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Investment Outlook & Commentary
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After a historic government effort, including rescuing 690 financial institutions, printing over a trillion dollars, committing over a trillion dollars annually in new government spending, and taking on who-knows-how-many-trillions in guarantees—we averted further financial catastrophe and "saved" millions of jobs.[1] At least this is the official justification. How true or not, only time will tell.

With the Dow breaking 11,000, a new relief has swept over capital markets, and media coverage of an improving economy and new bull market have replaced mortgage foreclosures and lost jobs. The latest *Newsweek* cover: "America's Back!—The Remarkable Tale of Our Economic Turnaround."

It has been a year since the stock market hit a decade-plus low. One consolation prize to Bailout Nation with its infusion of borrowed and printed money is the floor it put under the market and the fuel it now pours onto it. Admittedly, the rebound has been stronger and faster than we expected. While we participated in the upside, we didn't parlay portfolios whole-hog into stocks and other "risk-assets" after being relatively cautious on the downside. While regrettable in retrospect, to not have made more money in one of the best 12-month market runs ever, we'd rather assume this type of "omission" error than ones resulting in substantial loss, like being too bullish during a market correction. Contrary to the market's bullishness, we're increasing believers in cautious yet targeted investment exposure as volatility soon makes its return.

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This view is mostly because the bill is coming due; the U.S. government, and others around the world, will be forced to deal with years of secular and unsustainable growth in government and deficit finance. As countries inch closer to a fiscal point-of-no-return, investors of all kinds will need to re-evaluate their long-term assumptions and strategies.

Generally, Wall Street's long-term framework can best be summarized as a predestined and powerful rise in asset prices over time. Conventional investment wisdom says if money can be put to work for at least ten years—the shortest long-term time horizon—an investor should see handsome returns, but no worse than all his money back.

[1] "Jobs saved" is a new statistical favorite in Washington, even though it has no agreed upon meaning and cannot be independently verified.

To "prove" this and in order to set a longer-term investment strategy, Wall Street looks at past returns for stocks, bonds, and other asset types. *Need an 8% return? A mix of 60% stocks and 40% bonds will do the trick as it's shown over the past 25 years—now let's go find the proven winning funds and managers to fill this allocation and get some alpha.*[2] Actual asset allocation solutions may differ, but this is essentially the approach for individual and institutional investors everywhere.

As heretical as it may be, we are not believers that assets have a predestined rate of return. We have found no laws of physics, mathematics, or God stating what performance of anything should be over time. Stocks don't have to do 10% annually over time and bonds don't have to do 7% annually, either. (Just ask the Japanese, who today have a stock market one-third the value it was 20 years ago.[3]) To us, how stocks and other assets perform depend largely on the legal, economic, and social environment around them. As these factors change, so do prospects of risk and return for various assets. For better or worse, these beliefs are the reason why our clients' portfolios change, sometimes drastically, over time.

So with these notions, we are now pondering the longer-term fate of our increasingly profligate and indebted nation and world. Even for active short term strategists, assumptions on this topic will influence investment decision-making.

You may recall we haven't been deficit hawks in the past. The reason for this was mathematics: annual federal budget deficits could become surpluses with the modest string of strong economic growth. Strong real GDP growth, like 4 or 5%, results in double-digit tax revenue growth. Annual surpluses could chip away at the cumulative deficit, or at least keep it in check. Spending restraint and entitlement reform were two other possibilities giving hope that America's fiscal house could improve and withstand the inevitable strain of 80 million Baby Boomers entering retirement. This was our thinking then.

Time, politics, and the staggering increases in deficit spending during the Bush and Obama presidencies have changed all that. Large deficits matter sooner or later. As the first of the Baby Boomers reaches 65, the federal government is approaching a size not

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[2] "Alpha" is Wall Street speak for a fund or manager's excess return over a stated benchmark. For example, a stock fund may be compared to his benchmark, the S&P 500.
[3] Nor does any percentage return mean the same thing across places and across time. A 4% average return in deflationary Japan has been heroic; a 30% average return in Weimar Germany or Zimbabwe today means a tragic loss of wealth. A double-digit return was what you'd get by putting money is risk-free U.S. Treasurys in the early 1980s. Today only some of the riskiest junk bonds can get you those kinds of returns.

seen since World War II. Unlike then, however, growth in government is mostly coming from entitlement spending that seems nearly impossible to reduce or repeal in the future. With patronage, inflation, and more eligible Boomer beneficiaries coming "on stream," they are likely to increase.

"Non-discretionary" spending, including Social Security, Medicare, Medicaid, and other mandatory programs, now swallow all of the government's tax revenue (currently $2.3 trillion), leaving nothing for anything else including national defense, infrastructure, law enforcement, you name it. New borrowings make up the difference (currently $1.5 trillion annually).

More bad news: the cumulative deficit, expected to reach $14 trillion this year, is just a *cash* deficit. It reflects nothing of future liabilities, when the government, in just a few years time with nothing done, will irreversibly collect less in Social Security and Medicare taxes than it pays out in benefits. According to widely accepted estimates, the *present value* of those future liabilities and others including war commitments, is roughly $50 trillion. If the U.S. government had to follow the same financial reporting standards as a publicly traded corporation, it may show total liabilities of *$64 trillion*.

Both political parties are to blame for this, and the problem has been years, even decades, in the making. And sadly, with today's 24-hour news cycle, instant poll tracking, and constant campaigning, our elected leaders have perhaps never been less willing to choose long-term soundness over short-term political gain, or even to compromise.

The financial crisis has only added to fiscal strain through direct bailouts, assumption of debt, toxic asset purchases, nationalization of four of the nation's largest finance companies, and "stimulus" spending. Beyond the countless dollars in cost, we wonder if the government and Fed, through all of its rescue efforts, has only served to push the risk-taking, over-levering, and bubble-making forward, perhaps ensuring that other bubbles are surely to come, and in greater magnitude with the public balance sheet—the biggest one of all—now in the game.

All of this prompts questions for us, the answers of which will provide a framework in which we view and evaluate all investments. Questions include: How much will taxes be raised, and how will it affect the economy? Will the Fed print money as a way to lessen the debt burden? Which countries face similar challenges and whose will come to a head first? Does all of this mean future inflation or deflation? Are we looking at the end of dollar hegemony, and if so, which currencies do we need more exposure? Is gold an answer?

Yes, the longer-term is looking doubtful from where we sit, and we have more questions than answers. But this is a good start, and at least a more sensible approach to investing

while most stick with the timeless practice of buy-and-holding strategies based on past results. As always, our efforts first and foremost are something akin to Charlie Munger's wish: "All I want to know is where I'm going to die so I'll never go there."

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We've long lamented the inevitable tax increases scheduled after 2010, if for no other reason because they automatically reduce the after tax yield on investment activity and reduce entrepreneurial risk taking and job creation.

Tax rates on investing, as well as ordinary income, will be finalized with the president's budget by September (presidents have come to use the filibuster-proof budget to install tax legislation). Although details are scant, America's tax code going forward will be structured around a fulcrum set at the $200,000 and $250,000 a year income thresholds for single and joint filers, respectively. Those below the line will likely experience no explicit tax increases; those above (less than 5% of the population who contribute approximately 60% of all income tax revenue) will likely experience significant rate increases. These taxpayers will also soon pay a 3.8% surcharge on all income sources (including investments) to prefund the new Health Care Reform.

Although the effects of the impending tax code are hotly debated, nearly all acknowledge tax increases on the wealthy alone are insufficient to cover what appears to be a large and permanent deficit gap. The Obama administration recently floated the idea of adopting a Value Added Tax (VAT) or some kind of national sales tax. In any event, a future of higher and creative forms of taxation is almost a certainty, and it presents a headwind to future growth prospects. How much so is under deep consideration here.

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Despite our relatively pessimistic view on the bigger fiscal picture, even we can see a silver lining for investors today.

First, the U.S. may be one of the better houses in a bad neighborhood. As our fiscal picture worsens, most are far closer to fiscal doom. The troubles of Greece, Portugal, and Italy among others may be first victims of the larger debt problem globally. Capital must flow somewhere, especially if it needs safety in a time when "sovereign risk" is becoming a more realistic concern. Despite our worries and criticisms, America still has competitive advantages globally. America remains at the forefront of technology creation, efficiency hunting, and profit-making. In no other place are things so adeptly created, built to hugely profitable scale, and then refined and improved. Gaining rivals such as China still present huge risks including dubious legal protections and property rights, among others.

Regarding finances, the U.S. has demonstrated swift action in writing off bad debts and restructuring while most of the world's banks have swept their toxic assets and liquidity shortcomings under the rug in hopes no one will notice. And as bad as the dollar is abused, it remains the world's reserve currency; no other currency at this time can realistically take its place as a solid medium of exchange on a worldwide scale.

In other words, for all its problems, America is still a place people can keep and grow wealth. At least for now.

Second, many stocks remain attractive investments, especially compared to the low yields offered by other asset types including bonds and real estate. Many high quality companies offer higher yields with credible prospects of even higher income and internal growth. Our investment choices within equities are becoming more targeted; stocks today run the valuation gamut from the cheap to the are-you-kidding-me irrational. The dispersion of stock valuations has only increased over the last year as the biggest gainers have been lower-quality companies, many of which investors (and common sense itself) once left for dead. These have been the real winners of Bailout Nation, but ones we won't chase.

Third, a "false prosperity" should fuel bullish sentiment. A false prosperity is a notable yet temporary increase in output and profits as millions of businesses and individuals "ramp up" before foreseeable tax increases. From a tax revenue gathering point of view, tax increases are more effective when they are immediate and unexpected. However, when they are predictable, like the tax increases coming 2011, people rationally shift production, profits, and even their tax payments early. That companies are reporting strong profit growth but without matching increases in capital expenditure or hiring activity suggests a number of economic data, including GDP, profits, and even tax collection may surprise on the upside this year.

Stocks could continue their upward march, but the trick may be pulling off to the sidelines before everyone realizes the strength is not permanent. In fact, this is the foreseeable game plan going forward, being a few steps ahead in a revolving "boom-bust" game where government-stimulus and animal spirits give way to new sobriety and a focus on paying for an escalating fiscal bill—and over and over again.

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