The Long & Short of It
Quarterly Newsletter
Third Quarter 2014

Centralized Government Wins Again
During the third quarter of 2014, US treasuries won the race. Long-term US government bonds turned in a healthy total return of over 2.7%. Municipal bonds came in second place with the Barclays Municipal Total Return Index at 1.5%. Just about everything else did worse. The average taxable bond lost about 1%. High-yield bonds lost about 2% in a very volatile quarter. The S&P 500 index had a small gain of 1.1%, while mid-cap and small-cap stocks did much worse, returning losses of around 4% to 7%. International stocks fared little better, with the MSCI World Ex-US Index losing more than 5%.

An underreported news event during this quarter was the approval of federal regulations that will exclude municipal bonds from banks' high quality liquid assets that back up loans. Treasuries and balances held at the Fed are still allowed. In addition, on September 30, 2014, the US District Court for the District of Columbia ruled that back in 2012, Congress did indeed have the authority to extract 100% of the profits from Fannie Mae (FNMA) and give them to the Treasury—rather than FNMA's shareholders. This decision will likely be appealed but the precedent is clear. Furthermore, despite the improving picture for domestic industrial activity, as the punchbowl of quantitative easing (QE) runs dry, the mood at the economic party may sour.

The Federal Reserve's easy money continues to incentivize risk-taking, while Congress appropriates the profits and regulators declare treasury debt superior to municipal debt. As the federal government accrues power at the expense of state and local governments, the dynamics of debt evolve. In this letter, we will review the state of indebtedness and what it means for investors.

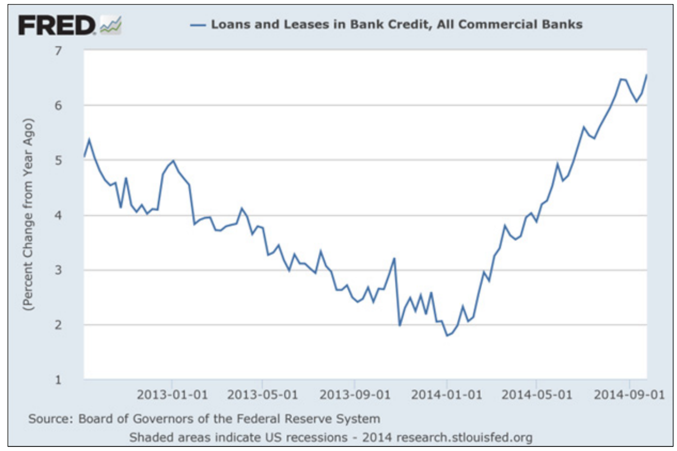
"Deleveraging? What Deleveraging?"
In its latest Geneva Report on the World Economy released on September 29, 2014, the International Center for Monetary and Banking Studies (ICMB) and Center for Economic Policy Research (CEPR) offered this summary:

> *The world has not yet begun to deleverage its crisis-linked borrowing. Global debt-to-GDP is breaking new highs in ways that hinder recovery in mature economies and threaten new crisis in emerging nations – especially China. The authors argue that the policy path to less volatile debt dynamics is a narrow one, and it is already clear that developed economies must expect prolonged low growth or another crisis along the way.*

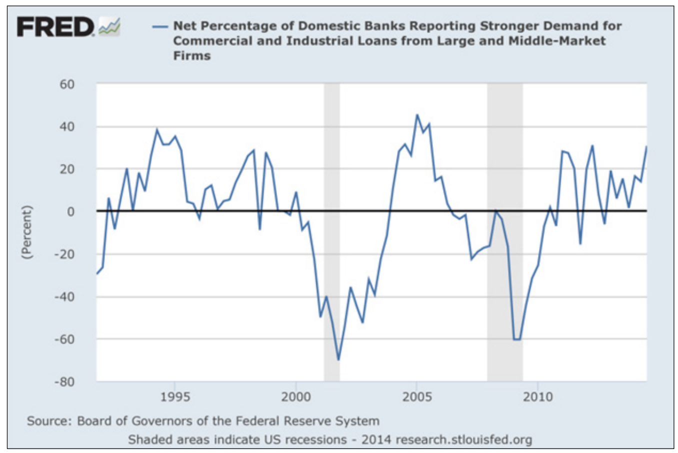
Within this framework of excessive debt, the Geneva Report points out that the European Central Bank (ECB) has not levered its balance sheet like the Federal Reserve, and European banks have not recapitalized as much. As a result, Europe has more zombie banks and lower levels of lending than we do stateside.

Lending: Our Economy's Primary Driver

The latest Loan Officer Survey underscores that lending is on the rise in the US. Bankers see not only increasing demand for loans but also an easing of lending standards, lower rates being charged, and greater willingness to make loans.



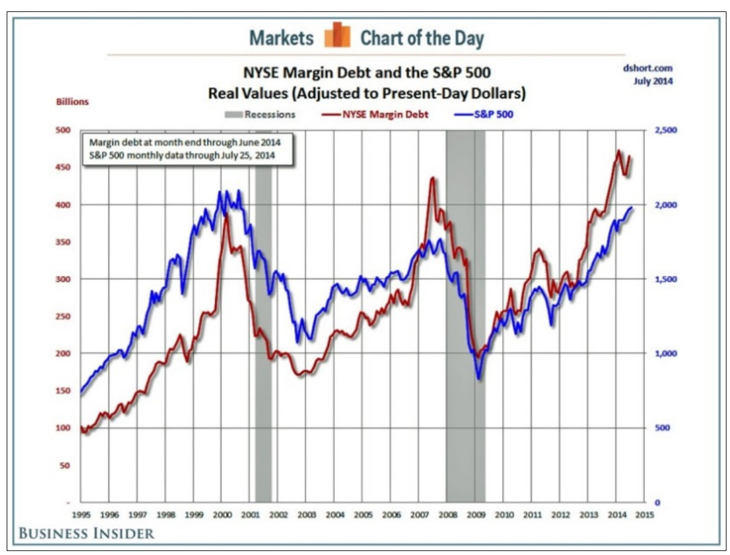
Consequently, banks and other financial companies worldwide are issuing bonds in the US at a record pace, taking advantage of this year's slump in interest rates and a brightening outlook for the sector. Debt sales reached $391 billion this year by the end of August, a 32% jump from the same period last year and a 19% rise from the same span of 2007—a year of record bond issuance—according to data provider Dealogic. Margin debt has also rebounded, reaching levels that suggest some sort of upper limit may have been reached.



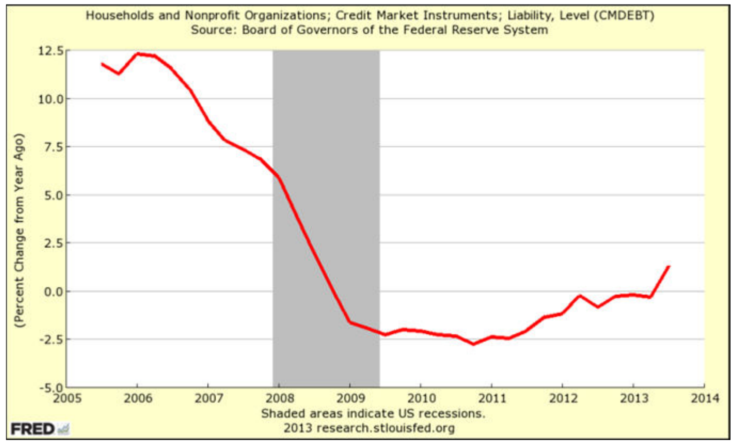
Borrowing is Back

In addition to increased lending, the relaxing of credit standards has stimulated more borrowing by consumers.

On August 7, 2014, Fair Isaac Corporation (FICO) announced that it will stop including in its credit-score calculations any record of a consumer failing to pay a bill if it has been paid or settled with a collection agency. Furthermore, less weight will be given to unpaid medical bills at collection agencies. These moves follow months of discussions with lenders and the Consumer Financial Protection Bureau, aimed at boosting lending without creating more credit risk. Since the credit crisis, most lenders have been very careful. These new guidelines are expected to boost consumer lending, especially among borrowers previously shut out of the market or charged high interest rates because of their low credit scores.



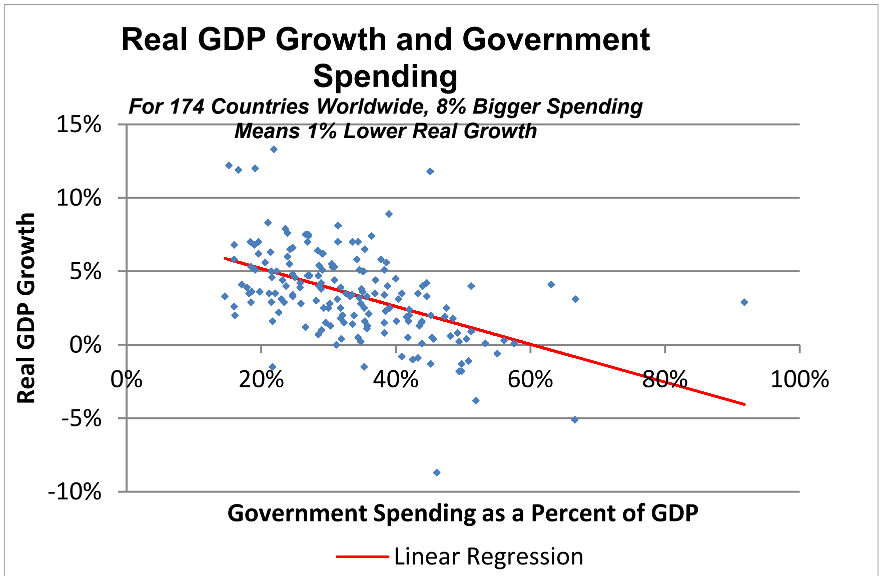
Consequently, the third quarter's Federal Reserve's *Flow of Funds* report showed the first increase in US household debt since before the financial crisis. In short, Americans have stopped paying down debt, and re-leveraging has officially begun. Of course, while Americans were paying down a small portion of their debt, the government and its agencies were increasing theirs dramatically. Put the two together, and there's been no decrease in total debt outstanding for the US. In fact, the public debt-to-GDP ratio has increased 50% since 2003.



Debt expands to fill the payments that interest rates and income will allow. Thus, long-term rising interest rates are essentially the only guarantee of a lasting decrease in debt levels. This can only happen through: 1) renewed real growth of aggregate demand and rising labor force growth rates, which will not occur until circa 2025-2030; or 2) the less likely possibility of a currency crisis and hyper-inflation. Large debt levels are probably here to stay for quite a while; especially as public sector spending and aging demographics in developed economies hinder prospects for growth.

Greater Debt Does Not Equate to Greater Prosperity

The chart we developed on the right shows 2013 government spending as a percent of GDP compared to real GDP growth for 174 countries across the globe and a "best fit" of that relationship. Greater government spending as a percentage of GDP is highly correlated with lower real GDP growth, with a 1% decline in growth for each 8% increase in government spending. Yes, it is true that big spending in one year will stimulate over the short term. This is likely to be one of the main reasons that any particular country falls above or below the red line. But over the long run, at any practical level of government spending, the reduction of long-term real economic growth will come with higher levels of spending.



Source: CIA World Factbook, The Heritage Foundation, The Wall Street Journal

Agree to Disagree

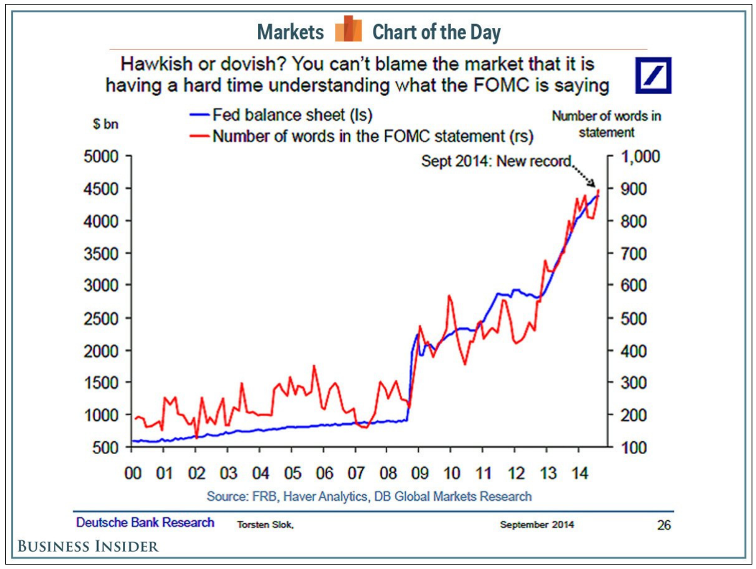
So what do we do about the current state of stalemate in Washington? Philip Klein, a Washington Examiner columnist, has a suggestion:

> *The architecture of the Constitution offers a natural solution to this problem (...of division in Washington amongst the parties…). Instead of trying to solve every issue at the national level, power should be shifted back to the states. Those states whose residents*

are willing to pay higher taxes for more government services should be free to do so, as should states whose residents are willing to forgo government benefits in favor of lower taxes.

Moreover, the growing dominance of our federal government in decision-making and economic activity means less diversification of ideas and slower wealth creation. In 2003, inflation-adjusted net worth for a typical household was $87,992. Ten years later, it was only $56,335 (a 36% decline), according to a study financed by the Russell Sage Foundation. Perhaps, consumers' hunger for debt is a reflection of their falling prosperity.

Lastly, in its ongoing efforts to improve the clarity and transparency of monetary policy, the Federal Reserve has ramped up how much it *tells* the world. Nevertheless, even with the extensive disclosure, the chart to the right suggests that traders, investors, and even Fed experts have no better sense of what the Fed is actually *thinking.*



Risk does not go away; it is merely postponed. It continues to become more and more important to understand the role of government in the portfolio as we develop wealth creation and preservation strategies that take advantage of the elephants and donkeys in the room.

Follow the research. Fade the emotion.

Amy Abbey Robinson, CIMA
amy@robinsonvalue.com

Charles W. Robinson III, CFA
charles@robinsonvalue.com
