

THE LINNEMAN LETTER

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Welcome To The Confused

Every executive with whom we speak expresses utter confusion about the state of the global and U.S. economy and capital markets. As a result, they are in a muddle about their investment strategies. They closely monitor economic and capital market data for signs that “everything is all right,” yet even as the U.S. economy grows at a seemingly healthy rate, they remain extraordinarily ill at ease. Why?

Simply stated, this discomfort reflects the fact that even though U.S. real GDP and employment are growing at moderately healthy paces, we remain in totally uncharted waters in terms of both the economy and our capital markets. And when private decision-makers are in unfamiliar (and unrecognizable) landscapes, they act very cautiously.

For example, we have not seen in our lifetime federal budget deficits as large as those which currently exist. Not only is U.S. federal spending as a percent of GDP at a peace-time high, but federal revenues as a percent of GDP are well below their historic norm, resulting in unprecedented budget deficits. Compounding the problem of unprecedented U.S. budget deficits is the fact that there is neither political leadership nor a political consensus on how to bring the federal budget back in balance. This is creating a situation in which the only clarity is that the current situation is not sustainable.

Another aspect of uncharted waters is that outstanding U.S. federal debt has doubled in the last four years, resulting in a nearly \$100,000 per household liability (and rising at the rate of \$12,000 per year) associated with that debt. Who will buy this mounting debt, and at what rate, are questions everyone asks but for which there are no clear answers. Over the past 18 months, the Federal Reserve has been the primary purchaser of newly issued federal debt, with the private sector a net seller. Will the Fed be able and willing to purchase newly issued federal debt? This is an important question, as the Fed is artificially keeping interest rates near zero across the yield curve. But no one (including the Fed) knows what the Fed will do, because we have never before witnessed such monetary expansion by the Fed. And since one underestimates the staying power of a determined sovereign at one's peril, we

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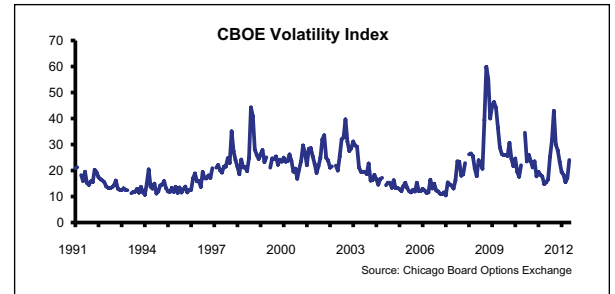


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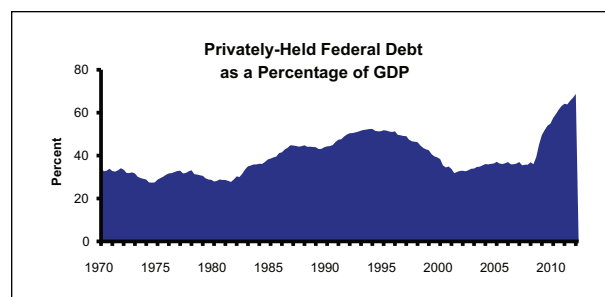
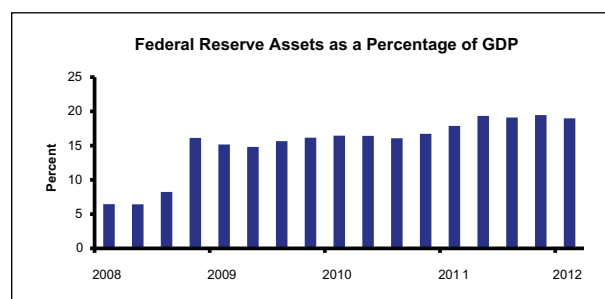
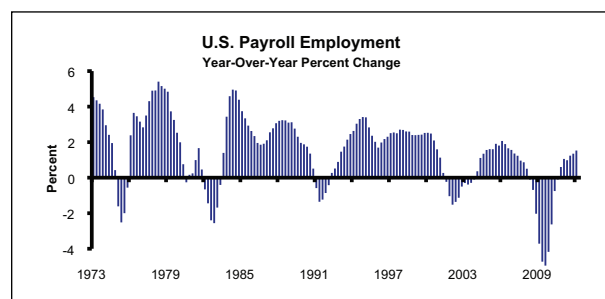
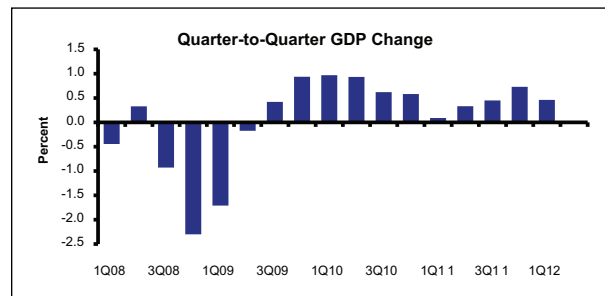
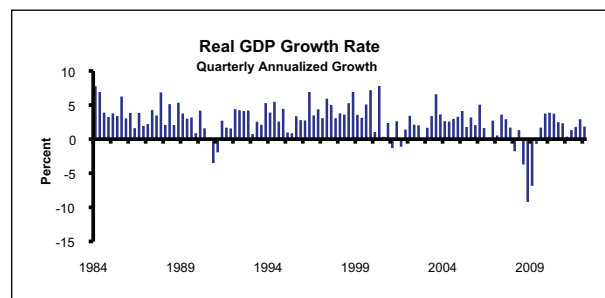
cannot be sure if today's interest rate environment will continue another day, week, month, year, or decade. All we know is that since the collapse of Lehman Brothers, the Fed has increased the monetary base by some \$2 trillion, nearly \$700 billion of which has occurred over the past 18 months. The result is an unfathomable growth in the monetary base, with nearly four times as much money today as existed on September 1, 2008.

A related element of uncertainty is that the 10-year Treasury yield today is far lower than the current rate of inflation, even as inflation is rising. Making matters even more confusing is that sovereign credit downgrades have often resulted in lower — not higher — interest rates. And as seen in Figure 1 in our economic overview article, many indicators for the U.S. economy are in excess of a standard deviation beyond their historic patterns. Such deviations are well beyond the experience of today's decision-makers.

Making the confusion greater is the fact that these phenomena are not limited to the U.S., but rather exist around the world. In fact, our problems are not as bad as those found in most European countries; as result, our exchange rate has strengthened even as we weaken, because we have weakened less than Europe. And Japan is in even worse shape yet.

One thing on which everyone agrees is that Europe and the Euro face great uncertainty, as their social insurance promises and government spending relative to tax revenues place ever greater strains on their economies. Only when European governments (or the European Central Bank) pump \$1 trillion into Portugal, Ireland, Greece, Italy, and Spain (PIGIS) does the European economy muddle along. But once such injections are three months old, the weight of the long-term stress reappears. These short-term "fixes" have fixed nothing. Like cortisone shots for athletes, they mask rather than cure the ailment, increasing the risk of even greater injury.

Adding to the widespread confusion are near-record oil prices driven by growing global GDP in the face of relatively flat oil production. Specifically, real global GDP has risen by approximately 40% over the last decade, while oil production has grown by a mere 10% (and by 0% over the last eight years). The short-term inelasticity of oil demand means that large run-ups in oil prices have occurred even as shale fracking has caused natural gas prices to plummet. And what happens to oil prices as Syria tumbles, Egypt grumbles, and the Iranian situation darkens? Again, no one knows. These uncertainties



are well beyond our normal bounds of experience and are occurring in the midst of a highly contentious election year in the U.S. and around the globe (including China's recently installed government).

Meanwhile, the Fed is intentionally forcing you to take on risk by setting the short-term rate at zero and forcing down long-term yields via quantitative easing. These interventions are historic in magnitude. The truth is that not even the Fed knows what the Fed will do in the future, as they too have never experienced such conditions that exist today.

Fundamentally, the Fed is commanding you to "choose your poison":

- Stay in cash and receive zero return as inflation runs 3-5%.
- Price your investments off of 10-year Treasury yields of 2% and assume that rates do not rise, running the risk of rapid interest rate increases if the federal government is unable to finance its next debt auction.
- Or pursue alternatives that involve greater business risk than you have previously undertaken (for example, buying single-family homes to rent in an attempt to find yield not available via buying traditional garden apartments).

In each case, you take on greater risk than you have at any time in your life. Is it any wonder that you are confused? Welcome to the large and non-exclusive club of confused decision-makers. We are living in an "Alice in Wonderland" world, where sovereign credit downgrades may reduce their debt yields, and the demand for safety is such that negative expected real yields are being paid on U.S. and German government debt. The simple truth is that no one knows the answers to these questions. Even highly informed opinions on these matters are based on some educated guesses, logic, extensions of normal behavior to very abnormal conditions, and occasionally a tiny bit of related history. Thus, however risky things appear, we believe that they are even riskier.

