



The “Freezer Moment”: When Reality Strikes

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Once upon a time, a young man named John received a parrot as a gift. The parrot had a bad attitude and an even worse vocabulary. Every word out of the bird’s mouth was rude, obnoxious and laced with profanity. John tried and tried to change the bird’s language, but nothing worked.

Finally, John was so fed up that he grabbed the parrot and put him in the freezer. For a few minutes the parrot squawked and kicked and screamed. Then suddenly there was total quiet.

Fearing that he’d hurt the parrot, John opened the freezer door, at which point the parrot calmly stepped out. “I believe I may have offended you with my rude language and actions,” the bird said. “I’m sincerely remorseful for my inappropriate transgressions and I fully intend to do everything I can to correct my unforgivable behavior.”

John was stunned. But before he could ask the parrot what had inspired this change of heart, the parrot sidled up to him and whispered, “May I ask what the turkey did?”

And so goes the story of the foul-mouthed parrot and his long-overdue “Freezer Moment.” So why have we shared this anecdote with you today? Because similar “Freezer Moments” appear today in many sovereign states. But, unlike the parrot and his sudden revelation, it is unclear when the financial markets will awaken to these realities and face up to the associated consequences.

The fact is that economies throughout the world are experiencing trouble. In emerging markets such as China and India, inflation is a problem; and for China in particular, it’s a problem that can no longer be ignored. Since the Chinese peg their currency to ours, they have a “de facto” monetary policy that is highly expansionary and appears to be creating a massive bubble in the property market.

Europe, too, is beset by enormous challenges. The combined problems of poor demographics and a weak currency structure suggest larger challenges ahead for the EU. While it may be in everyone’s interest to save the Euro – after all, who wins if it fails? – it remains unclear how this “grand bargain” will actually get done. Moreover, many European countries, including Great Britain, have opted to pursue monetary and fiscal austerity measures in the hope of combating the sharp rise in sovereign debt relative to GDP in their respective countries.

Let us take a closer look at the epicenter of the Euro crisis: Greece. Greece has lied about its finances for years and has been in default for nearly half of its existence as a country. There is more than €350 billion of Greek sovereign debt. Given current yields and the growth prospect of Greece’s government revenues, at least €200 billion of this total needs to be forgiven to allow the debt to be serviceable. Who will bear this loss? Greece’s bondholders or non-Greek taxpayers.

Here’s the math. Greece currently spends 14% of its government revenues on interest payments. Moreover, Greece’s government revenue constitutes 40% of its GDP, and its VAT is already at the high level of 23%. As the government increases taxes on the private sector, businesses are fleeing Greece for countries in which rates are lower. With sovereign debt to GDP at 140% and sovereign debt nearly three and one half times government revenues, Greece was shoved into the freezer quite a while ago. The notion that Greece can borrow its way out of debt is ridiculous. Even the parrot could tell you that this is a solvency problem, not a liquidity problem.

Ireland is also a mess, as is Portugal. Unlike Ireland which has an educated populace, in Portugal only 28% of the workforce has a high school education or better. This combination of a poorly educated society, poor labor mobility, and high debt levels relative to GDP bodes ill for the “P” in PIIGS (Portugal, Ireland, Italy, Greece and Spain). What’s more, the “we won’t pay” attitude of the Greek citizenry has already led Finland’s Finance Minister to express his lack of support for an EU-sponsored bailout of the PIIGS. If the PIIGS are a sinking ship, he reasons, why should the rest of us go down with them? It requires unanimous consent of all members within the EU for a bailout; and at this point, unanimity seems unlikely.

The indebted countries are indeed responsible for their dire straits. As mentioned, Greece lied about its statistics, Ireland foolishly decided to guarantee the enormous debts of its reckless banking sector, and Portugal borrowed cheap money but undertook no restructuring of its economy. Nevertheless, the problem remains. If a country cannot devalue, and one says no to debt restructuring, and taxpayers of Germany and other rich European countries want a risk premium in interest for loans to these peripheral countries, then it is impossible to avoid what economists call a “debt trap.” In a debt trap, the combined level of the debt and the interest payable on the debt is growing faster than the country’s GDP.

Figure 1 offers yet another sobering perspective on Europe's tangled web of debt. As the reader can see, it's complicated.

FIGURE 1: EUROPEAN WEB OF DEBT

Source: *New York Times*, May 2010

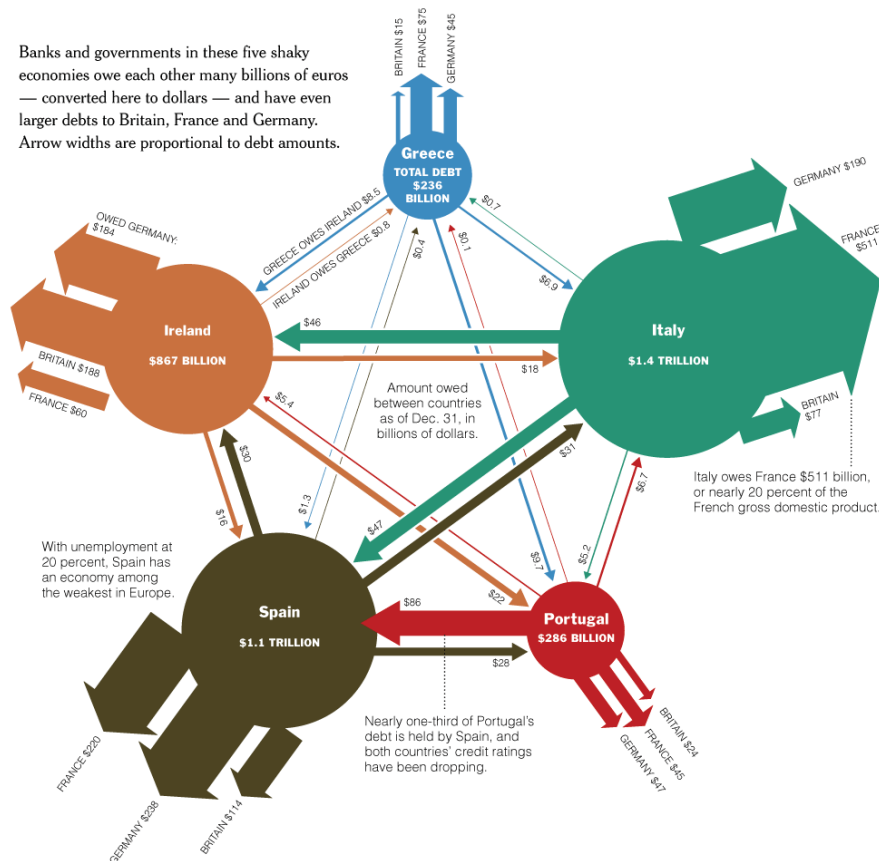
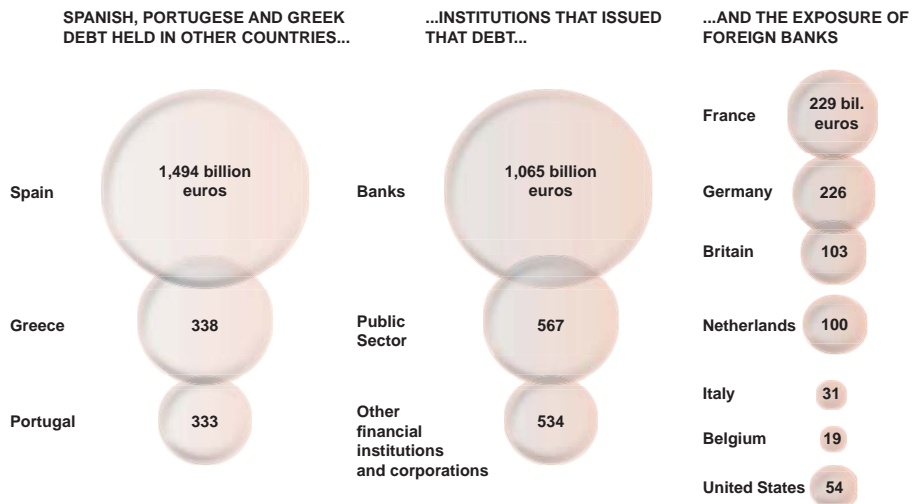


Figure 2 suggests who will suffer if the EU bailout does not happen. Except for exports, Europe's growth rate will be anemic for years to come. Their "Freezer Moment," in other words, is already at hand.

FIGURE 2: WEB OF DEBT AMONG NATIONS AND BANKS WILL ENSURE A SOLUTION

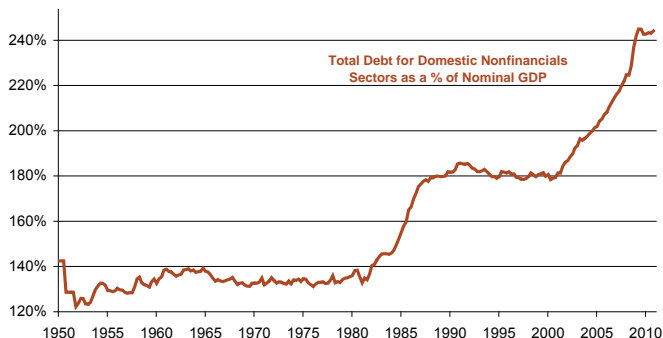
Source: *Royal Bank of Scotland*, *The New York Times*, June 2010



Now, let's turn our attention to the home team. As far as the U.S. is concerned, it is both amazing and terrifying that we've been governed with such incredible bi-partisan ineptitude for more than a generation. Our debt has soared to nearly 100% of GDP. In fact, since 1990, debt has been an important driver of GDP as shown in Figure 3.

FIGURE 3: U.S. DEBT % OF GDP

Source: Federal Reserve Flow of Funds, BEA and Omega Advisors, Inc.



And how have we, as a nation, addressed this problem? The short answer is that we haven't: we've continued to kick the can down the road. However, our days of inaction are numbered. In Gregory Mankiw's New York Times piece from March 27th of this year entitled "It's 2026 and the Debt Is Due," the author envisions a presidential address to the American people in 2026, outlining the actions that must be taken to rescue our nation.

He imagines a scenario in which, as a result of the aforementioned rise in debt to GDP, the Treasury tries to auction its most recent issue of government bonds, but no one buys them. To address the problem, the IMF makes the U.S. a loan with serious debt reduction terms, including cuts to all entitlement programs and much higher taxes. The lesson here is that, had we faced our obvious debt problems a generation earlier, these actions would still have been necessary but the costs would have been spread over 16 years.

The concerns raised by Mankiw's essay should be addressed now, but there is no political will or leadership to do so. With elected officials concerned largely with perpetuating their elected positions, there is little motivation to tackle the long-term entitlement issues we face. As Mankiw points out, by 2026 it will be too late to change policy without severe consequences. Today, however, there is still time. How will we know when we've reached the point of no return? Quite simply, it will be the day bond investors decide the current interest rates on U.S. Treasuries are too low for the perceived risk and rates begin to rise.

That moment may appear sooner than we think. As one Australian client recently asked me, "Who will buy the debt to finance your deficit when QE2 ends? Foreigners will buy your debt only to the extent they need to do so to facilitate trade; the American people do not want to own U.S. Treasuries; Bill Gross of PIMCO states that he owns no Treasuries in his World Bond Fund and considers the whole quantitative easing process to be a Ponzi scheme." QE1 and QE2 have been of critical importance with respect to financing our deficit. From his point of view, given the soaring national debt forecasts, the U.S. has little choice but to engage in successive tranches of quantitative easing as far as the eye can see. Supposedly, QE2 expires in June. If so, what happens to interest rates?

Higher rates would be a problem for the U.S. This problem will come less in the form of credit risk, but rather in duration risk. Given the shape of today's Treasury curve, a one percent rise in the ten-year bond from the current 3.57% rate would reduce the value of today's ten-year bond by a negative 7.85%! Moreover, since roughly 60% of U.S. debt is scheduled to mature within the next three years, an increase from near zero for the T-bills to just 60 basis points for the two-year note will dramatically increase costs. Every 100 basis-point increase in the weighted average cost of debt will end up costing \$142 billion in interest alone. A move back to 5% short rates will increase U.S. interest expense by \$700 billion. Current U.S. government revenues are just over \$2.2 trillion (CBO FY2011 forecast). This analysis suggests that QE3 may be just around the corner should any rise in interest rates cause a slowdown in the rate of what is already a modest recovery.

Surprisingly, that can be bullish for equities – at least in the short run. Based on the tone of the last few pages, you might be surprised to hear such a positive statement. But our view of near-term equity returns reflects what history reveals as possible outcomes of expansionary monetary and fiscal policies. In general, low interest rates support high valuation levels for equities. Moreover, rising government spending actually helps corporate profits as the formula in Figure 4 suggests (see circled term). In the short run, then, the outlook for stock market returns may well be positive should these two monetary and fiscal policies be continued.

FIGURE 4: THE SOURCE OF CORPORATE PROFITS

Source: Free Cash Flow and Shareholder Yield, William W. Priest & Lindsay H. McClelland, 2007

$$P \text{ (Profits)} = (C - \text{DPI}) + I + \textcircled{(G - T)} + (X - M)$$

\downarrow \downarrow \downarrow \downarrow
 Δ in savings Δ in investments Δ in budget deficit Δ in trade balance

- C=consumption
- DPI=disposable personal income
- I=BI+RI where BI is capital spending and investments RI is residential spending
- G=government spending
- T=tax receipts
- X=exports
- M=imports

On the other hand, the long-run consequences of these policies are not quite as rosy. Debt-financed GDP growth cannot last forever. To quote Kyle Bass, “It was excess leverage and credit growth that brought the global economy to its knees.” Since 2002, global credit has grown at an annualized rate of approximately 11% while real GDP has grown approximately 4% over the same time frame. For the past near-decade, credit growth has outrun real GDP growth by an astounding 275%. As Bass points out, without a resolution of this global debt burden, systemic risk will fester and grow. The outlook for sovereign bonds of developed countries, with the exception of Canada and Australia, is a gloomy one.

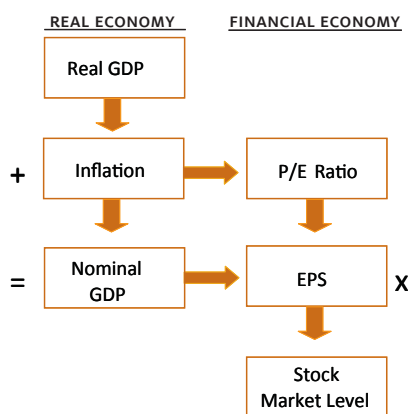
It is most important, however, to remember that investors buy companies, not countries. Investing has gone global for a reason. The Law of Comparative Advantage is at work, and it is highly visible in supply chain management. Home country bias, while still evident, diminishes every year as investors seek access to global growth through multinational companies.

Companies provide goods or services for a profit. The capital underlying these enterprises requires a return or else that capital will be withdrawn, either voluntarily or involuntarily (Schumpeter’s creative destruction process). Should no return be available that equals the firm’s cost of capital or better, that good or service will no longer be offered by the private sector. This capitalistic process is what allows companies to trump geographies. Capital is global and can literally be moved anywhere in the world where a rule of law is present.

Let us remember what equities do for the investor. They are a hedge against inflation in the long run and they capture productivity gains. No other investable asset possesses both of these dimensions. In Figure 5, we can see how this works.

FIGURE 5: HOW DOES THE REAL ECONOMY RELATE TO THE FINANCIAL ECONOMY?

Source: Epoch Investment Partners, Inc.



Here, we show the relationship between the real economy and the financial economy as reflected by the stock market. Real GDP is determined by the growth in the workforce and productivity. If we assign one percent to the former and two percent to the latter, we have real global GDP growth of three percent. Add inflation to that number and we have an estimate for nominal GDP. Over the long term, corporate earnings growth tends to equal nominal GDP growth. Thus, it can be said that corporate earnings effectively capture both inflation and productivity.

As Figure 5 also reveals, valuation is influenced through the mechanism of interest rates. High inflation generally goes hand in hand with high interest rates. And, as most of us intuitively know, there is a very high inverse correlation between interest rates and price/earnings ratios. For most of the stock market’s recent history, this correlation has been around minus 0.8. For the past 50 years, this correlation is less but still a significant one of minus 0.61.

So, if QE policies by the U.S. and others (think Japan) keep rates low, that is good for equity valuations. If a government chooses the Keynesian option of increased government spending to offset shortfalls in private consumption and private investment, that policy is positive for earnings. Thus, in the short run (i.e. 2011 and 2012), the outlook for global equity returns, particularly those companies that generate consistent free cash flow and possess management teams that have demonstrated an ability to allocate capital well, may be surprisingly good should these policies continue in some fashion.

“Freezer Moments,” however, will still loom large. Poor governance within the developed countries combined with soaring sovereign debt levels will eventually endanger the economies of many developed countries (France, UK, Italy, United States, Japan) if not addressed. Investors should run, not walk, from long term sovereign debt instruments of developed countries save Canada and Australia. Systemic risk in the global economy is rising and it will hit the bond market first. Equity markets will not be immune, as valuation measures are impacted from rising rates and final demand proves more sluggish than most pundits believe today. But equities of large, global companies should do relatively well, if not absolutely well. And dividend paying companies – that is, companies that return capital to shareholders via cash, share repurchases, debt pay downs – will fare best of all.

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