Can America Become Greece?

Keith C. Goddard, CFA
August 9, 2011

Advisor Perspectives welcomes guest contributions. The views presented here do not necessarily represent those of Advisor Perspectives. The views of this article represent those of the author and do not necessarily represent the views of Capital Advisors, Inc.

Investors face four possible implications from the recent downgrade of America's long-term credit rating by Standard & Poor's: 1) Lower prices for financial assets; 2) Higher volatility in the asset markets; 3) Greater potential for trend-following investment strategies, and 4) Attractive opportunities in "blue chip" stocks. Those outcomes are best understood through the lens of an octogenarian investor.

Nothing makes an 85-year old man tune you out faster than the topic of long-term investing. "Don't tell me about the long run," he might say, "I need investments that work right now!" I can't argue with the old-timer's logic. I plan to invest the same way at 85, if I'm lucky enough to get there.

But what if *everyone* adopted the attitude of an 85-year old investor? How might financial markets evolve differently if no one framed their behavior from a longer-term perspective? What if it became *rational* for everyone to adopt a shorter time horizon?

The historic action taken by Standard & Poor's last week to downgrade the long-term credit rating of the U.S. government takes us a step closer to finding out. Granted, it's only a step. The factors that drive money into U.S. Treasury bonds remain intact for now, regardless of what S&P thinks.

Even so, a downgrade of America's credit rating *is* significant. It will echo through the financial markets for many years to come by pulling forward the average time horizon investors consider when they allocate their capital. Like the 85-year old man who must factor his own mortality into his investment choices, America's credit downgrade may remind investors of every age not to take the "long term" for granted when it comes to the relative standing of the world's largest economy.

Those who downplay the significance of America's damaged credit rating argue that S&P did not introduce any new information in its report, so market prices need not adjust. Maybe… but that's the same reasoning that led people to believe home prices must be "right" five years ago because they were set by the invisible hand of an efficient market. The global economy is still paying dearly for that mistaken belief.

© Copyright 2011, Advisor Perspectives, Inc. All rights reserved.

In the current situation, the belief being challenged is that U.S. Treasury bonds are risk-free. Standard & Poor's says they are not. How many investors around the world might find the time to double-check their facts on this topic in the wake of S&P's very public declaration?

If they did, what they would find is a nation whose fiscal trajectory looks eerily similar to Japan, or even Greece, about 10 years ago. For instance, the Congressional Budget Office (CBO) projects that nearly 80 million Americans will become eligible for Social Security and Medicare benefits over the next 20-years. The so called "dependency ratio," which measures the ratio of those aged 65 and older to the working age population, will rise from 22% to 38% over the next 25 years according to the CBO. Against this background, the CBO projects that federal debt could reach 100% of GDP in 10 years; 200% in 25 years; and 300% in 35 years.

This cannot happen, of course, because the United States would become Greece – with spiraling interest rates and a crashing economy – long before reaching the debt ratios implied by its current demographic trends and entitlement programs. But what will change the trajectory of America's future: will elected leaders alter policies voluntarily, or will it require a riot in the markets to force policy makers into action?

The time horizon for resolving this critical question is pretty short … almost certainly within 10 years if the CBO projections for America's debt-to-GDP ratio are in the ballpark. This is too short of a timeline for investors to ignore, which suggests that a new risk variable might begin to factor into the valuation equation of just about everything.

Call it the "America Becomes Greece" variable, or "ABG" for short.

Several considerations will confront investors if "ABG" becomes a common risk factor in the valuation process of financial assets. Here are four:

1. **The "fair value" of most financial assets may go down**: To illustrate, consider the price you might pay for a stake in a start-up biotechnology company. It takes about 10 years to bring a new drug to market. If you believe there is even a remote possibility of ABG within the time horizon of this company's business model, would you invest the same amount as you might if there was zero chance of ABG? Similar logic applies to any investment with an uncertain payoff. It's called a "risk premium." The higher the risk premium, the lower the price of whatever asset is being measured.

2. **Volatility may go up:** Resilience requires confidence in the future. If investors' start to believe the "long term" simply provides more time for something to go wrong, resilience gives way to an itchy trigger finger. In general, the shorter the average time horizon of the agents in a market, the higher the volatility of whatever is being traded.

3. **Momentum strategies may be effective:** Numerous studies demonstrate the effectiveness of trend-following strategies in the asset markets. If a greater percentage of investors think like octogenarians – i.e. "find me something that's working now" – serial correlations in

© Copyright 2011, Advisor Perspectives, Inc. All rights reserved.

the asset markets may become more pronounced than usual. Quantitative indicators like relative strength and moving averages may be effective tools for uncovering investments that are "working now."

4. **Favor "blue chips":** If ABG is a valid risk over the coming decade, investors would be wise to favor blue chip stocks. Companies with a global business model, low debt, and a generous *and growing* dividend may represent a better store of value in uncertain times than traditional safe havens like cash, bonds or gold.

The United States will never default on its debt because it can print its own currency. But it *can* fall into a debt trap, just like Greece. When the cost to service a nation's debt grows faster than its economy, the country enters a death spiral. Greece is already there. Greece will restructure its debt.

If the U.S. enters a death spiral someday, it will print the currency needed to pay its debts: an effective default through debasement of the dollar. A triple-A credit rating for U.S. government debt implies this will never happen. Anything less suggests it might.

Life goes on whether the U.S. government is rated AAA, or AA+. But it matters.

Keith C. Goddard is with Capital Advisors, Inc., a Tulsa, OK-based advisory firm and is co-manager of the Capital Advisors Growth Fund (CIAOX). He can be reached at kgoddard@capitaladv.com.

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
http://www.advisorperspectives.com/subscribers/subscribe.php

© Copyright 2011, Advisor Perspectives, Inc. All rights reserved.