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## Investing Environment

*“Americans can always be counted on to do the right thing after they have exhausted all other possibilities.”*

— Winston Churchill  
British politician  
1874 - 1965

*“Things fall apart; the centre cannot hold.”*

“The Second Coming”  
— W. B. Yeats, Irish Poet  
1865 - 1939

The last three quarterly Investing Environment letters have addressed the global debt crisis which, in my view, is the critical issue about which all investors must form a view. The European debt crisis was the topic of the first quarter’s letter while the second and third quarter letters addressed the budget crisis in the United States. This letter will provide a summary of the key conclusions of past missives, update the conclusions to reflect subsequent events and summarize the results of the interactive survey included with last quarter’s letter.

### European Debt Crisis Update

Rereading past Investing Environment letters is a humbling experience. Punditry is a tough business. A fast moving crisis like the European Sovereign Debt Crisis makes predictions all the more hazardous. That said, the key points made by the paper, along with the preliminary verdict of time are summarized below:

#### Conclusions

- 1 Europe’s banks, including those of Germany and France, are in a perilously undercapitalized state given exposure to the sovereign debt of weak countries.
- 2 The ECB would have to cut interest rates.
- 3 The Euro zone will need to create mutually guaranteed funding instruments (Eurobonds, they might be called) or face possible breakup of the Euro zone.

#### Verdict of Time

- Now universally acknowledged.
- The policy rate remained unchanged until new ECB president Mario Draghi cut rates from 1.5% to 1.25% in November. Better late than never.
- Angela Merkel has steadfastly opposed Eurobonds, which may well be unconstitutional in Germany and many member countries. Breakup of the Euro zone is now openly discussed, whereas the topic was taboo at the time of the quarterly letter.



With the passage of nine months, it has become clear that a common currency zone is unworkable without common fiscal, economic and social policies. Absent common fiscal economic and social policies, which in many Euro zone countries would be unconstitutional, the trust that is so critical to financial markets has been fractured. Currencies, being simply pieces of paper, rely on the credibility of the issuing country and its banking system. The euro relies on the credibility of a political coalition of 17 nations, something even more fragile than the credibility of a single nation. The situation in the bond market is equally fragile as credit, by virtue of its name alone, is about trust or belief. Once the risk management department of an institution no longer considers a security risk-free and exposure size becomes scrutinized, the trust factor has been compromised.<sup>1</sup>

The compromising of trust in the sovereign debt market introduces a troubling dynamic. In the past, the typical buyer of sovereign debt did not think of himself (or herself) as being in the business of handicapping outcomes; rather the business is clipping coupons and getting capital returned. Presently, the buyer of European Union sovereign debt faces a range of outcomes that seems to grow daily. Will debt be restructured? Will debt be monetized by the European Central Bank (ECB) or guaranteed by others? Will the debt be redenominated in new currencies? Against this backdrop the response of many natural buyers of European sovereign debt is to sell first and ask questions later, driving bond prices down and yields upward. This situation invites the conclusion that the ECB should expand its role of lender of last resort to banks to become a lender of last resort to sovereigns. Sadly, more active ECB involvement in sovereign debt markets might make the situation worse. The problem is that private sector buyers, if the Greek precedent holds<sup>2</sup>, can be transferred into subordinated status in a restructuring, thereby rendering hot money types the only private sector buyers.

Where does this leave us? The situation boils down to this: European and especially German elites<sup>3</sup> must decide if they want the Euro to survive. If not, Europe must prepare for a controlled dismantling of the Euro zone. If yes, the necessary steps would include:

1. Massive purchase of government bonds by the ECB, perhaps with guarantees that private sector holders would be treated *pari passu* with public sector holders.
2. New bonds issued would be jointly guaranteed by the entire Euro zone.
3. Economic policies in all European nations would be more closely coordinated, which necessarily involves a meaningful loss of sovereignty.<sup>4</sup>

Will the center hold? My view is that the legal, political and economic obstacles associated with saving the Euro will prove overwhelming; the (hopefully) controlled dismantling scenario seems more likely to me. At a minimum, I would be surprised if Greece was a member of the European Monetary Union two years hence.

## The United States Budget Situation

The conclusions, in brief, of the last two letters concerning the U.S. situation were as follows:

1. The United States fiscal situation is very serious. Official numbers understate the problem because they do not reflect fiscal chicanery and exclude state and local debt. The level of debt is likely constraining economic growth, based upon the work of Reinhart and Rogoff.<sup>5</sup>
2. The United States is playing a dangerous game with financial markets. Confidence can evaporate very quickly. Consider the mini-panic that ensued when S&P downgraded U.S. debt this summer.

<sup>1</sup>An interesting side note is that diversification is the traditional answer to risk management. In corporate credit, credit indices consist of hundreds of issuers with the largest issuer carrying a weighting of 1.9%. Government bond indices are much more concentrated. The U.S. consists of 28.7% of sovereign debt outstanding. Italy is 8% of world debt and 24% of Euro debt. (Source: Citi)

<sup>2</sup>Under the proposed Greek restructuring, the ECB insisted on being made whole while the private sector incurred the write-downs

<sup>3</sup>Many commentaries emphasize Germany's role in bailing out profligate nations while failing to note how Germany benefits from the Euro. If Germany returned to the Deutschmark, their currency would appreciate meaningfully thereby derailing German's export sector, curbing growth and further exposing its fragile banking system.

<sup>4</sup>On December 9, 2011 the European Commission issued a statement that calls for national constitutions to embrace "structural budget deficits" of just -.5%. This is an aggressive target, but the proposal is light on details and timing. In particular, it does not detail when "automatic consequences" for budget violations are triggered. Moreover, there are major loopholes. Stay tuned. More to come.

<sup>5</sup>Carmen M. Reinhart and Kenneth S. Rogoff "This Time is Different: Eight Centuries of Financial Folly" (Princeton University Press, 2009)



3. The fiscal problem is a political problem, not an economic problem. Our fiscal situation can be managed with the proper political will; Canada serves as a role model.
4. Solutions to the fiscal problem must include tax increases and spending cuts, but should heavily favor spending cuts. Keynesian fears of economic collapse caused by fiscal restraint are likely unfounded.

The most significant event subsequent to the publishing of these letters was the announcement on November 21, 2011 of the failure of the ironically-named “Supercommittee” to produce a deficit reduction plan. With the failure of the Supercommittee to produce a deficit reduction plan, \$1.2 trillion in spending cuts will be triggered, beginning in 2013.

While the Supercommittee may have failed in its mission, I am pleased to report that the readers of this letter stand ready and willing to assist in resolving the impasse. The results of the interactive survey on options for solving the U.S. fiscal crisis were fascinating and represent a collective wisdom sorely lacking in the political class.

### Budget Survey Response Summary

Many thanks to readers who responded to our first interactive client survey. While the survey was not a statistically valid sample from a statistician’s point of view, the results were interesting. Recall that the survey listed the major policy options available for closing the budget deficit as forecasted by the Congressional Budget office.

The following table summarizes the survey results:

		2015	2030
Estimated Deficit (Congressional Budget Office)		\$418 Billion	\$1,250 Trillion
Mean Survey Deficit Reduction (Client Survey)		\$427 Billion	\$1,363 Trillion
2015	Deficit Reduction		
	Proposed by Survey Respondents	Over \$418 Billion	63.2%
		\$200 – 418 Billion	33.3%
		Less than \$200 Billion	3.5%
2030	Deficit Reduction		
	Proposed by Survey Respondents	Over \$1.35 Trillion	NA
		\$675 Billion – \$1.35 Trillion	NA
		Less than \$675 Billion	8.8%

The results of the survey by type of policy action are quite interesting and are summarized below. Note that I have only included categories that can impact the deficit in a meaningful way. One implication of the survey is that there are only a few levers that are relevant to the discussion; cutting foreign aid or funding to the national parks, however popular or unpopular, simply don’t move the needle and are ignored for these purposes.

### Entitlement Reform

There is a broad understanding on the part of respondents that entitlement reform is necessary. Fully 83% of respondents supported raising the Social Security retirement age to either 68 or 70 years of age. One of the single most popular policy options (72%) was to use an alternative measure for Social Security inflation from wage growth to inflation.<sup>6</sup> If those two policy actions were implemented, the Social Security funding problem would be solved.

On the more difficult question of Medicare reform 77% of respondents supported raising the eligibility age to 68 or 70. An additional 63% supported capping Medicare spending growth to GDP +1%. This option implies more formal health care rationing. As such, I was surprised that nearly two-thirds of respondents were supportive.

In sum, there was a broad based recognition that entitlement reform is necessary and should begin by recognizing that people are living longer than they did when Social Security and Medicare were launched.

<sup>6</sup>Wage growth is a function of inflation and productivity and is, accordingly, normally higher than inflation measured over a full cycle.



## Defense Spending

There was a broad consensus that Defense spending cuts must bear part of the burden of deficit cutting. Moreover, the views were highly nuanced.

There is a high degree of war weariness with the conflicts in Iraq and Afghanistan. Fully 84% of respondents support reducing troop levels in Iraq and Afghanistan from 150,000 to either 60,000 or 30,000. In addition, 70% support reducing the military presence in Europe and Asia to pre-Iraq war levels. Support for weapon systems cuts is much lower. In fact, one of the least popular policy options (14%) was to cut the Navy and Air Force fleets. The implicit judgment of respondents seems to be that the military's edge going forward should be in technology and weapons systems. Perhaps the success of drones in the war on terror has influenced respondents' thinking.

## Taxes

Once again, there seems to be a broad recognition that higher taxes will need to be a part of the deficit reduction plan. The Bush tax cuts are set to expire at the end of 2012. A total of 59% supported expiration of all or part of the Bush tax cuts with 40% supporting expiration for households making over \$250,000 annually, while 19% supported expiration of all Bush tax cuts. Support is even stronger for higher estate taxes. Interestingly, the single least popular policy action was reducing the mortgage interest deductions for high income households, perhaps an implicit recognition of the fragile state of the U.S. housing market.

## Summary

1. With 95% of respondents favoring policy actions that at least cut the estimated 2015 budget in half and 63% balancing the budget, the conclusion that the U.S. budget deficit is a political, not an economic problem, seems inescapable.
2. There is widespread acceptance that all sides will need to compromise. The Democrats will need to give ground on entitlement reform while the Republicans will need to show flexibility on defense spending and taxes.
3. Perhaps most interesting to me is the judgment that the Department of Defense will need to change. There is widespread support to bring troops home, both from war zones and non-war zones. However, there is much less support for cutting weapons systems. Perhaps respondents, having observed widespread technological substitution in their lives, have concluded that the military must continue to embrace technological substitution, such as drones.

Best wishes to all for a peaceful, happy and prosperous 2012.

A handwritten signature in black ink that reads "John".

John O'Connor  
December 30, 2011

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