Innealta
CAPITAL

COMMENTARY: JULY 1, 2011

JUMPING TO CONCLUSIONS

- As has been the case for the better part of two years now and with few exceptions, the rationale being used to defend the investment strategies of buying risky asset classes are devoid of fundamentally sound macro- or financial economics. Rather, they are based on various temporary policy initiatives that most likely will not offer any meaningful long-term solutions to evolving (and for the worse) systemic problems, focused as they are instead on stemming behavioral forces. All salve, no cure.
- The current list of policy initiatives that are being used to explain or defend extremely ill thought-out investment advice include: Greece sovereign debt restructuring; Temporary corporate tax holiday; U.S. Treasury debt ceiling compromise; and the likelihood of a QE3.
- Much of the decoupling from fundamentals that we are experiencing throughout the capital markets is behavioral. In our opinion there is almost no theoretically sound explanation to defend most valuations. Hope and faith are best left to theologians, not equity managers and sell-side analysts.
- This is not a temporary phenomenon. Fundamentally we need to recognize that economic growth is going to be challenged over the coming quarters and perhaps even years. Ignoring reality and using exogenous, poorly contemplated and fleeting policy measures as rationale for investing in risky assets is short sighted and not in the interest of the investing public. It is self-serving and in our opinion transactionally motivated. With fewer and fewer policy gimmicks remaining to support this current behavioral dynamic we expect more volatility. In fact, most of our risk metric dynamics have been deteriorating. We believe that this is evidence that our hypothesis is materializing. Eventually, the hope-based psychology will be challenged. When that takes place tactical strategies have the opportunity to exploit it.

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1. Greece sovereign debt restructuring
2. Temporary corporate tax holiday
3. U.S. Treasury debt ceiling compromise
4. The likelihood of a QE3

Greece

The sense of urgency being conveyed by Greek and EU politicians over the former's Parliamentary antics is bordering on comical. The economic and subsequent debt problems facing Greece were decades in the making. They will take decades to solve. But that's not to say that urgent action is not needed. However, those actions must constitute solutions, which would stand in stark contrast to the proposals that have been bandied about over the past month. Nothing that's been discussed in the open is a solution. All are merely suspensions of the inevitable.

The focus now is on austerity, which has its counterproductive pressures, not the least of which is productivity-sapping public demonstration. But there is a moment at which cuts in government spending are compensated by increases in private activity (though the grand lack of productivity in parts of the Euro zone makes that a challenging assumption). Club Med needs to get there soon. So much more intelligent to confront insolvency now, rather than allow the troubles to compound and worsen. For European officials to use phrases like "economic suicide" or "the world economy is at stake" to describe the possible effects of a nay vote are ridiculous. Also, to suggest that the Greek Parliament wouldn't "approve" the current austerity plan is equally insane. Despite the anarchistic mobs in the streets of Athens, it would be crazy for Greek politicians to turn down an easy way to postpone the need for meaningful solutions. Would an alcoholic prefer a libation today in lieu of attending the first AA meeting? Of course. In our opinion this is what EU and Greek policy makers are doing. Let's wait until tomorrow to deal with the crisis.

Even more, implementing the austerity plan is far different than agreeing to it. And making the whole endeavor successful shall prove an even greater challenge. The European Union (EU) and the European Central Bank (ECB) have blinked and set an unsustainable precedent.

Greece is the poster child of how socialized government can't finance itself. The Europeans, and the EU in particular, may not want to believe that, but they best digest the memo that reads the same thing may be occurring in Spain, Italy and Portugal. Even as we type this, Portugal is revealing that its budget deficit is worse than had been imagined, making bailout-mandated targets that much harder to hit. It would not surprise us if a few months from now we're search/replacing Portugal for Greece in this piece to describe the investment environment.

Sure, cuts in spending are required to regain solid footing. But cuts in themselves won't be nearly sufficient to constitute a solution. Upon even a superficial review of the fundamentals, any reasonable economist will quickly conclude that a default is almost assured. The numbers just don't add up—despite what some weak elected leaders desperately want the world to believe. The incestuous relationship between banks and policy makers is unsustainable. The breaking point will come. The events in Greece and the so-called contagion effects are in no way resolved by what happens over the near term as a result of some Parliamentary vote.

Meaningful restructuring of debt will have to take place. Until then the European financial sector will remain insolvent. Sleight-of-hand accounting and meaningless risk analysis (how do we exclude a sovereign default, which by semantics alone is not a foregone conclusion?) do not change the fact that much of the debt sitting on balance sheets has virtually no chance of being repaid under almost any circumstance. To use these same bonds to satisfy capital standards throughout the banking system in Europe is decoupled from financial reality. The solvency issue of Greek sovereign debt has not been addressed. Nor has the impending fiscal realities in Spain, Italy and Portugal. We exclude Ireland simply because the causes for Ireland's very real sovereign debt issues are unique relative to those of the southern European EU members.

For the capital markets to use this as a reason to buy risk assets is as stupendously short-sighted as the policies themselves. The inherent risk throughout the EU actually increases with the aforementioned deferment of restructuring. How this correlates to a sound investment strategy escapes us—unless the investor is a pure risk seeker. As risk-averse investment strategists we prefer the safer asset classes.

Temporary Corporate Tax Holiday for Foreign Profits

Never fearing rational judgment, equity fanboys have a relatively new rationale that is truly idiotic. According to some analysts the notion of a temporary tax holiday on foreign profits of U.S. corporations would be equivalent to a monetary policy stimulus. The underlying premise of the argument goes something like this: repatriation of large sums of cash will result in U.S. corporations spending those monies to expand business, hire employees and drive growth. The issue we have with this logic is that it assumes that the cause of our current economic malaise is due to a lack of liquidity. It's not. American companies don't need cash. They already have loads of it...plenty to finance any capital budgeting needs they may have.

We're all for repatriation of profits at lower tax levels, but those dollars simply will end up in corporate coffers. Some may be used to buy back stock or to temporarily increase dividends. But it is very, very unlikely that it will contribute one iota to organic economic growth. These analysts really must read more Milton Friedman and analyze the empirical evidence. Temporary policies aren't impactful for sustainable long-term effects (notwithstanding policies involving the termination of life). In fact, many empirical results imply that temporary policies merely add to the risk dimension. Corporate decision makers generally prefer static government policies—whether they are regulatory, monetary or fiscal. So, like the logic behind the Greece situation, the conceptual underpinnings of this rationale are basically nonexistent. In our experience, when the logic becomes this skewed it most always ends badly for risk asset valuations. Capital preservation and income generation become dear. Hence our current allocations.

Debt Ceiling Compromise

Another "heavens will fall" propaganda effort by politicians revolves around whether or not Congress should raise the current U.S. Treasury debt ceiling. Everyone from Bernanke to Geithner to the Executive branch are warning of "financial Armageddon" if the debt ceiling is not raised. Economically the arguments used to defend such warnings are lacking since more than enough revenue flows into the U.S. Treasury each month to meet debt requirements. It is disingenuous to suggest otherwise. The U.S. Treasury would have to choose to default. This is doubtful as it would be fiscally irresponsible to do so and could only occur by active decisions by the policy makers. Note that we're not stating that disruptions in government services may not eventually result if not properly addressed, only that default can and most likely would be avoided. We are also not arguing to not raise the ceiling (the immediate withdrawal of government spending could potentially have dire economic consequences). Merely that the default claims are preposterous.

We can only hope that any resulting compromise would include meaningful fiscal restraint. This would be deflationary in the short term and extremely positive economically in the long run. It would also be bullish for Treasury securities. Given the track record of our politicians, however, we're not holding our breath. Let's face it: the very basis of negotiations—CBO budget estimates—is fundamentally and ridiculously flawed. Their estimates are statistically meaningless not to mention irrelevant from a historical track record perspective. But the politicians still use them as a basis for all budget negotiations. All estimations are only as good as the assumptions made to produce them. When those assumptions are flat out theoretically unjustifiable (like the doubling of tax revenue between 2010 and 2016 and new all time highs by 2013) we can easily dismiss the estimates. Yet politicians don't seem to know that simple truth and base policy on the failed analyses anyway.

Despite these problems we can only hope that political fortitude prevails. It would be an extremely important development for the country and the Treasury market. A further reduction in the supply of long-dated Treasuries would push yields down further. Has anyone noticed the tremendous reduction in supply that has already taken place on the long end of the Treasury curve? Over the past decade or so the percentage of long-dated Treasuries as a percentage of total outstanding debt has been cut in half. If deficit reduction becomes reality we can expect further reductions in supply.

QE3

During Bernanke's news conference he purposely used vague terminology implying that a QE3 is possible contingent on economic developments. This is problematic to us since he is assuming that QE1 or QE2 were successful. It should prove no surprise to readers of the pages over the past few months that we'd vehemently argue otherwise. These policies are declared a success by policy makers using revised objectives and straw-man references. To state something like "the economic situation would have been far worse had we not implemented these policies" is an empty and fallacious declaration. How do they know that? In our view the policies have destroyed the dollar and merely attempted to artificially support risky asset prices. Is it difficult to appreciate why the economy has not responded to such short sighted and misguided policies? Really? Bernanke made a number of comments regarding his and the Fed's confusion over why the recovery thus far has been so weak. We find such statements surprising and concerning as it is an admission of cluelessness by our monetary policy makers. For analysts to then use the possibility of a QE3 as a rationale to purchase equities is more than a bit counterintuitive to us. In our view, a directionless Fed is more to fear than applaud.

Monetary policy thus far has treated our economic issues as ones of liquidity. Clearly, our problems are rooted in balance sheet restructuring and subsequent deleveraging throughout our society. They are not of the liquidity sort. They are secular and, as in Greece, were years in the making. They will take years to resolve. Throwing (printing) good (though less good because there is more of it) money after bad (because it did little to solve the problem) is hardly a policy that will contribute to organic economic growth. Synthetic stimuli—both fiscal and monetary thus far—are short-lived. The economic data are now exhibiting that reality. In time the capital markets will figure that out and fundamentals will reign. Eventually, they always do.

STILL VERY CAUTIOUS, BUT READY FOR OPPORTUNITY

Much of the decoupling from fundamentals that we are experiencing throughout the capital markets is behavioral. In our opinion there is almost no theoretically sound explanation to defend most valuations. Hope and faith are best left to theologians, not equity managers and sell-side analysts. The current psychology is being promulgated by politicians. Make no mistake that we believe that this is an important facet of understanding investment theory. However, when the economic data are or already have turned negative—whether they are consumer spending tallies, consumer confidence trends, manufacturing indices, employment figures, real estate values or leading-indicator metrics—they are hard to ignore. Even further, many of these metrics remain at levels consistent with recessionary periods. Such has been the success of the synthetic policies deployed to date.

This is not a temporary phenomenon. Fundamentally we need to recognize that economic growth is going to be challenged over the coming quarters and perhaps even years. Ignoring reality and using exogenous, poorly contemplated and fleeting policy measures as rationale for investing in risky assets is short sighted and not in the interest of the investing public. It is self-serving and in our opinion transactionally motivated. With fewer and fewer policy gimmicks remaining to support this current behavioral dynamic we expect more volatility. In fact, most of our risk metric dynamics have been deteriorating. We believe that this is evidence that our hypothesis is materializing. Eventually, the hope-based psychology will be challenged. When that takes place tactical strategies have the opportunity to exploit it.

We find it fascinating that the time span between fundamentally unsupportable equity valuations seems to be getting shorter. Remember it was just over 3.5 years ago that large-cap domestic equities were hitting all-time highs right on the onset of a severe recession and a meltdown of the U.S. financial sector. Back then the same folks using the aforementioned explanations were making similarly suspicious justifications for why equities were the place to invest. Are things fundamentally better now? Any kind of objective and reasonable analysis would conclude not a chance. To borrow a phrase—to be forewarned is to be forearmed. The illusion can't last. We operate in reality and our tone here is merely an effort to balance the lack of objectivity throughout our industry. Grasping at straws and ignoring the mounting evidence is reckless in our opinion. Sometimes a fresh splash of cold water can be invigorating.

Investment decisions based on conceptually and empirically validated theories will eventually be rewarded. History has proven this to be the case and we're confident it will again. And, so, we position our portfolios accordingly. Opportunities will arise and we'll be ready to take advantage of them.

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