PLUMB REPORT | PLUMB PERSPECTIVE EDITORIAL

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Things To Keep You Awake At Night

I have a problem with snoring. To be more accurate, Mary Kay (and anyone else trying to sleep in my zip code) has a problem with my snoring. According to her, the malady presents itself primarily when I'm sleeping. Even though I'm in sleep mode less than 30% of the day, in the spousal area, I'm like most husbands—I'm an ardent practitioner of continuous quality improvement. The Japanese call this process ***kaizen*** and, after seeing how well kaizen has worked for Toyota, I can't stop my relentless pursuit of husbandry perfection. As such, within mere decades of learning how much my snoring bothered MK, I literally leaped at the opportunity to schedule a sleep study.

At the Guantanamo Bay Center for Sleep Medicine, they started by attaching 15 electrodes all over my body. Straps were VELCRO®ed around my waist and chest to minimize my habit of breathing. Gutters were attached to both cheeks to monitor drooling. Small kites were strung from my teeth to record the wind velocity exiting my mouth and nose. I was all set and ready to divulge any state secrets with which I had been entrusted. Instead, Helga (the demented nurse from B-horror movies) wished me a cheery…

> ***You sleep now! We watch!***

…and it was time for me to doze off into dreamland.

Slumber did not come as easily as one might expect given that I was right there, smack dab in the middle of a sleep center.

Still, I must have slept at some point. They had the data to prove it. Apparently, if you're able to sleep with all of these wires attached to you, you are sleeping too comfortably. To prevent this dangerous condition, I now need to try to sleep with a CPAP machine. This machine is very effective at preventing me from sleeping comfortably, if at all. No sleep = no snoring.

For readers who are unfamiliar with a CPAP machine, a short explanation is in order. The makers of my CPAP machine—***The Katrina Force 5®***—have created a technological marvel. They have, somehow, harnessed the power of those wind machines they use to test automotive aerodynamics and crammed it into a unit smaller than a shoebox. A hose comes out of the machine and seals itself to my face, covering my nose. If it is not sealed properly, air leaks out the sides of the nosepiece pushing back the skin on my face so that I look like **an astronaut during maximum g-force centrifuge training**.

If it is sealed properly, it turns my nose into an "innie." Sturdy straps wrap securely around my skull to keep it from flying off my face, in the event I somehow work up the courage to actually turn it on. It's not only fashionable, but also an excellent birth control device.

Helga's accent prevented me from fully understanding her explanation of the medical theory supporting ***The Katrina Force 5®***, but I've done some research on my own. To the best of my understanding, here's what's supposed to happen if I accidentally fall asleep with this contraption strapped to my face. Apparently, as I snore, warm moist air tries to loudly exit my nose. This is met with a blast of cooler air from ***The Katrina Force 5®***. As these two fronts collide, a cumulonimbus thundercloud is formed in my sinuses. The resultant lightening blasting out of the sinus cloud strikes the offending snore somewhere near my epiglottis. The snore is instantly obliterated and I exhale sort of normal air with a scent of ozone. Anyway, that's how I think it's supposed to work, although I haven't actually been able to fall asleep with this thing yet.

Still, I've found ***The Katrina Force 5®*** to be remarkably useful when I'm awake. The fun began when I figured out how to redirect the gale force wind coming into my nose so that it would bypass my lungs completely and blow right out my mouth.

Now, thanks to ***The Katrina Force 5®***, I can:

» Whistle really loudly.

» Help the aged by assisting centenarians with their blazing birthday cakes.

» Walk around clearing debris off my lawn without a leaf blower.

» Open my mouth in front of a dog so he thinks he's hanging his head out of the window of a moving car.

Most importantly, consistent with my goal of being #1 kaizen husband, I can blow Mary Kay a kiss and dry her hair simultaneously (Note to self: Floss First!).

So there you have it. That's what keeps me awake at night. You, dear reader, probably don't have access to your own ***Katrina Force 5®.*** As such, you may not be getting your minimum monthly requirement of sleepless nights—especially with all this happy talk about a V-shaped economic recovery. Don't worry. Your sleep-filled nights are over. Here's a healthy helping of…

THINGS TO KEEP YOU AWAKE AT NIGHT
A PLUMB PERSPECTIVE EDITORIAL

I ended my last editorial by saying,

> ***The sailing ahead is perilous. While I think the housing market is the most immediate danger confronting us, it is by no means the only one. I'm also worried about the dollar (and many other currencies), rising interest rates, inflation, commercial real estate and a serious global double-dip recession. Most importantly, I'm very worried about our willingness to go deeper and deeper in debt in order to avoid actually dealing with our problems. These are all topics I'll be addressing in the months ahead.***

This month, I'm going to discuss a list financial issues dire enough to give a narcoleptic insomnia (or, at a minimum, to give a drowsy person a second wind). Long-enduring veterans of the Plumb Report no doubt have a general feel for the themes I have stressed over the past 5 1/2 years. This month, I'd like to give an overview of where we are today and how I am investing based upon this view.

Flying home from North Carolina the other afternoon, our airplane flew right over our home. I had never seen our house from that height and it looked pretty cool. Unfortunately, my top-down view of the global economy doesn't look nearly as cool. Let's take a look at the major factors that are influencing my investing decisions.

U.S. Residential Housing Prices Haven't Landed Yet

In my last editorial, **How We Can Adjust Our Sails**, I discussed this topic at length. It appears that the next leg down in house prices has begun. My estimate is that U.S. house prices will bottom in 2012-2013 some 20% – 30% below where they ended 2009.

Is Atlas Starting To Shrug-Off An Overleveraged World?

From the average Las Vegas mortgagee all the way up to entire countries (currently Greece), more and more debtors are so far underwater that there is no way out, short of default. This global deleveraging is going to be the seminal event that shapes our lives for a generation, just as the Great Depression did 80 years ago. Neither our political systems nor our citizenry is prepared to deal with the pain that we would need to impose upon ourselves today in order to avoid even more pain in the future.

Instead, the general strategy is to try to delay the inevitable until the creditors impose it from the outside. We will continue to react to, rather than preempt, a cascading series of crises. The latest example is this week's IMF/Euro-zone bailout plan. I anticipate the incidence of defaults to continue to increase at all levels: mortgages, credit cards, other consumer debts, state and local governments, and entire countries. These defaults can play out in many ways and have numerous effects. All are economically damaging and increase uncertainty.

Interest Rates Will Garner More Interest

With an increased wariness of default, creditors will demand more interest and insist on tighter lending standards. This will cause nominal bonds to lose value. It will also cause adjustable rates to rise, which will amplify the default problem. Finally, short-term debt will become increasingly difficult to roll over, throwing entities that have relied upon this method of financing into a more precarious financial position.

Time-Tested (and Time-After-Time Failed) Inflation Will Become The Norm

For centuries, governments have been unable to resist the temptation to increase the money supply to reduce the real value of their debt burden. Prior to the advent of fiat currency, this involved reducing the value of the metal content in the coinage. Today, **as Ben Bernanke has made abundantly clear**,

> ***(T)he U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost.***

Bernanke will be greatly aided in his printing operations, by **the four most recent Fed Board of Governors appointees**. The old Fed Board could hardly be described as a cote of hawks, but with these new appointments, the Board has been transformed into a true piteousness of doves.

With the recent about-face of the European Central Bank, it seems **Milton Friedman was right**:

> ***We are all Keynesians now.***

This monetary inflation will show up first, and most dramatically, in the prices of supply-constrained goods, services and assets. This will be especially true for items for which demand increases in times of crisis and economic deterioration.

Gold is a perfect example of this type of asset. Almost all the gold ever mined is still in existence today. Incremental supply is added very slowly (1%-2% per year). For all practical purposes, the supply of gold is virtually fixed. The supply of currency is anything but fixed. Therefore, all things being equal, as the supply of fiat currency goes up, the exchange ratio between gold and fiat currency (the price of gold) increases as well. Furthermore, in financial crises, people's preference to hold gold, rather than fiat currency, increases. The main feature that makes fiat currency more attractive to hold than gold is that it pays interest. But with interest rates so low, this advantage becomes de minimis. This is why gold's price is skyrocketing.

Not Everything Is In Tight Supply

There are many goods, services and assets that are not supply constrained. In many parts of the economy, we have excess capacity that needs to be absorbed before prices will rise significantly. I have already talked about one of these items—residential housing. There is a tremendous oversupply of housing stock in many countries including the U.S. Despite rapid growth in the money supply, to once again paraphrase Milton Friedman, we do not have too much money chasing too few houses. That's one of the reasons I think housing has further to decline.

We also have lots of unused supply in the labor force. Currently, over 17% of the U.S. labor force is either unemployed or underemployed. Until these numbers come down significantly, we will not see much growth in household income.

Given all of the excess supply in major areas of the economy, consumer prices will not rise as fast as one might expect given the inflation in the money supply. Still, I think it's very likely that over the next 10 years, the CPI will rise faster than the 2% per year currently implied by the yield differential between nominal treasuries and 10-year TIPS.

Fun With Fiat Currencies

The other day, I was reminded about one of the illustrations a business school professor showed us more than 20 years ago. It stuck with me. The professor held up a $20 bill and said he was going to auction it off to the class. The highest bidder would receive the $20. The twist was that the second highest bidder had to also pay whatever he bid (and would receive nothing). He gave everyone time to make sure they understood the rules, and began the bidding at $1. If the bidding stopped there, that bidder would receive a $20 bill for $1. Of course, it didn't stop there. The bidding reached $10. And then, it dawned on the person who had bid $9, that he would pay $9 for nothing and watch the $10 bidder double her money. He bid $11. Now it became clear that the professor would receive $21 for his $20 bill. Still, the bidding continued because the winner would get a $20 bill for less than $20. But, when it hit $20, the $19 bidder sheepishly did the math and bid $21. And then, the $20 bidder bid $22. Now, having set the trap, it came down to who would blink first. Both bidders were going to lose, but the bidder who gave up first was going to lose more. I think the professor ultimately sold the $20 bill for a total of $77. The lesson of this exercise was that the only way to avoid losing money was to figure out how the game would end and, then, not start.

History had amply demonstrated that the same lesson applies with F.I.A.T. (**F**undamentally **I**nflationary, **A**bsolutely **T**empting) currencies. Fiat currency is currency that a government issues with nothing backing it, except the promise that the government will be responsible about how fast it prints it. The U.S. Treasury is very explicit about this **on their website**:

> ***Federal Reserve notes are not redeemable in gold, silver or any other commodity, and receive no backing by anything. This has been the case since 1933. The notes have no value for themselves, but for what they will buy.***

Always, however, there comes a time when the politicians need to decide between administering the tough medicine of austerity or printing money to postpone the day of reckoning. They always choose the latter option and their fiat currency's purchasing power begins it's power dive. The only way to win with fiat currencies is to not start playing with them.

Right now, all the currencies in the world are fiat currencies. These currencies, like everything else in the marketplace, are priced based upon supply and demand. In currency markets, these prices are called exchange rates. Money supply growth, interest rates, the economic outlook and purchasing power are just some of the important factors that influence the supply of and demand for a country's currency. The exchange rate is even more complex because it represents the **relative** attractiveness of these factors for the two currencies that are being exchanged. For example, which country is going to crank their printing press faster to deal with their debt problems? How much interest are they offering to compensate for this monetary inflation? These factors are going to continue to be more volatile as these financial crises multiply. As volatility increases, the importance of rebalancing increases.

Furthermore, there are three factors that have, in the past, been so improbable as to have been immaterial to exchange rates. This may not be the case going forward. Specifically:

1. The viability of the euro will be challenged as they try to deal with the problems of their more financially distressed members (Greece, Portugal, Ireland, Italy, Spain, etc.).
2. The yen will be impacted by a major shift that is taking place demographically, right now. The Japanese are aging from savers into withdrawers. Japan will no longer be able to **internally** finance its massive debt burden. Foreign creditors may prove more reticent to finance Japan's massive debt-to-GDP ratio.
3. The U.S. dollar has been the world's unquestioned reserve currency since at least WWII. This has provided an additional source of demand for the U.S. dollar and a support for its value. To the extent this status comes into question, the dollar's value will be reduced. This, however, could be initially offset by a flight to the "safety" of the dollar.

If I had to put all of my money into just one fiat currency today, I don't think it would be too "loonie" to choose the Canadian dollar. They are a resource rich country that doesn't seem hell-bent on debasing their currency.

Sub-par Will Not Be Super

Many countries will experience sub-par economic growth. Financial crises are notoriously damaging to economies. Since the crises I foresee are global, one of the primary tools for exiting economic downturns—exports—will not be an effective offset to weak domestic demand. Consequently, consumer demand, the main driver of U.S. economic growth, will take another turn down. Credit will get tighter, taxes will increase, unemployment will stay elevated and consumer confidence will whither. All of this will negatively impact household disposable income and spending. For the next decade, the primary consumer demand we will see is the demand that "Somebody Do Something!"

When You're Stuck In A Hole…

…stop digging. I've always appreciated the common sense of this sage wisdom. Unfortunately, sage wisdom and common sense are rarely the output of backhoe-wheeling governments around the world. Governmental shovel-readiness is nothing new. As is extensively documented in **This Time is Different: Eight Centuries of Financial Folly** by Carmen M. Reinhart and Kenneth Rogoff, this storyline has been playing out virtually since the invention debt. The authors have studied hundreds of financial crises encompassing the whole world. Their data begin in 12th century China and continue up to the current ongoing financial crisis. With a focus on sovereign defaults (today it's Greece) and banking crises (today it's TARP recipients), they show that far from being different, the current crisis is just another, albeit massive, piece of evidence that this time is exactly the same as the 250 times before.

Always, at the core of the problems, lies too much leverage. Specifically, the problem is too much debt relative to the value of the assets or income stream needed to support it. All the problems I've been discussing stem from excessive leverage:

- The housing crisis was caused by mortgages that were too big to be supported by the household's income stream and the value of their home.
- The crises in the financial sector are being caused by too much leverage to be able to withstand a downturn in the assets that were purchased on margin.
- The sovereign crises are happening in countries that have taken on too much debt and promised substantial future entitlements (just another form of debt). When these obligations grow too large relative to the projected income stream (tax revenues), countries must either increase their future income stream or renege on their obligations (through default, printing money or reducing promised entitlements).
- The exact same thing is happening to states and municipalities, but they do not have the option of defaulting through printing their own money.

Unfortunately, far from stopping, the debt-diggers are generally increasing their excavation rate. Debt levels are exploding worldwide at every level. Just like with a household, borrowing to maintain an unsustainable lifestyle only postpones the ultimate resolution and makes it worse. There is no will to address this issue because the time for non-draconian measures has already passed; draconian measures need to be imposed. Realistically, however, imposing draconian measures is not something that people willingly do to themselves, nor do they elect or re-elect leaders who will.

Markets Take Away Shovels

When an individual, a company, a state or a country refuses to take the tough medicine required to address their fiscal problems, the markets step up and administer the tough medicine for them…good and hard. The pain is worse and comes in the form of a dramatic decrease in the quality of life. If you want to see how this looks, turn on the TV and watch the **street protests in Greece**.

I'm not just worried that the Greek crisis will spread across Europe and threaten any chance of a meaningful global recovery. My view is that we're seeing a preview of coming U.S. attractions. To those who say, "What's happening to Greece can't happen in the U.S." I have to ask, "Why not?" Sure, right now we have the privilege of printing the world's reserve currency and U.S. treasury bonds are currently a popular safe haven. To me, that simply buys us a little more time to keep digging. We will hit our credit limit eventually and the markets will impose the tough medicine upon America.

Eventually, there is a tipping point where increasing the money supply actually reduces the purchasing power of the entire pile of currency—the value of the currency declines faster than the money supply grows. A country, even if it prints the world's reserve currency, cannot inflate its way out of its debt hole.

Before that happens, however, foreign lenders may decide they don't want any more U.S. debt at low interest rates in a declining currency. Then, interest rates will rise dramatically and the debt service load will quickly become overwhelming. Ask anyone who spent the equity in their home to supplement their lifestyle—when that credit line gets called, the quality of life drops precipitously.

Conclusion

Before this happens in the U.S., we will see it in Greece, then Portugal, Spain, Ireland and Italy. The euro and the Euro zone will be reshaped. Next, will be Britain and Japan. We don't have any less of a problem, but we have a little more time, until we lose our safe haven, reserve currency status. Bailouts are not a solution. All we're doing is transferring water from one sinking ship to another and hoping that somehow it will all evaporate.

In light of this narrative:

» I am bearish on paper assets relative to hard assets.

» The best hard asset will be gold.

» The worst paper asset will be debt denominated in the failing currencies described above.

» I expect a double-dip recession followed by sub-par global economic growth for at least the remainder of the decade.

» I expect rapid growth in money supplies all over the world.

» This will lead to increased consumer price inflation, but not as much as one might expect. Excess capacity and supply will restrain pricing power in many areas.

» Income growth will be stagnant.

» Interest rates will rise.

» Income redistribution will be the order of the day both through taxing the rich and from a change in the relative wealth of nations.

» Currency volatility will increase, making rebalancing even more important than usual. The dollar may strengthen initially due to a flight to safety, but longer-term, I foresee dollar weakness owing to a decline in its attractiveness as a reserve currency.

» Housing prices face more near-term declines due to the factors I outlined in my last editorial. Longer-term, however, residential real estate is another real asset that could benefit as a store of value.

» All of this means that the frequency and severity of financial crisis will increase.

Maybe it **is** different this time, but Carmen M. Reinhart and Kenneth Rogoff have given us 250 reasons why it isn't. I've positioned my portfolio based on the assumption that it won't be different this time either. If it isn't different this time, I believe the ***Plumb Performance Portfolio***© will outperform a standard stock-bond portfolio by an even wider margin than it has in the past.

Next Editorial

This month, I've offered a qualitative outline of how I see things evolving. Next month, I'll look at these issues more quantitatively. We'll see if, given where we are today, this qualitative outlook is quantitatively consistent with history. Until then, sleep tight and don't let the Fed bugs bite.

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