” the average retirement age. How can it be rational for a nation with a limited economy to enable its citizens to retire at age 53? Well, it isn’t. Greece was able to outspend its revenues for years because it benefited from the “reflected halo” of the E.U.’s financial strength and low euro-related interest rates.

On June 4, 2005, the *International Herald Tribune* carried an op-ed piece by Thomas Friedman in which he presciently observed the following:

> . . . [the forces of globalization are] eating away at Europe’s welfare states. It is interesting because French voters are trying to preserve a 35-hour work week in a world where Indian engineers are ready to work a 35-hour day. Good luck. . . .
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> I feel sorry for Western European blue-collar workers. A world of benefits they have known for 50 years is coming apart, and their governments don’t seem to have a strategy for coping.
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> A few weeks ago, Franz Muentefering, chairman of Germany’s Social Democratic Party, compared private equity firms which buy up failing businesses, downsize them and then sell them to “a swarm of locusts.”
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> The fact that a top German politician has resorted to attacking capitalism to win votes tells me just how explosive the next decade in Western Europe could be, as some of these aging, inflexible economies which have grown used to six-week vacations and unemployment insurance that is almost as good as having a job become intimately integrated with Eastern Europe, India and China in a flattening world. . . .
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> Next to India, Western Europe looks like an assisted-living facility with Turkish nurses.

In a nation with closed borders, a government can do almost about anything it wants. It can print money with which to buy things for people who don’t earn those things themselves . . . as long as sellers will accept that newly printed money at face value. **But in a global economy, competitive forces make it hard for people – or countries – to live better than their output justifies.**

Less fundamental but more colorful, I’ve learned about a number of factors which exacerbate the situation in Greece and elsewhere. While just anecdotal, these tales are rampant in Europe:

- As may be typical of Mediterranean nations, compliance with Greek tax laws is, shall we say, "spotty." In this country of 11 million people, just a few thousand report incomes above €100,000.
- There's a box to check on the tax form if you have a swimming pool, and 324 residents of Athens said "yes." However, when tax investigators checked satellite photos, they got a slightly different figure: 16,974. That's 2% compliance. (*The New York Times*, May 10)
- As part of the unorthodox arrangement, these countries have significant "black" or "shadow" economies. In Greece, 20-30% of transactions are said to take place in cash and/or through overseas bank accounts, unreported in both cases.
- The prevailing rule in Greece seems to be "4-2-4." If you have a pending tax obligation of €10, you meet with the tax collector. You hand him four for himself, you pay the authorities two, and you keep four. It's not a fluke that the typical Athens tax collector, with a salary of €50,000, is said to own real estate worth €2 million.
- Going the proverbial baker's dozen one better, workers in Greece's public sector had quite a deal: they were paid two "bonus months" per year.
- In Spain, half of all employees are unionized and protected by very strict work rules that limit efficiency and essentially preclude layoffs. This means any steps to cut costs fall on the rest of the work force, which is hit disproportionately.
- It seems that Italy (an E.U. founder but also a "Mediterranean") maintains "a fleet of more than 626,000 official cars, more than 10 times the number in France, Germany or the UK." (*Financial Times*, May 12)

Together these things – low output, high government spending, under-the-table business dealings, tax evasion, and financial profligacy – represent a recipe for trouble. **Today's developments merely prove that things that don't make sense can't go on forever**:

- Perpetually spending more than you bring in.
- Enjoying a standard of living you can't afford.
- Running an annual deficit that increases constantly as a percentage of GDP.
- Owing amounts that increase constantly as a percentage of GDP.
- Doing all the above while having a currency as strong – and an interest rate as low – as in nations where these things are not the case.

Things can go on longer than they should, and these probably have, but eventually there's a price to be paid. The world is up in arms today over everything that's wrong with the European financial picture, even though these conditions probably aren't much changed from a few years ago. It's just that now people have decided to focus on them.



## The Role of Debt

As I mentioned above, debt isn't the problem, or the cause of the problem. But it has been the facilitator.

In "The Long View" (January 9, 2009), I wrote (albeit without reference to Greece) about a strong uptrend over the last few decades in what I called "expansiveness":

> Every business, government, non-profit organization or individual has a certain amount of equity capital, net worth or surplus. That capital, in turn, will support a certain level of activity: production and sales, lending, government action, charitable grants or consumption. **But over the last several decades, if you wanted to do more of these things than your capital permitted, you could borrow capital from someone else.**

**Without credit – I think back to my pre-credit card college days of 45 years ago, for example – you couldn't spend money you didn't have. Thus you couldn't buy things you couldn't afford. Then the miracle of credit came along and it became easy to get in over your head.**

What would have happened if governments couldn't finance deficits by issuing debt? Greece would only have been able to pay the benefits it could afford. Less pleasant, but perhaps healthier.

And what would have happened if builders weren't able to borrow, and thus had to sell each newly built home before they could erect the next? Spain wouldn't have been the site of a boom in which 2.8 million homes were built (with only 1.5 million sold), and with as many building permits issued as in France, Germany, Italy and the Netherlands put together.

*The Wall Street Journal* of November 24, 2008 carried the following quotation from Irving Fisher, writing 76 years ago ("The Debt-Deflation Theory of Great Depressions," *Econometrica*, March 1933):

> When it comes to booms gone bust, "over-investment and over-speculation are often important; but they would have far less serious results were they not conducted with borrowed money."

While this statement wasn't made with regard to Greece or even to government activities in general, it is clearly relevant to the current situation.

**In recent years, most of the nations of the world spent more than they took in to give their citizens more of what they wanted. As long as the capital markets were open, few could think of a reason why this policy wouldn't work forever**. Economic units all over the globe were able to borrow to cover deficits. All that mattered was the ability to service the debt, even if that required borrowing money to pay interest. No one seemed to demand the ability to repay.

When I was younger – in what seems like a distant past – national debt began to expand, and I remember heated debate regarding the significance, wisdom and likely consequences of that trend. The subject receded in recent years, since every nation now does it to some extent and people became inured to the controversy, as they tend to do.

Two sentences stand out on this subject, from Bill Julian of Bill Julian Research on April 11. He quotes John Maynard Keynes as having said, "Government debt is really debt we owe to ourselves. So it doesn't matter." But today, most nations' debt is no longer all "to ourselves," as nations with surpluses are largely financing the ones with deficits. Thus it's hard to conclude national debt doesn't matter. Welcome to 2010.

**In the "old days," government deficits were often part of counter-cyclical stimulus, a concept with which Lord Keynes is identified. It seems logical that when its economy is depressed, a nation will spend more than it receives in taxes in order to stimulate. Then, in times of prosperity, it will cut expenditures, run a surplus and pay down debt. But permanent deficits appeared in the late twentieth century, and thereafter national debt has grown in good times and bad. The idea of national debt being repaid has evaporated.** Today, public and private institutions in Greece, Spain and Portugal owe €2 trillion to foreigners, with no possibility of repayment in sight.

<u>Solutions and Stumbling Blocks</u>

Thus far, most of the actions being taken to address the crisis are of two types: financial maneuvers to calm the financial markets in the short term, and austerity measures designed to reduce deficits in the long term.

The United States' credit crisis of late 2008 serves as a model for what must be done. The elements that arise in a credit crisis are consistent: uncertainty regarding the future, fear of credit losses, and refusal to make loans. **Financial systems run on confidence, and, when confidence dries up, things can grind to a halt.** Clearly, then, the most immediate efforts must be to restore confidence and keep credit flowing.

This problem is particularly severe at financial institutions (and what is a national economy today other than a financial system, hopefully with a manufacturing sector tacked on?). Financial institutions are, by definition, marked by high leverage, and if confidence declines, the providers of credit tend to ask for their money back. Since these institutions never have enough cash on hand to satisfy the demands of the would-be withdrawers, they can fall prey to a run on the bank. The first task, then, is to restore confidence and keep capital available.

Thus, at the beginning of May, the E.U. put together a rescue package for Greece worth €110 billion. And then, when the possibility of contagion to Spain, Italy and Portugal began to be recognized, that was increased on May 10 to €750 billion (or $900 billion, a figure remarkably similar to the U.S.'s program). In addition, the European Central Bank established a program to buy government bonds of the affected nations, along the lines of our "quantitative easing."

Many European governments have announced plans to reduce deficits. Their tactics include reduced spending, freezes or cuts in public sector employment and wages, and higher retirement ages. Some have enacted tax increases to augment revenues. Greece even says it's going to start collecting more of the taxes that are owed. Austerity is all the talk in Europe, and some leaders are predicting periods of substantial suffering. That's what happens when a borrow-and-spend cycle that has advanced beyond prudence is brought to a halt.

**It's important to recognize, however, that one potential solution – traditionally perhaps the easiest – isn't available to the members of the European Union: currency devaluation.**

A key element in the situation is the absence of independently floating exchange rates. Think for a moment about international finance. Countries differ in terms of growth rates, productivity and inflation rates. In recognition of the differences, interest rates and exchange rates change relative to those of other countries. In general, countries that are better off in terms of growth, productivity and inflation will have stronger currencies and pay lower interest rates.

**The easiest way for a nation with excessive foreign debt to solve its problem is through devaluation.** If the drachma weakens relative to the deutschemark, a Greek who owes a German a certain number of drachmas now owes him fewer deutschemarks (of course, if the debt is denominated in deutschemarks, he now owes him more drachmas). This process can occur through an explicit devaluation or through hyperinflation, and we'd be overwhelmingly likely to see it in action from a standalone Greece.

Between 1980 and 2000, the drachma depreciated by roughly 85% relative to the deutschemark, a reflection of economic reality. But with the countries of Europe tied together with a single currency, this can't happen.

Nations throughout Europe are doing what they can. That means reassuring financial markets and implementing austerity measures, but not devaluing (as long as the debtor nations in question remain part of the E.U.).

<u>So, Will It Work?</u>

"Will It Work?" was the title of a memo I wrote on March 5, 2009, discussing whether the Obama administration's rescue plan would be successful. The problems were new and huge, like today's in Europe, and the solutions being attempted were untested, also like today's.

The last section of "Will It Work?" was devoted to the three things I said had to be accomplished in order for the rescue to be effective: delever the economy, replace the capital that has been destroyed, and restore confidence. The recipe in Europe is no different, although the U.S. government had to shore up the financial institutions, whereas in Europe governments first have to support other governments.

In addition, there are wrinkles in Europe that the U.S. didn't face to the same degree. They can make it challenging to solve problems and especially to reach agreement quickly:

- The European Union consists of 27 sovereign nations, each with its own central bank and finance ministers. In addition there are the European Central Bank ("ECB"), the European parliament and the E.U. ministers.
- The countries have very different political views and are led by people from all over the political spectrum.
- The approach of nations to the problem will be colored by history that in some cases includes war and occupation. Countries will be asked to bail out others they fought against in the past.
- Finally, the countries' financial status varies widely. Only a few – primarily Germany – can contribute meaningfully to a bailout, and they will be asked to carry the vast majority of the burden. Will they be willing to do so?

As an indication of the intra-European differences, *The Wall Street Journal* said the following on June 15:

> Germany views the crisis on the euro zone's Southern fringe as a symptom of other countries' failure to copy Germany's fiscal discipline and structural overhauls to its economy. Its proposed remedies focus mainly on pushing other countries to cut budget deficits.
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> France, however, believes Germany's large trade surplus and weak domestic demand are part of the euro zone's problem, since they force weaker economies to pay for their imports with debt, rather than through exports to the German market, Europe's biggest.

In addition to political complexity, efforts to solve the problem will run into two important issues:

- **Austerity measures and tax increases are anti-stimulative, and they are being applied at a time when the economies in question are weak and need stimulus. Economic historians such as Ben Bernanke recognize that adding liquidity is the best way to deal with a slowdown, and that the withdrawal of liquidity exacerbated the Great Depression.**

- **In the long run, reducing deficits and debt will not be enough. The countries in question have to increase their productivity and competitiveness.**

In "Will It Work?" I quoted from Paul Krugman (*The New York Times* of February 16, 2009):

> As the great American economist Irving Fisher pointed out in the 1930s, **the things people and companies do when they realize they have too much debt tend to be self-defeating when everyone tries to do them at the same time**. Attempts to sell assets and pay off debt deepen the plunge in asset prices, further reducing net worth. Attempts to save more translate into a collapse of consumer demand, deepening the economic slump. (Emphasis added)

The yoking together of the European nations introduces some interesting ramifications. Some Northern European export economies – Germany in particular – are doing quite well. At this stage of the cycle, they might be considering rate increases and their currencies might be strengthening. But it's doubtful the ECB will raise rates anytime soon, and the euro has weakened versus other currencies. Thus, for example, the German economy and German exports will be stimulated when they arguably don't need it. Germany will export more than it otherwise might have, with some of its gains recirculated in the form of aid to other countries. Good so far, but possibly inflationary. Complicated and not easy.

**The analysis of sovereign debt is in large part political, not economic**. Thus the open questions are political, as described above, complicated by the multi-national aspect of the E.U. and the absence of provisions for disciplining financial non-compliers, ejecting members or winding down the Union.

But as we saw in the U.S. in 2008 and 2009, there should be little doubt that everything possible will be done to save the euro and the E.U. (albeit perhaps with one or two fewer members and/or a touch of "debt rescheduling"). They're likely to continue to exist, but many of the key questions in Europe surround the level of economic vibrancy we'll see.

My purpose in writing this memo was to summarize and explain the developments in Europe, and that's the vein in which I started. But then I started to think more broadly.

We Have Met the Enemy and He Is Us

According to *The New York Times*, a leading central banker addressed his legislature on June 9 regarding his country's fiscal operation, which he said "appears to be on an unsustainable path."

> "**A variety of projections** that extrapolate current policies and make plausible assumptions about the future evolution of the economy," he said "**show a structural budget gap that is both large relative to the size of the economy and increasing over time**. . . ."
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> "In addition, government expenditures on health care for both retirees and non-retirees have continued to rise rapidly as increases in the costs of care have exceeded increases in incomes. **To avoid sharp, disruptive shifts in spending programs and tax policies in the future, and to retain the confidence of the public and the markets, we should be planning now how we will meet these looming budgetary challenges**." (Emphasis added)

Greece? No. Spain? No. Portugal, Italy or Great Britain? None of the above. **That was Ben Bernanke speaking before the Budget Committee of the House of Representatives.** Thus my use above of the most famous line from Walt Kelly's comic strip "Pogo." Greece and the other members of "Club Med" may be on the hot seat today, but few developed nations are exempt, and certainly not the U.S. The differences between the countries in the headlines and many others are matters of degree, not kind.

David Leonhardt's column in *The New York Times* of May 12 provides a good way to start in on this subject:

> It's easy to look at the protesters and the politicians in Greece – and at the other European countries with huge debts – and wonder why they don't get it. They have been enjoying more generous government benefits than they can afford. No mass rally and no bailout fund will change that. Only benefit cuts or tax increases can.
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> Yet in the back of your mind comes a nagging question: how different, really, is the United States?
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> The numbers on our federal debt are becoming frighteningly familiar. The debt is projected to equal 140 percent of gross domestic product within two decades. Add in the budget troubles of state governments, and the true shortfall grows

> even larger. Greece's debt, by comparison, equals about 115 percent of its G.D.P. today.
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> **The United States will probably not face the same kind of crisis as Greece, for all sorts of reasons. But the basic problem is the same. Both countries have a bigger government than they're paying for.** And politicians, spendthrift as some may be, are not the main source of the problem.
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> We, the people, are.
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> We have not figured out the kind of government we want. **We're in favor of Medicare, Social Security, good schools, wide highways, a strong military – and low taxes. Dealing with this disconnect will be the central economic issue of the next decade, in Europe, Japan and [the U.S.]. . . .**
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> As societies become richer, citizens tend to want better schools, better medical care and other government services. [The U.S.] is following that pattern, but without paying the necessary taxes. That combination has us on a course to Greece-like debt.
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> As a rough estimate, the government will have to find spending cuts and tax increases equal to 7 to 10 percent of GDP. The longer we wait, the bigger the cuts will need to be (because of the accumulating interest costs).
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> Seven percent of GDP is about $1 trillion today. In concrete terms . . . the combined budgets of the Education, Energy, Homeland Security, Justice, Labor, State, Transportation and Veterans Affairs Departments are less than $600 billion. (Emphasis added)

Leonhardt provides some data for "cyclically adjusted primary balance as a percentage of GDP" that make for frightening comparisons:

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|---|---|
| Portugal | - 2.8% |
| France | - 3.7 |
| Spain | - 5.6 |
| Greece | - 6.0 |
| Iceland | - 6.5 |
| Britain | - 6.8 |
| United States | - 7.3 |
| Ireland | - 8.2 |

*The Times* defines "primary balance" as ". . . a measure of each country's medium-term deficit as a percentage of GDP excluding interest payments and assuming that unemployment in all countries drops significantly (to what economists consider 'full employment')." In other words, these projections incorporate a good bit of optimism. The U.S. deficit is swollen by stimulus measures that should shrink, but the data still make us look bad in some pretty bad company.

The U.S. is better off than Europe in a number of ways:

- Its national debt isn't high as a percentage of GDP (according to CIA data, our ratio in 2009 was only 53%, versus 113-115% for Greece and Italy, and 62-77% for the Netherlands, the United Kingdom, Germany, Portugal and France).
- It benefits from having the world's primary reserve currency.
- Its Treasury securities are still a primary destination during any flight to quality (thereby reducing its interest costs).
- It possesses advantages in terms of top educational institutions, natural resources, creativity and intellectual progress.

On the other hand, its drawbacks include a tradition of deficit spending; heavy total indebtedness (especially at the household level); many of the demographic issues that I described as affecting Europe (e.g., aging population, potential for structurally high unemployment); costly entitlement programs; declining competitiveness and a shrinking manufacturing base.

Including the private sector, total U.S. debt stood at 358% of GDP in late 2008. That compares to about 200% of GDP prior to the Great Depression and a peak of 300% in 1933 (sources: Bureau of Economic Analysis, Federal Reserve and Census Bureau). **The U.S., too, will have to go through some major belt-tightening . . . painful if it starts soon, but much more so if it is delayed until the future promises are allowed to build up further.**

I think David Brooks put it very well in *The New York Times* on May 13:

> If you're elected president or prime minister in pretty much any country in the developed world today, you're faced with the same set of challenges: to reduce national deficits without choking off a fragile recovery; to trim the welfare state and raise taxes while still funding the things that lead to long-term growth; to try to enact brutally painful measures at a time when voters don't trust their leaders; to do it at a time when politics are polarized and a hundred different interest groups have the ability to block change.
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> The chances that the world's leaders are going to be able to do these things successfully are between slim and none. It's hard enough to figure out the right mix of spending cuts and tax increases. It's nearly impossible to build a political majority willing to enact them. Sometime over the next decade or so, the world will probably suffer from another series of crushing fiscal crises with significant economic pain and maximum political turmoil.

While Brooks led off with the paragraphs reproduced above, he found "Glimmers of Hope" (the title of his column) in the constructive budgetary approach being adopted by the new governing coalition in Great Britain.

This assessment from the Milken Institute should provide some motivation for problem solving:

> By 2020, trillion-dollar deficits will become the norm even in years of solid economic growth and low unemployment, rather than an unpleasant aberration linked to a deep recession.
>
> Absent wrenching changes in fiscal policy, things will only get worse after that. The retirement of the baby boom generation and the growth of health costs at a rate far faster than the growth of GDP mean that government spending on Social Security, Medicare and Medicaid (which pays for most nursing-home care for the elderly) is likely to explode. By the nonpartisan Congressional Budget Office's reckoning, spending on those three programs alone is expected to reach 18 percent of GDP in the year 2040. That is the average level of revenues, measured as a portion of GDP, that the federal government has collected over the past 50 years. So, in this scenario, there would be nothing left to pay for everything from defense to interest on the debt. Thus, unless those entitlement programs (and other spending) can be drastically curtailed or taxes raised significantly, large and growing deficits are a certainty.
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> But the auguries aren't good. Both political parties have become advocates of low taxes. President Obama's State of the Union address was a veritable panegyric to the virtues of tax cuts (although he is willing to raise taxes a bit for the rich in general, and rich bankers in particular). And now that Republicans have become defenders of spending every last dollar that Medicare recipients are currently promised, the prospect of reining in entitlement programs seems more remote than ever.
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> In a politics-as-usual scenario, with no changes in the current policy of low taxes and unrestrained entitlement growth, the federal debt is projected to reach 100 percent of GDP by 2023. By 2038, it would reach 200 percent of GDP.

I'll close on this subject with some even more pessimistic words from Bill Julian:

> Add to the debt woes of European nations and US states the unfunded liabilities of the US government ($30 to $50 trillion, depending on who you ask) the bearded nationalization of the largest financial institutions in the world, Fannie and Freddy, and you have to ask, how could it have gotten this bad?
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> . . . conditions of instability could reappear [quickly]. And this time, the crisis will center on government debt and the bond markets. The collectivist impulse spawned by Keynes as a solution to fiscal problems brought on by the bad behavior of the banks and the governments who cover for them will have gone as far as they can. There will be no one left to bail out "the system." The US government will be left with a nasty choice: austerity and fiscal discipline, or monetizing the debt [through devaluation or hyperinflation] and face a likely collapse of the bond market.

**The bottom line appears to be that the U.S. must anticipate austerity, higher taxes, and the sluggish growth that combination is likely to produce. Failing that, we may face devaluation, default and other unthinkable developments. We are not exempt from the problems besetting Greece, or the awakening regarding the notions listed on page 5.**

<u>The State of the States</u>

Many professional investors include *What I Learned This Week* from 13D Research among their highest-priority reading. Its discussions are big-picture and almost academic, but Kiril Sokoloff seems more likely than most to cover the big market-movers of tomorrow. He discussed the financial condition of the states in his June 24 issue, and I can't resist quoting extensively (I could give you more, but there has to be a limit):

> Across the U.S., state governments are on the edge of fiscal calamity . . . Last month, a report from the U.S. Center on Budget and Policy Priorities issued estimates that in fiscal 2010 the U.S. states collectively posted a near $200 billion budget shortfall, equivalent to 30% of all state budgets. As *Time*'s David von Drehle recently observed: *"Such persistent budget woes are unparalleled in the era of modern American government. You'd have to go back to the 1930s to find a parallel."*
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> **After plunging in 2009, tax revenues are starting to stabilize in some places**, but revenues are still far off pre-recession levels. Collection of sales, personal-income and corporate taxes – which constitute 80% of state revenue – slumped 12% over the past two years. Meanwhile, fixed costs continue to keep states deep in the red.
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> As would be expected, state and local governments have begun to take some much-needed steps – cutting costs, trimming pension eligibility, and depleting their rainy-day funds. In fiscal 2010, forty-five states reduced services to residents and over 30 states have raised taxes, in some cases significantly, according to the Center on Budget and Policy Priorities. **Fourteen states are expected to have reserves of less than 1% of their annual spending by the end of fiscal 2010 – they are basically living hand-to-mouth. . . .**
>
> But **the states, it must be remembered, have a large number of fixed costs, which continue to expand.** In addition to soaring pension obligations, the federal government has pushed a lot of its burdens onto the states, beginning with the sprawling mess that is Medicaid. Created by Congress, administered by the states, and funded by a mishmash of state, local and federal funds, *the healthcare system for America's poor is a train wreck waiting to happen.*
>
> **Medicaid spending, which accounted for 21% of state general fund expenditures in 2009, rose 6.6% that year and is expected to rise 10.5% in fiscal 2010,** according to Linda Bilmes, a professor at the Harvard Kennedy School. But while the number of enrollees increases, funding for the system will barely budge. As Arizona's Governor Jan Brewer said in her state-of-the-state

address this year: "Government revenues have sagged to 2004 levels and some people say we should just adopt the 2004 budget" – easier said than done when your state's Medicaid rolls have grown by nearly half a million since then. . . .

**The states, like the federal government, are facing a demographic headwind that will continue to shrink their tax revenues and compound their growing social safety net obligations.** As Graham-Fisher's Josh Rosner reminds us, the baby boomer's peak earnings potential is behind them:

> *These boomers are now moving to become the largest tax on the social safety net. The largest generation in U.S. history will retire with less equity in what has historically been the largest retirement and intergenerational wealth transfer asset for most families – their homes.* ***In many cases, these people will have no new*** [sic] ***personal savings when they reach the end of their working lives and will essentially become wards of the state.*** *This increased burden on the U.S. Treasury, in a decade, is the largest unconsidered impact of the current crisis.*

Last year, the states' fiscal woes were partly assuaged by the federal stimulus package. But nearly 70% of the $787 billion of stimulus funds approved early last year will have been spent by September, according to the CBO. (And while the emergency cash infusion helped the states keep their heads above water, it ultimately compounded their plight, since even though the federal funds are not necessarily recurring, the jobs and obligations they fund are.) This year, however, **the federal stimulus money is going to be thinned dramatically.**

The Obama administration has asked for about $50 billion for 2011, but *experts believe it would require another $160 billion in cash just to meet demands for the next two years.* And this assumes there is no increase in unemployment or decrease in tax revenues. Even though there is scant appetite among election-susceptible Democrats in Washington to add more zeroes to the end of the federal deficit, there may be no alternative. If the federal government does not intervene, the entire U.S. economy could be put at risk. **After all, aren't California and Illinois, like the country's banks, "too big to fail"?** (Emphasis in the original)



I touched on the subject of the states' fiscal condition in "Tell Me I'm Wrong" (January 22); that and the passages above from Sokoloff's piece should suffice for now. However, I do want to go into a bit more detail regarding one of the key contributors to Greece's troubles: pensions.

Pension promises have long been used in the U.S. as a budgetary quick fix. As in some parts of the private sector (see auto companies and "legacy" airlines), the public sector has a history of substituting sweetened pension benefits (and retiree medical benefits) for higher wages in the here-and-now, a prime example of "kicking the can down the road." Employees bargained for promises of enhanced retirement payments in exchange for agreeing to limit increases in current compensation, but the cost of keeping those promises will be high and, as of today, is far from fully funded.

**The Pew Center on the States estimates that as of June 30, 2008, the states had set aside $1 trillion less than would be needed to pay future pensions and medical benefits**. On July 6, *The New York Times* reported on a study by Joshua Rauh of the Kellogg School of Management: ". . . assuming states make contributions at recent rates and . . . earn 8 percent, 20 states will run out of cash by 2025; Illinois, the first, will run dry in 2018. . . . Illinois, once its funds were depleted, would be forced to devote a third of its budget to retirees; Ohio fully half."

States such as California and Illinois clearly have debts that will be hard to pay and budgets that will be hard to balance. Fractious politics, the requirement for super-majorities on tax and budget matters, and the role (in my state) of referenda all render solutions elusive. **Will there be a bailout?** This is a great question to start thinking about today (although the prevailing ethic is to not worry about anything until doing so is absolutely unavoidable).

**I have no doubt that the federal government wants to avoid a bailout at all costs, and that the rhetoric will remain staunchly anti-rescue. But when push comes to shove, I sincerely doubt a state will be permitted to go bankrupt.** As Warren Buffett said at this year's Berkshire Hathaway annual meeting, "I personally think it would be very hard, in the end, for the federal government to turn away a state that is having extreme financial difficulties." (*Financial Times*, May 4)

Just as the E.U. doesn't want to give deficit spending a green light, fiscally responsible states don't want to pay debts that others created through overspending. **If the federal government were to bail out a defaulting state, what would keep any state from running deficits, knowing they could count on others to pay off their debts? When overspending isn't punished, what is there to discourage it? What better example is there of moral hazard?** Wouldn't it actually be irrational for a state politician to vote to deny his constituents a benefit if he knew the tab eventually would be picked up by others?

And by the way, like Europe, the U.S. has its own differences. Certain regions will be asked to foot the bill for others in a federal bailout. And certainly some states have been more "expansive" than others and have run up bigger debts. All just like in Europe. In the same way that Germans may be hesitant to bail out free-spending Greece, Texans may think twice about bailing out California, and North Dakotans may have doubts about New York. "Red" states are unlikely to leap to help struggling "blue" states given the Republican view that Democrats over-expand the role of government.

* * *

Experience shows how radically markets fluctuate between seeing the proverbial glass half full and seeing it half empty. Rather than achieve a happy medium, sometimes the markets focus exclusively on good news (as during the twelve months through April) and sometimes exclusively on bad. Greece kicked off a turn to the negative in late April, which was exacerbated by the Gulf oil spill and rising concern over the possibility of an economic double dip. On May 8, after Greece's troubles blossomed, *The New York Times* quoted Bill Gross as saying, "Up until last week there was this confidence that nothing could upset the apple cart as long as the economy and jobs growth was positive. Now, fear is back in play."

Just a few months ago, no one seemed to have a problem with nations that ran chronic deficits and continuously increased their debt. Then investors changed their mind – as they tend to do – and today they take a dim view of these practices. Government solvency is considered a critical issue. Here's how guest contributor and hedge fund analyst Andrew Marks (also my son) sums up current sentiment:

> Sovereign debt has become like fiat currency, as it is supported only by people's willingness to believe in other people's willingness to refinance it. The debt of an issuer with no plan to repay and no underlying way to meet maturities other than through refinancing sounds eerily like a subprime mortgage.

**Markets are safer when fear balances greed, and when worry about losing money balances worry about missing opportunity.** We don't like it when fear rears its head and stocks drop, but certainly that creates a healthier environment in which to be a holder, and one which should offer better buying opportunities. **Over the first part of this year it was easy to say prices had gotten ahead of fundamentals; all things being equal, that now seems less true.**

The current positives for investors include moderate valuations, rising corporate earnings and the likelihood we're already in a recovery. On the other hand, I continue to feel consumers are too traumatized to resume spending strongly, and I see unpleasant and rarely contemplated long-term possibilities including those discussed above. In particular, conservatism, austerity and increased savings are good for economic units individually but bad for a stagnant overall economy. **Bottom line: anyone who invests today in a pro-risk fashion out of belief in the recovery must be confident he'll be agile enough to take profits before the long-term realities set in.**

I've had a heck of a time pulling together all of these ideas, and I've found it even harder to come up with anything like answers. But I hope the discussion has been helpful, and that you'll think about the questions I've raised and encourage others to do so as well. **I don't enjoy feeling like a worrywart, but I doubt my concerns are unfounded, and I can't imagine silence would be preferable.**

July 19, 2010