



DEEP ROOTED THOUGHTS

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Sovereign debt? That's someone else's problem, right?

Nations get into trouble when they do not manage their financial affairs prudently. Often it seems the easiest way to balance a budget is to simply borrow the money that is needed. Sovereign debt includes borrowing in the form of bonds, bills, and notes issued by a country's government. The media has recently begun to highlight the large debt burdens that many countries are facing. This article provides more information about how this phenomenon of increasing sovereign debt is impacting global economies and individual investors.

Until the last century, the responses to countries not honoring their debt obligations were relatively easy to anticipate. First, the country that was owed the money would stop doing business with the country that failed to pay its obligations. Next, if the army of the country that was owed the money was superior to the country that did not pay, they would often attack and take physical assets as repayment with a little extra extracted as payment for overdue interest and penalties. While this is now considered barbaric for civilized countries and is greatly complicated by the interconnectedness of the global economy, it was relatively efficient and served as a strong deterrent to avoid debt crises.

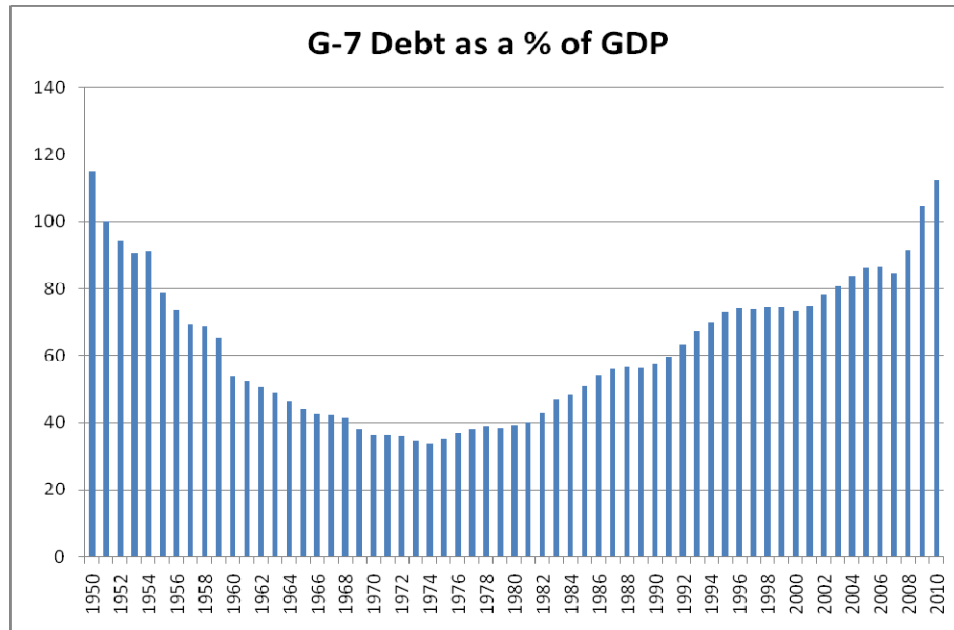
That was then, this is now.

Today there are many countries with bulging debt burdens, not just one or two as we have experienced in the past. The levels of debt have risen to high levels at a period when interest rates are at historic lows and we are in a global recession. The recession and low rates increase the difficulty the various countries face in rectifying the situation.

While the sovereign debt levels complicate international relations and trade, they also impact individual investors indirectly. While there is no immediate need to load up on ammunition and non-perishable food, better decisions can be made if we understand the current conditions and have a framework for how sovereign debt crises have played out in the past.

Governments have been defaulting on their debt for as long as records have been kept. At the annual Chartered Financial Analyst conference I attended in May in Boston, Niall Ferguson, a Harvard professor who is widely considered to be the world's leading economic historian, illustrated how Greece has been a perpetual offender. In addition to not being surprised that the Greek government recently repeated its previous financial failures, he offered some sobering statistics about the magnitude of the current global debt load.

As the chart below illustrates, even the seven industrialized nations that have led global growth for the past century are incurring debt loads that are reminiscent of where they were at the end of World War II. The G-7 consists of the United States, Canada, France, Germany, Italy, Japan, and the United Kingdom. The countries in the G-7 have debt loads that are now exceeding their total annual productivity. In simpler terms, they owe more than they make.



Source: IMF

The debt loads have arisen due to structural failures to balance budgets, recessionary growth declines, and most recently bail-out funds related to the global real estate and financial crises. Most experts agree that these numbers are likely to get worse in the near future. In fact, the Organization for Economic Cooperation and Development (OECD), which includes North America, Europe less Russia, Australia, and New Zealand, forecasts that their 2010 budget deficits will be six-times higher than they were in 2007 (prior to the recession).

Some countries whose sovereign debt burdens have been in the news recently include:

<u>Country</u>	<u>Debt as % of GDP</u>
Japan	227.0%
Greece	115.0%
Belgium	102.7%
United States	93.6%
United Kingdom	81.7%
Ireland	75.9%
Spain	69.6%

A recent study by Credit Suisse evaluated the riskiness of sovereign debt for twenty five nations across multiple factors. Their research pegged Iceland and Greece as the two riskiest countries. No surprise there. India and Brazil, two emerging economies that had been considered very risky just a decade ago, were rated in the top third. Disappointingly, the United States was right in the middle with nations such as Argentina, Columbia, and Kazakhstan rated safer. While we have no interest in buying any bonds issued by Kazakhstan, it is disconcerting to see how the debt levels of the developed nations have negatively impacted their credit worthiness.

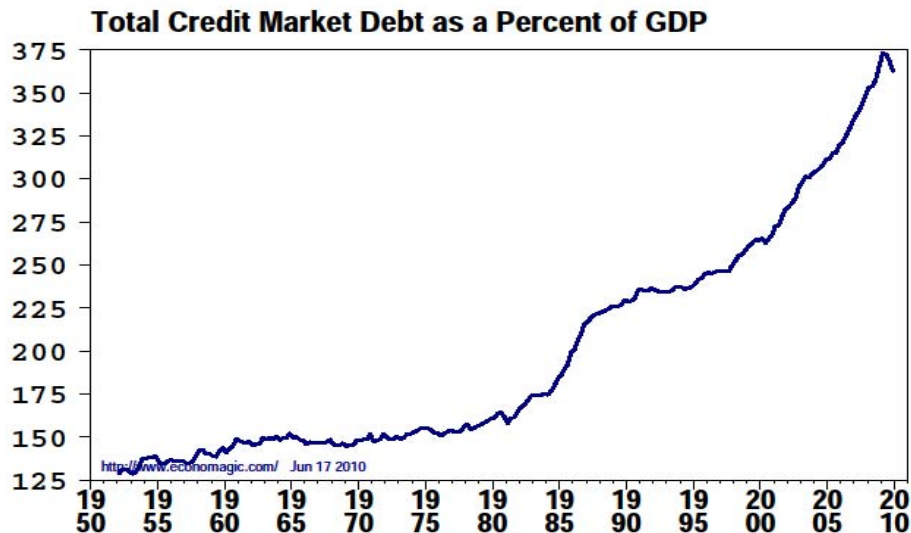
What can be done?

As Niall Ferguson points out, fiscal reform (spending less and taxing more) becomes increasingly challenging when the majority of people are receiving entitlements and transfers and are not paying into the system. This is currently the situation around the world. Inflation, which devalues the outstanding debt, can work assuming those who hold the debt do not object to getting paid less in real terms. With more than half the U.S. debt owned by people and entities outside our borders, it is unlikely that they will accept this solution. Global growth can also close the gap but it will be constrained by higher taxes, increased government regulation, higher tariffs and other trade barriers, and decreased leverage at both the corporate and household levels.

As bad as the situation is in Japan, almost all of their debt is owned by the Japanese. Therefore, their government can keep rolling over the debt with fewer consequences because they are just delaying repaying themselves. Conversely, the United States now has numerous creditors around the world who expect to be repaid on schedule.

There are no easy answers to reduce the global debt levels. The few courageous responses that have been offered recently have come from across the pond. Newly elected British Prime Minister, David Cameron, explained “The decisions we make will affect every single person in our country. And the effects of those decisions will stay with us for years, perhaps decades to come.” In Germany, Chancellor Merkel is pushing for similar austerity measures. While the austerity policies are not politically popular, they seem essential if we want to return to the prosperous growth levels that were enjoyed in the last two decades of the twentieth century. As the G-7 debt chart illustrated, it took decades to build the debt levels to their current state. It will likely take another decade of concerted and coordinated efforts to reduce them back to more acceptable levels.

In the United States, where the sovereign debt level is now around 90% of GDP, a more shocking picture emerges when the total credit market is evaluated relative to the country's output. If household, corporate, and financial institution debt are added to the government debt total, then we are actually carrying a composite debt burden that is over 350% of GDP. The amount is almost triple where it was in the 1950's. Over the past two generations, American businesses and American households have increased their borrowing in pursuit of more. We are probably going to have to be satisfied with less in the next decade if we intend to rein in the outstanding debt.



Even J.P. Morgan, who is relatively bullish and feels that the U.S. consumer may be able to buy enough goods and services to mitigate the global debt crisis, soberly observes that increased global financial regulations will add further constraints to the growth of economies and add additional governmental costs which will likely need to be paid for with more debt.

PIMCO, arguably the world's most respected bond manager, projects a very bumpy five-year period for the investment markets. PIMCO feels that stagflation (high inflation coupled with high unemployment) is possible in the United States due to recent policy decisions and the potential pull-back of consumer spending. Globally, they feel that the United States is still the safest country in which to be invested, however they point out that the developing economies of Brazil, India, and China provide higher growth opportunities than the U.S. or any of the other G-7 nations. Interestingly, Brazil, India, and China also have much lower Debt-to-GDP ratios than most of the developed nation economies.

PIMCO also cautions that we should expect more extreme outcomes (both positive and negative) than we have seen in prior decades as countries work their way out from their debt burdens. Their official outlook is for investment returns to be in the 4% to 6% range, before taxes and expenses, for a diversified portfolio for the next three to five years.

At the individual level, these global challenges require a re-evaluation of the expected returns from the investment markets and some recalculations regarding how much can be safely withdrawn from a portfolio by those who are in retirement.

In what should we invest?

The answer is probably not gold. Many pundits have suggested that gold will always be a safe investment and could triple in value if China requires the U.S. to back its currency with gold. Maybe. With the current price of gold hovering near \$1,250 an ounce it seems to be shimmering. In 1980, gold was \$850 an ounce. On an inflation-adjusted basis, that one ounce of gold from 1980 should be worth \$2,400 today. It is worth only half that much. Therefore, I am not convinced that gold is a great store of value nor a great hedge against future inflation.

Bond investing becomes more challenging as fears of rising interest rates, inflation, credit downgrades, and slower growth combine to depress bond prices. It is also unclear whether longer-term interest rates will rise when the U.S. government eventually raises the short term rates. The uncertainty around bonds leads to greater discounts being applied to their values. Credit quality and yield have become increasingly important in evaluating bond investments.

Stock market volatility makes holding large positions in stocks uncomfortable for many investors. However, stocks have historically been a great way to overcome inflation and grow wealth. Even in low return environments, all portfolios should have exposure to stocks.

A well diversified portfolio with a variety of investments that are not highly correlated will help avoid major losses in wealth. We will continue to seek new, viable investments and approaches that increase the diversification in client portfolios and help to improve expected returns while decreasing the volatility of the portfolio. History suggests that periods of lower returns should be expected. If lower returns are unavoidable, keeping costs low and tax efficiency high will allow investors to keep the greatest percentage of available returns. We must keep faith in human ingenuity and investment market resiliency. Better days will follow. Much as we saw in 2009, they can come quickly and trying to time them is impossible.

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