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Investment Outlook

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Damages

I have an amnesia of sorts. I remember almost nothing of my distant past – a condition which at the brink of my 69th year is neither fatal nor debilitating, but which leaves me anchorless without a direction home. Actually, I do recall some things, but they are hazy almost fairytale fantasies, filled with a lack of detail and usually bereft of emotional connections. I recall nothing specific of what parents, teachers or mentors said; no piece of advice; no life's lessons. I'm sure there must have been some – I just can't remember them. My life, therefore, reads like a storybook filled with innumerable déjà vu chapters, but ones which I can't recall having read.

I had a family reunion of sorts a few weeks ago when my sister and I traveled to Sacramento to visit my failing brother – merely 18 months my senior. After his health issues had been discussed we drifted onto memory lane – talking about old times. Hadn't I known that Dad had never been home, that he had spent months at a time overseas on business in Africa and South America? "Sort of, but not really," I answered – a strange retort for a near adolescent child who should have remembered missing an absent father. Didn't I know that our parents were drinkers; that Mom's "gin-fizzes" usually began in the early afternoon and ended as our high school homework was being put to bed? "I guess not," I replied, "but perhaps after the Depression and WWII, they had a reason to have a highball or two, or three."

My lack of personal memory, I've decided, may reflect minor damage, much like a series of concussions suffered by a football athlete to his brain. Somewhere inside of my still intact protective helmet or skull, a physical or emotional collision may have occurred rendering a scar which prohibited proper healing. Too bad. And yet we all suffer damage in one way or another, do we not? How could it be otherwise in an imperfect world filled with parents, siblings and friends with concerns of their own for a majority of the day's 24 hours? Sometimes the damage manifests itself in memory "loss" or repression, sometimes in self-flagellation or destructive behavior towards others. Sometimes it can be constructive as when those with damaged goods try to help others even more damaged. Whatever the reason, there are seven billion damaged human beings walking this earth.

For me, though, instead of losing my mind, I've simply lost my long-term memory. It's a damnable state of affairs for sure – losing a chance to write your autobiography and any semblance of recalling what seems to have been a rather productive life. But I must tell you – it has its benefits. Each and every day starts with a relatively clean page, a "magic slate" of sorts where you can just lift the cellophane cover and completely erase minor transgressions, slights or perceived sins of others upon a somewhat fragile humanity. I get over most things and move on rather quickly. The French writer Jules Renard once speculated that "perhaps people with a detailed memory cannot have general ideas." If so, I may be fortunate. So there are pluses and minuses to this memory thing, and like most of us, I add them up and move on. If that be the only disadvantage on my life's scorecard – and there cannot be many – I am a lucky man indeed.

The ring of fire

In last month's *Investment Outlook* I promised to write about damage of a financial kind – the potential debt peril – the long-term fiscal cliff that waits in the shadows of a New Normal U.S. economy which many claim is not doing that badly. After all, despite approaching the edge of 2012's fiscal cliff with our 8% of GDP deficit, the U.S. is still considered the world's "cleanest dirty shirt." It has federal debt/GDP less than 100%, Aaa/AA+ credit ratings, and the benefit of being the world's reserve currency – which means that most global financial transactions are denominated in dollars and that our interest rates are structurally lower than other Aaa countries because of it. We have world-class universities, a still relatively mobile labor force and apparently remain the beacon of technology – just witness the never-ending saga of Microsoft, Google and now Apple. Obviously there are concerns, especially during election years, but are we still not sitting in the global economy's catbird seat? **How could the U.S. still not be the first destination of global capital in search of safe (although historically low) prospective returns?**

Well, Armageddon is not around the corner. I don't believe in the imminent demise of the U.S. economy and its financial markets. But I'm afraid for them. Apparently so are many others, among them the IMF (International Monetary Fund), the CBO (Congressional Budget Office) and the BIS (Bank of International Settlements). I hold on my lap as I write this September afternoon the recently published annual reports for each of these authoritative and mainly non-political organizations which describe the financial balance sheets and prospective budgets of a plethora of developed and developing nations. The CBO of course is perhaps closest to our domestic ground in heralding the possibility of a fiscal train wreck over the next decade, but the IMF and BIS are no amateur oracles – they lend money and monitor financial transactions in the trillions. When all of them speak, we should listen and in the latest year they're all speaking in unison. **What they're saying is that when it comes to debt and to the prospects for future debt, the U.S. is no "clean dirty shirt." The U.S., in fact, is a serial offender, an addict whose habit extends beyond weed or cocaine and who frequently pleasures itself with budgetary crystal meth. Uncle Sam's habit, say these respected agencies, will be a hard (and dangerous) one to break.**

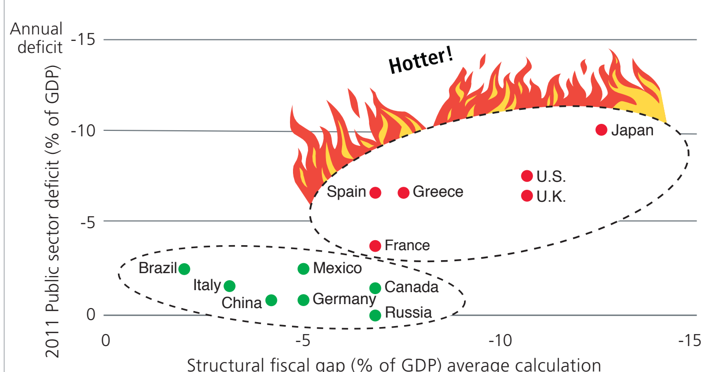
What standards or guidelines do their reports use and how best to explain them? Well, the three of them all try to compute what is called a "fiscal gap," a deficit that must be closed either with spending cuts, tax hikes or a combination of both which keeps a country's debt/GDP ratio under control. **The fiscal gap differs from the "deficit" in that it includes future estimated entitlements such as Social Security, Medicare and Medicaid which may not show up in current expenditures.** Each of the three reports target different debt/GDP ratios over varying periods of time and each has different assumptions as to a country's real growth rate and real interest rate in future years. A reader can get confused trying to conflate the three of them into a homogeneous "fiscal gap" number. The important thing, though, from the standpoint of assessing the fiscal "damage" and a country's relative addiction, is to view the U.S. in comparison to other countries, to view its apparently clean dirty shirt in the absence of its reserve currency status and its current financial advantages, and to point to a more distant future 10-20 years down the road at which time its debt addiction may be life, or certainly debt, threatening.

I've compiled all three studies into a picture chart perhaps familiar to many *Investment Outlook* readers. Several years ago I compared and contrasted countries from the standpoint of PIMCO's "Ring of Fire." It was a well-received *Outlook* if only because of the red flames and a reference to an old Johnny Cash song – "I fell into a burning ring of fire – I went down, down, down and the flames went higher." Melodramatic, of course, but instructive nonetheless – perhaps prophetic. **What the updated IMF, CBO and BIS "Ring" concludes is that the U.S. balance sheet, its deficit (y-axis) and its "fiscal gap" (x-axis), is in flames and that its fire department is apparently asleep at the station house.**

To keep our debt/GDP ratio below the metaphorical combustion point of 212 degrees Fahrenheit, these studies (when averaged) suggest that we need to cut spending or raise taxes by 11% of GDP and rather quickly over the next five to 10 years. An 11% "fiscal gap" in terms of today's economy speaks to a combination of spending cuts and taxes of $1.6 trillion per year! To put that into perspective, CBO has calculated that the expiration of the Bush tax cuts and other provisions would only reduce the deficit by a little more than $200 billion. As well, the failed attempt at a budget compromise by Congress and the President – the so-called Super Committee "Grand Bargain"– was a $4 trillion battle plan over 10 years worth $400 billion a year. These studies, and the updated chart "Ring of Fire – Part 2!" suggests close to four times that amount in order to douse the inferno.

And to draw, dear reader, what I think are critical relative comparisons, look at who's in that ring of fire alongside the U.S. There's Japan, Greece, the U.K., Spain and France, sort of a rogues' gallery of debtors. Look as well at which countries have their budgets and fiscal gaps under relative control – Canada, Italy, Brazil, Mexico, China and a host of other developing (many not shown) as opposed to

RING OF FIRE – PART 2!



Source: IMF, BIS, CBO, PIMCO. As of July 2012.

Chart 1

developed countries. As a rule of thumb, developing countries have less debt and more underdeveloped financial systems. The U.S. and its fellow serial abusers have been inhaling debt's methamphetamine crystals for some time now, and kicking the habit looks incredibly difficult.

As one of the "Ring" leaders, America's abusive tendencies can be described in more ways than an 11% fiscal gap and a $1.6 trillion current dollar hole which needs to be filled. It's well publicized that the U.S. has $16 trillion of outstanding debt, but its future liabilities in terms of Social Security, Medicare, and Medicaid are less tangible and therefore more difficult to comprehend. Suppose, though, that when paying payroll or income taxes for any of the above benefits, American citizens were issued a bond that they could cash in when required to pay those future bills. The bond would be worth more than the taxes paid because the benefits are increasing faster than inflation. The fact is that those bonds today would total nearly $60 trillion,
a disparity that is four times our publicized number of outstanding debt. We owe, in other words, not only $16 trillion in outstanding, Treasury bonds and bills, but $60 trillion more. In my example, it just so happens that the $60 trillion comes not in the form of promises to pay bonds or bills at maturity, but the present value of future Social Security benefits, Medicaid expenses and expected costs for Medicare. Altogether, that's a whopping total of 500% of GDP, dear reader, and I'm not making it up. Kindly consult the IMF and the CBO for verification. Kindly wonder, as well, how we're going to get out of this mess.

Investment conclusions

So I posed the question earlier: How can the U.S. not be considered the first destination of global capital in search of safe (although historically low) returns? Easy answer: It will not be if we continue down the current road and don't address our "fiscal gap." IF we continue to close our eyes to existing 8% of GDP deficits, which when including Social Security, Medicaid and Medicare liabilities compose an average estimated 11% annual "fiscal gap," then we will begin to resemble Greece before the turn of the next decade. **Unless we begin to close this gap, then the inevitable result will be that our debt/GDP ratio will continue to rise, the Fed would print money to pay for the deficiency, inflation would follow and the dollar would inevitably decline. Bonds would be burned to a crisp and stocks would certainly be singed; only gold and real assets would thrive within the "Ring of Fire."**

If that be the case, the U.S. would no longer be in the catbird's seat of global finance and there would be damage aplenty, not just to the U.S. but to the global financial system itself, a system which for 40 years has depended on the U.S. economy as the world's consummate consumer and the dollar as the global medium of exchange. If the fiscal gap isn't closed even ever so gradually over the next few years, then rating services, dollar reserve holding nations and bond managers embarrassed into being reborn as vigilantes may together force a resolution that ends in tears. It would be a scenario for the storybooks, that's for sure, but one which in this instance, investors would want to forget. The damage would likely be beyond repair.

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