



Another Story of Too Much Debt Investing During Unsustainable Economic Conditions

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May 1, 2012

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US-based investors cannot ignore the macro environment, and therefore must consider the consequences of our increasing indebtedness and its impact on capital markets. We can gain valuable insights into our fiscal problems from the housing bubble and the European sovereign debt crisis – lessons which every value investor should heed.

Our debt levels are unsustainable, and that creates unique investment challenges which impact how we are positioning our portfolios. First, however, let's look at the housing bubble and the European sovereign debt crisis to understand how they relate to our fiscal situation.

Lessons from the housing bubble

Prior to the onset of the housing bust, one of the more telling sets of data which gave one a distinct sense of “something isn't right here” was that of nationwide home equity. Home prices had more than doubled in the decade from 1996 to 2006, and with such an increase in prices it was natural to expect that home equity should have also risen substantially. However, to the amazement of many of us at the time, home equity on a nationwide basis steadily *dropped* throughout the housing boom and reached its lowest level in decades as the housing market peaked in 2006.

Presented with this set of facts, it was fairly straightforward to conclude that the only possible reason for home equity to drop to decade lows at the same time home prices rose dramatically was if the amount of new mortgage debt was rising even faster than the increase in home values. Since home prices had doubled over the previous 10 years, this was an incredible circumstance. The amount of new mortgage debt needed to drive home equity lower while nationwide home prices doubled was enormous, in the trillions of dollars, and all this new debt greatly increased the risk to the entire market if home prices were to stop rising and start to fall.

As we all know today, the amount of new debt flooding the housing market during the bubble was indeed enormous. Fueled by all this new debt, home prices rose far higher than was sustainable by the economic fundamentals, such as income growth and demographics, which support home prices in more normal times. The higher prices rose, the more the housing market depended on ever-increasing debt just to sustain itself, and once that debt flow began to dry up the inevitable crash came.



Six years later, home prices nationally are well on their way back to levels which are sustainable, i.e., can be supported by underlying economic fundamentals. The [most recent release](#) of the Case-Shiller 20-city Home Price Index shows it declined to a new post-2006 low in January, and it is now down 34.4% from its peak. While it will take a long time for all the remaining imbalances (such as excess housing inventory) from the bubble to be worked through, the housing market is certainly headed in the right direction.

From a historical perspective, there is little about the recent housing boom/bust that is fundamentally unique – it was a debt-fueled bubble that eventually ran out of fuel and burst, similar to other financial bubbles in the past. This same dynamic has played out time and time again in the financial markets, and we are currently seeing it play out again – this time, at the sovereign level.

The debt-bubble redux in sovereign markets

At its core, the crisis unfolding in Europe is similar to the later stages of the housing bubble. Governments of some smaller European countries have been using enormous sums of debt, relative to the size of their economies, to keep their Gross Domestic Product from falling, but they are now finding it harder to borrow the funds they need at interest rates they can afford. In a few cases, like those of Greece and Ireland, sovereign governments have been completely cut off from the financial markets and are now relying on the European Union and the International Monetary Fund to fund their budget deficits. In Greece's case, even with this aid, the government has been unable to borrow enough to keep its GDP from contracting. This is all too similar to the U.S. housing market, where the amount of new debt could not support sky-high prices.

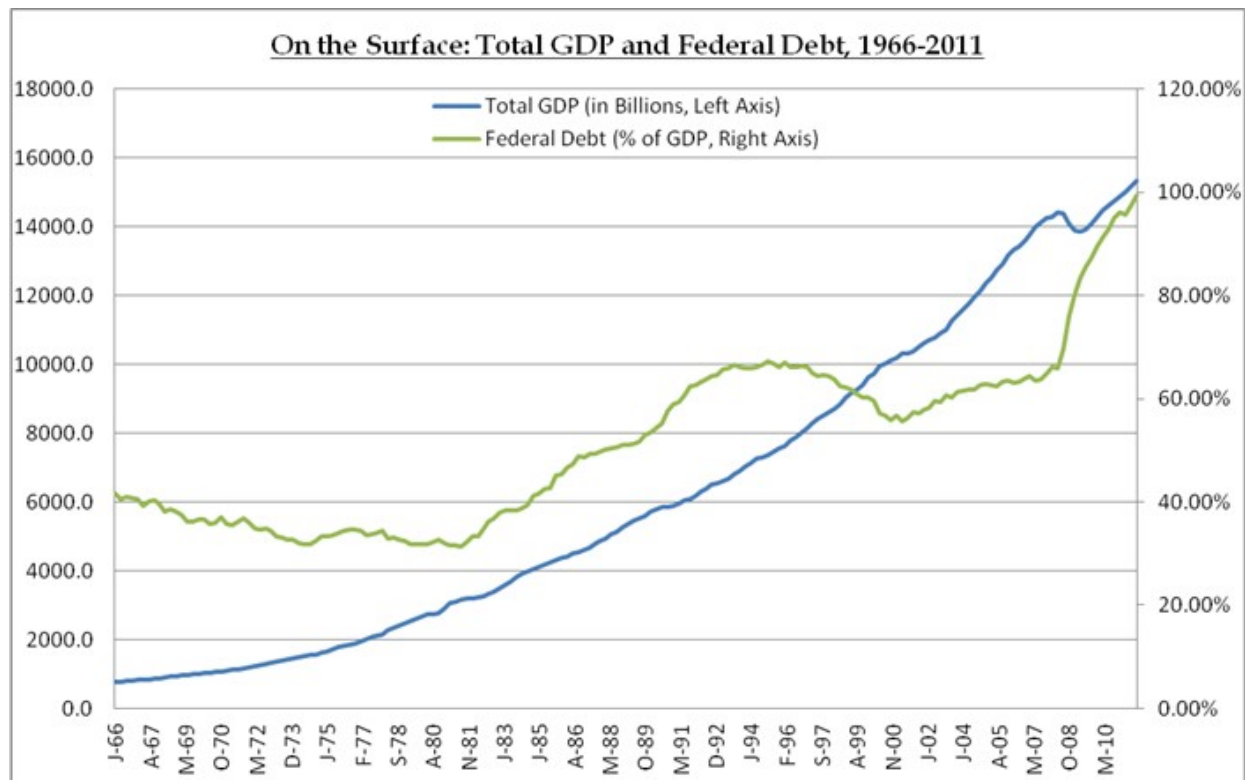
Of course, certain aspects of every financial bubble are unique. Along with the housing bubble came all sorts of "financial innovations," such as the infamous CDOs and synthetic CDOs that we have all heard about, and this enabled the bubble to last longer and grow much larger than it would have otherwise.

Similarly, with the aid of the European Central Bank and the European Union, Greece was able to postpone a default for several years more than it would have otherwise, and during that time the government steadily accumulated even more debt. In its latest effort to postpone the crisis, the ECB lent out the equivalent of \$1.3 trillion in three-year loans to Euro-area banks in December and January, which enabled those banks to buy more sovereign debt of those weaker Eurozone countries running high deficits. However, while these innovations and coordinated actions have been enough to sustain unsustainable debt trajectories a little while longer, reality cannot be avoided forever – it is just a matter of when.

Lessons for the US

If we look at the current situation here in the U.S., we find another debt dynamic very similar to the housing boom/bust and the situation that some smaller European countries have recently

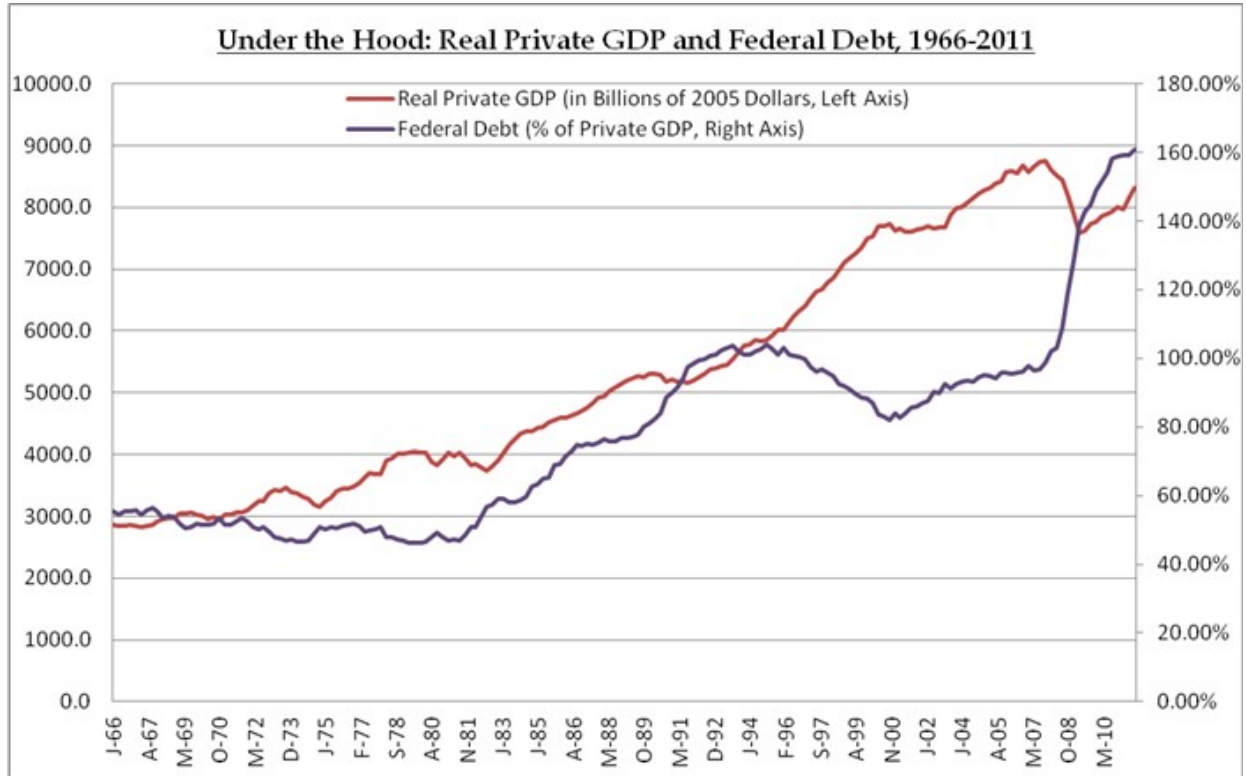
confronted. On the surface, we see that our Gross Domestic Product (blue line in the chart below) has recovered nicely from the 2007–2009 recession and has continued to rise. Although the dip in GDP during the recession was the most severe in decades, the recovery has been, on the surface at least, substantial. However, this recovery has come at a cost, and that cost is represented by the green line on the chart, which shows federal debt as a percent of GDP.



To the eyes of many, the trajectory of the two lines on the previous chart does not represent an immediate problem. They argue that as long as GDP is rising, the dramatic rise in debt can be managed without economic consequences that are too severe. For instance, taxes could be raised a little, spending could be cut a little, and this would easily restore a more sustainable trajectory to the growth in the federal debt relative to the economy. In addition, the thinking goes, the inevitable strengthening of the economic recovery will no doubt contribute positively towards reining in the growth in government debt as well.

While it's certainly possible it could work out that easily, a look “under the hood” of the recovery from the recession reveals a starker view. The recovery of GDP in the previous chart is in large part due to the substantial increase in deficit spending by the federal government, which has acted as counterbalance to the deleveraging private economy. If we subtract government spending and the effects of inflation from the blue GDP line in the previous chart, we are left with the red line in the chart below – which approximates the

private economy. The purple line shows the federal debt as a percentage of the private economy.



While total GDP has recovered to new highs over the last few years, the level of private economic activity today remains mired below its 2007 peak. Despite the vast increase in debt the government has incurred in its effort to stimulate the economy, it has only just been enough to counter the underlying weakness in the private economy. Without this perpetual borrowing and spending by the government, the economy would begin contracting again.

If this need for continuous borrowing just to keep GDP from contracting sounds familiar, it's because it is precisely the dynamic seen near the end of the housing bubble and just prior to the meltdown in Greece. In the end, the use of ever-increasing amounts of debt to prop up an asset class or to keep an economy levitating above where it would settle of its own accord can only last for so long. Eventually, the process collapses under its own weight.

While it may be some time before the rising federal debt starts to have an impact on the real economy, the financial markets will start to react long before that becomes apparent. During the housing bust, the market for the riskiest mortgage debt started to dry up in early 2007, before the stock market peaked, before the recession began, and more than a year before the peak of the credit crisis in the fall of 2008.

The same has been true in Europe, as the markets began balking at buying Greek government bonds at low rates back in 2009, more than two years before Greece actually defaulted. However, that delay only marginally helped the Greek stock market, which fell 73% during the recession of 2007–2009, before declining *another* 79% from late 2009 through the end of 2011 – even as the bailouts came in. The markets often find comfort in pushing off hard economic choices, but sometimes the markets begin to recognize an unsustainable financial trend and react well ahead of the eventual crisis. However, that “recognition point” is impossible to predict.

As the U.S. economy heads into its fourth year of economic recovery, the federal government continues to run a deficit of approximately 8% of GDP. The baseline assumption of most economists is for a continued strengthening of the economy in the coming years, with few entertaining the possibility of another downturn. However, if the economy were to weaken we would see the deficit widen considerably from where it stands today.

In an environment where global markets are keenly aware of unsustainable debt trajectories, it would not take much to trigger a very different market environment from the calm we have seen recently. Over the past few weeks we have seen just this type of rapid shift in Spanish markets, where, despite the huge lending program by the ECB a few months ago, bond yields have begun to rise again and stock prices have been sinking:



Investing during unsustainable economic circumstances

If the stock market today were already undervalued, we at Sitka Pacific would not be so concerned with many of these macro issues. Undervaluation comes with two crucial benefits: a financial margin of safety, and a negative sentiment backdrop that adds to that margin. When the market is undervalued, it can absorb a number of negative shocks and still provide a reasonable return.



However, when a market is overvalued, it is not in a position to absorb negative shocks and still deliver a reasonable return – or even a positive return. It's during these circumstances, as we find ourselves in today, that we have to think about the return of capital as well as the potential return on capital.

If we think back to 1998 or 2006, shortly before the tech bust or the housing-induced credit bust, we can ask the question: how should an investor have been allocating his or her portfolio in the face of unsustainable market and/or economic trends, and an overvalued market? In both of those cases, what turned out to be good investment strategies started with an assessment of the likely impacts of the end of the unsustainable trend, the likely impact of the policy response, and a willingness to make the appropriate changes to one's portfolio before they were recognized and priced in by the markets.

In both 1998 and 2006, that meant moving out of stocks and into safer assets like cash and Treasury securities in anticipation of economic weakness. It also meant buying precious metals in anticipation of the eventual policy response, which would likely include the Fed lowering interest rates and a significantly increasing federal government deficit.

Today, despite facing another unsustainable trend that will have significant consequences for the economy and markets at some point, we find ourselves in quite a different set of circumstances. The Federal Reserve already has short-term interest rates pinned near zero, and the federal government already is running a substantial fiscal deficit. This means there is no room for the Fed to lower interest rates, and any significant deterioration in the government's budget from where it stands today may not be greeted with enthusiasm by the markets (to put it mildly).

This time, although we are facing a similar set of economic risks to those we faced in 1998 and 2006, Sitka Pacific's approach to mitigating those risks has to be different. At this stage, there are fewer safe-haven positions available because, if the markets begin to react negatively to a deterioration in the federal budget and/or actions the Federal Reserve takes (most likely more quantitative easing), Treasury securities and the dollar would likely be at the center of the storm. Even if the Federal Reserve commits to buying enough Treasury debt to keep interest rates low, it's likely the small yields on Treasury notes and bonds would not compensate for the loss of value in the dollar. And given that the dollar will ultimately bear most of the costs of the Fed's future easing actions, our firm views an exposure to gold as essential.

We would like to be able to say that we could choose a group of stocks that we feel confident investing in today, without concern of a significant drawdown when the market eventually comes to terms with the reality of the government debt situation in the U.S. Unfortunately, as 2001, 2002 and 2008 proved, there are few (if any) places to hide in the stock market during the selloffs within a long-term bear market. Investors who don't want to subject their portfolios to the risk of a significant drawdown when the markets come to terms with this debt situation



need to adopt a different strategy than staying invested and simply hunting for the best individual stocks.

Until the market reaches a valuation that enables us to invest without as much concern for the macro picture, our overall approach to this long-term bear market is very simple: try to avoid the inevitable large declines, and try to capture some gains from the larger market rebounds. This approach is hardly an exciting one during periods when there is a high risk of a decline in the market, so we remain defensive. But this approach isn't intended to be entertaining – it is intended to generate a positive return through a long-term bear market that is defined by negative returns.

We have chosen to maintain allocations in our portfolios that we think offer a good chance to make it through the next turbulent period within this long-term bear market, when the markets adjust to the reality of our debt situation. That process could easily start this year if there is a downturn in the economy or a continued deterioration in Europe's sovereign debt markets, or it could still be years away. However, based on the performance of a number of major equity markets outside the U.S. and a number of key commodities over the past year, it seems that process may have begun already. If so, any gains in the stock market from today's prices will prove transitory.

Regardless of when that process begins, when it ends the market will most likely be very attractive from a valuation standpoint, and as we've discussed in recent letters, it would likely come at a time similar to when previous long-term bear markets have made long-term nominal lows. Under those conditions, potential returns will be high and risk will be far lower – a very different market environment than we face today.

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