

# Monthly INSIGHTS

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Volume 1 · Issue 2 · March 2010

## Greece, Merle Travis, and Kentucky Coal Miners

„ You load 16 tons, and what do you get?  
Another day older and deeper in debt.  
St. Peter don't you call me 'cause I can't go.  
I owe my soul to the company store.”

*Merle Travis, Country/Western Songwriter and Musician*

### Summary

- The world's developed economies simply have too much debt.
- Deleveraging is a painful process that should, at minimum, restrain global GDP growth.
- Given the concentration of debt facing certain nations and states, the market and the economy remain at risk of further disruption.
- There are multiple possible outcomes and solutions to the debt problem, some less painful than others.
- While near-term growth remains strong, investors should protect themselves against ongoing market disruption and prepare for subdued, longer-term economic growth.

### The Cost of Borrowing

At some point in our lives and to different degrees, most of us have borrowed money from a bank, a relative, or even a friend and know the discomfort of repaying a debt. This can be a torturous experience and although it does not necessarily get easier, you are hopefully wiser the next time around.

I was about seven years old the first time I borrowed money. I had been eyeing a toy that cost \$12.99 and, of course, I only had four dollars from my allowance – a whole two weeks' savings. My father generously 'loaned' me the remaining \$8.99 and while many parents would have left it at that, it was rarely so easy with my father. During the car ride home he explained that each week he would add one cent for each unreturned dollar until the 'loan' was fully repaid.

Right then, I realized I should have negotiated the terms in advance. In total, it took me five weeks to repay my father and instead of having \$1.01 from that final weekly allowance, I received only \$0.76. In the end it cost me \$13.24, which equated to a 50% APR on my borrowings (I was, fortunately, spared the sales tax).



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This is the sort of event that shapes future behavior and makes one wary of borrowing money. When you think about this simple example, it is easy to see how a debt burden can spiral out of control. If your income doesn't cover your expenses, how can it cover your expenses when the cost of borrowing is added to that base amount?

Merle Robert Travis (November 29, 1917–October 20, 1983), a famous Country/Western songwriter and musician from my home state of Kentucky, recognized the difficulties associated with indebtedness. The lyrics of his most well known song, "Sixteen Tons," refer to the exploitation of coal miners through a tactic called debt bondage. Under the system, employers paid their workers with unexchangeable credit vouchers to the "company store," which in turn carried food and other necessities often at artificially high prices. In addition, workers usually lived in company-owned housing and their rent was automatically deducted from their pay. With limited options, workers often became so indebted that they were unable to leave the system.

While it may be quite a stretch to compare the debt burdens of today's consumers and developed nations to those of the Kentucky coal miners, it is important to remember the ultimate cost of excess borrowing – economic restrictions. With the coal miners it was a restriction from being able to legally leave their employer for a better job. In the much less dire situation of my youth, I was restricted from any further spending until I earned enough allowance to cover the cost (plus interest) of my purchase. While it may not be in the same manner, timeframe, or structure, today's developed nations and their consumers will eventually be restricted by the cost of their excess leverage.

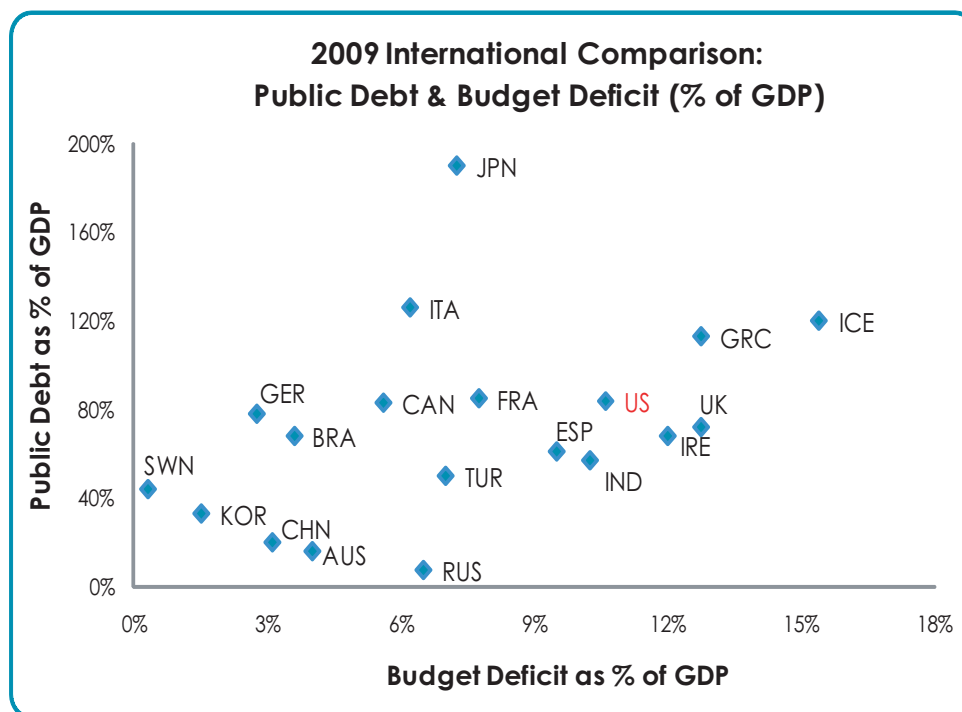
### Today's Global Debt Situation

Throughout much of the 1980's and 1990's, a period many economists call the Great Moderation, the global economy and financial markets experienced lengthy and robust expansions, relatively mild and short recessions, and extremely low inflation levels. Financial market returns, on average, were higher and more stable than during most previous decades and for many businesses this was an extremely good period of consistent growth. Some argue that this economic welfare was the result of advancements in monetary policy and improvements in the government's ability to manage the economic system and capital markets. But, perhaps things were just too good for too long.

The Great Moderation created the perception that the economy and the financial markets would forever produce increased stability and above-average growth. Banks benefitted from financial market growth, above-average merger and buyout activity, generally low default rates, and rapid loan origination. Consumers benefitted from a dramatically improved labor market, a surplus of high-earning jobs, and readily available credit. From the 1970's to the early 2000's, consumer debt grew from 60% to 100% of disposable personal income. Governments, lacking discipline themselves, used growing tax revenues to fund more government programs at an increasing rate, leaving little cushion in their budgets.

Fast forward ten years later through two recessions, and a global war on terror, and we find the world's economies and financial markets close to where they were in 2000. Developed governments have continued to follow the same playbook to deal with recessions – providing enormous monetary and fiscal stimulus in order to avoid financial collapse. Having provided this stimulus and essentially absorbed excess private debt, many of the developed nations' balance sheets and fiscal deficits are now in much worse shape than they were 10 years ago.

The graph below shows a sampling of nations' debt-to-GDP and deficit-to-GDP ratios at the end of 2009. A number of nations have deficits and debt levels that are quite extreme relative to the size of their economy. Admittedly, there is great disparity between the nations with greater fiscal discipline (Germany) and those without (Greece). Eventually, this cannot continue. The financial markets recognize this, as evidenced by Greece's recent problems funding its deficits.



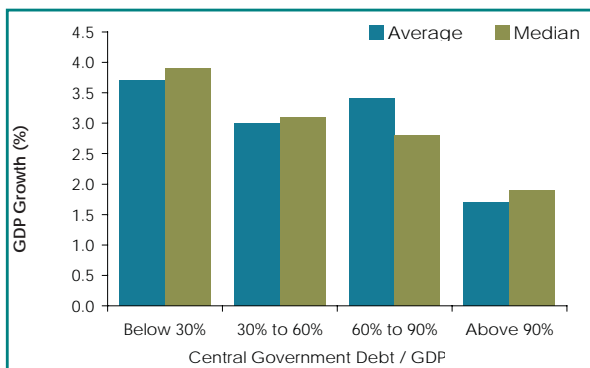
Source: Strategas Research, OECD Economic Outlook

**Global Debt Bondage?**

There is great debate as to *whether* and *how* government deficits and debt levels affect the economy. While most economists admit that excessive government debt is unsustainable, very few studies have put forth a definitive and clear idea of how much government debt is too much. Furthermore, few studies provide insight into the effect of excess national debt on economic growth.

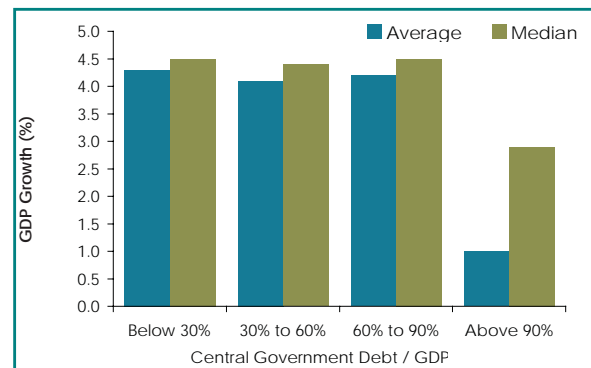
However, on December 31, 2009, Professors Carmen M. Reinhart (University of Maryland) and Kenneth D. Rogoff (Harvard), both of whom are contributing economists for the National Bureau of Economics, produced a study aimed at demystifying this elusive subject. Their study explains the existence of critical debt-to-GDP levels for both developed and developing economies. As shown in the following graphs, while the relationship between economic growth and debt is relatively loose when the national debt is below 90% of GDP, economic growth is much lower when the national debt rises above this level.

**The Effect of Government Debt on Real GDP Growth for Developed Economies (1790-2009)**



Sources: Reinhart & Rogoff (2009)

**The Effect of Government Debt on Real GDP Growth for Emerging Economies (1946-2009)**



Sources: Reinhart & Rogoff (2009)

Economies that reach these critical debt levels find themselves imprisoned in a way not too dissimilar from Merle Travis's coal miners. Once the debt burden becomes large enough relative to the size of the overall economy, there are few, if any, painless options. On one hand, a government can increase taxes, but this tends to lead to slower GDP growth or, even worse, a decline in economic activity. Similarly, government spending can be reduced but this can also act as a drag on the economy. National governments, as another option, can actually default or restructure their debt, but this undermines the nation's credibility as a borrower and tax increases and spending cuts may still be necessary to appease creditors.

Finally, some economists advocate that a government use its control over its domestic

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currency to its advantage. Throughout history, many nations have chosen to debase their currency, essentially creating more of their own currency, in order to repay national debts based in that currency. The term “debase” refers back to the practice of reducing the base (gold or silver) content in a country’s coins in order to increase the amount of national currency. While this may enable the country to repay its debt, the currency typically loses value and gives rise to longer-term inflation.

A more modest approach than to devalue a developed nation’s currency, perhaps, would be to use monetary and fiscal policies to stimulate the economy enough to produce a reasonable, but not excessive, amount of inflation. This, as well as the idea of targeting a higher inflation rate of 4%, has recently been proposed and supported by a group of IMF economists and Professor Rogoff. The ideal outcome would be if economic growth and inflation rose just enough to facilitate the repayment of consumer and government debts. Of course, this maneuver requires a consumer and government with sufficient fiscal discipline to restrain spending and increase taxes enough to reduce their respective debt burdens. While this strategy may provide the most ideal and least volatile scenario, the debt reduction and increased taxes would limit investment returns and restrain economic growth.

Regardless of the strategy employed, the long-term effect on economic growth for the next 5-10 years remains essentially the same. The need to reduce excess debt balances to more sustainable long-term levels will likely subdue future growth. How we get there is up for debate. It is possible that the debt burdens of some individual nations (or even U.S. states) will become so overwhelming that we will see more of the dramatic outcomes discussed above – defaults, debt renegotiation, significant and sudden fiscal policy shifts. Any of these would provide significant downward pressure on the financial markets and could propel us into a more significant and sustained sovereign debt crisis – a less than ideal outcome. On the other hand, given the propensity for the world’s central bankers to reach for the academically ideal solution, we could see attempts through fiscal and monetary stimulus to reinvigorate the world’s near-term economy while putting in place plans to withdraw stimulus when certain economic milestones are reached.

### Investment Strategy Recommendations

The financial markets remain caught in a tug-of-war between long-term concerns over excess sovereign debt and near-term stimulus-driven growth. The balance between these two opposing themes swings daily as articles about either the strength of the economic rebound or Greece’s financial crisis battle for front page coverage in *The Wall Street Journal*.

We recommend, in light of this continued conflict between the near-term growth and long-term concerns, that investors maintain a neutral allocation to market-related risks. This means not being materially overweighted or underweighted in equity assets as the markets are not clearly pointed in either direction. This neutral allocation also positions your portfolio to take advantage of any significant market moves that occur as the result of one of the two themes prevailing on a near-term basis. If markets decline as a result of sovereign debt problems, but these concerns do not yet pull forward the payday for other sovereign government borrowing, the market's decline should be viewed as an opportunity to rebalance by adding to equities. Similarly, if the world economy picks up steam because stimulus remains stronger longer than expected, but sovereign debt remains a growing issue, this should be viewed as an opportunity to rebalance by selling equities.

In addition to this primary theme, we continue to recommend investing to benefit from four other longer-term themes:

1. In the more volatile, sideways market that we expect for the foreseeable future, we believe it will be necessary to continuously shift toward developing value opportunities. Currently, we see value opportunities in U.S. quality growth equities and European multinationals.
2. We believe, due to the aging baby boomer generation, investors on average are starved for yield and that this will continue to drive investment flows into any asset class that shows the ability to produce relatively consistent yield at a reasonable valuation. We continue to see "higher quality" (BB-rated) high yield bonds and utility stocks as the most attractive higher-yielding options.
3. Emerging Asia remains a primary driver, and perhaps the only sustainable driver, behind global economic growth. China remains very supportive of its growth agenda and has turned its attention to growing domestic demand for its own goods. With perhaps one of the only financially sound and fiscally secure balance sheets, China has abundant resources to point its centrally-controlled economy in the right direction. It will be important for portfolios to remain exposed to growth in emerging Asia directly or through investments that benefit indirectly.
4. Absolute return strategies such as hedge funds and opportunistic long-only managers should also perform better during the expected sideways, volatile market than more traditional fully-invested long-only managers. Their ability to utilize short-selling or shift to a higher allocation in cash when valuations become stretched should enable them to capitalize on the volatility by more actively employing those strategies as the market swings up and down.