Economic Collapse, Economic Disruption, and Market Volatility | September 2016

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"Are we on the verge of another 2008-2009 economic collapse?" It's a common question asked when markets rise in any significant way despite the good news of increased stock market levels. "Is a pending disaster looming that will slide the US economy back towards a downturn like 2008?"

Let's step back for a moment and look at how valuations are arrived at based on rational cash flow projections. Market valuations are a function of cash flows. Benjamin Graham and value investing theories postulate that cash flows and equity prices eventually must meet at some point in time. This thesis requires longer periods of time to eliminate market noise as temporary conditions can greatly increase volatility. The easy answer derived from examining price-earnings ratios and other valuation statistics is less than satisfactory when confronting issues of intermediate term market volatility.

This white paper is less about intermediate fluctuation and more about the concern that systemic issues may cause dislocation in financial markets and lead to significant volatility. The common reference point for systemic market disruption is the financial crisis of 2008-2009. During this timeframe, there was a fundamental economic crisis that impacted banks as a result of excess values in the real estate market. Additionally, financial institutions carried significant leverage which negatively impacted their ability to withstand downside volatility and impacted their capital structure in a meaningful way as real estate values began to unwind.

The question investors are asking is, "Are we in a situation now with the rapid increase in market values in the equity markets and fixed income bond values where we face another potential crisis that could cause significant market dislocation?" It's a meaningful and important question and one that we have considered carefully as we analyze economies and market values.

It is our view that the key systemic risk is a more long term issue: the US deficit. We believe the $20 trillion US deficit will impact GDP growth, economic expansion, and long-term asset values. This debt directly impacts the vibrancy of the US economy and we believe is a significant factor in the current modest growth rate for US GDP growth. It is a fiscal headwind and we expect this condition to continue.

The US economy, like many global economies, faces increased challenges as a result of the changing demographic conditions. This makes the issue of deficit reduction an even more important challenge to address. The United States' deficit problem is not a new one; this issue has been discussed for years as deficits continue to spiral out of control.

The problem is set to become an even bigger challenge as US entitlement continues to ramp upward over the next 10 years. With the labor force participation rate continuing to fall as more workers exit the workforce (and less workers are generating capital to fund retirement benefits), a combination of demographic factors combined with deficits will be a significant drag on overall economic growth.

Because debt coverage is such a significant part of the annual cost for the federal government, investments that might be poured into building out infrastructure and growing the economy in other proactive ways is negatively impacted. The problem will only grow as interest rates rise.

The deficit is a difficult problem to solve. The alternatives available are unpalatable for broad segments of the US population and this creates legislative challenges for elected officials as they seek to represent their constituents. Additionally, the nature of the US democratic system often impacts the willingness of politicians to advocate difficult choices resulting in a phenomena well-known to the US legislative observer - gridlock.

It is not only the United States that faces challenging economic conditions. High deficits and struggling growth rates are common throughout the industrialized world. One only needs to look at the stagnation in Europe and the slowing growth rates in China and Japan to see that strong growth on a global basis is simply not occurring.

One alternative suggested is to pay down deficits to spur greater wealth resulting in more tax revenue. This certainly is a reasonable alternative if one can stimulate growth to a level that allows for the expansion of wealth in excess of 4% GDP expansion on a consistent basis. Economic growth solves a lot of problems and the deficit might be significantly positively impacted if one could generate conditions to stimulate growth to this degree. How to do this is the challenge and leads us back to gridlock and inaction.

Other alternatives are fairly straightforward - cut spending or increase taxes. Neither of these choices is popular with a significant percentage of the population and, as a result of legislative gridlock, both of these options are likely not alternatives that will gain traction.

So, if deficits remain a significant negative headwind for the US economy, the consequence for markets and overall economic growth is likely foreseeable and we believe is occurring at present. Our fundamental thesis is that economic growth will remain substandard as deficits continue to be a negative input in the economic growth equation. It is our estimate that GDP growth is, and will be, negatively impacted at least 1% a year due to deficits both private and governmental in nature.

Circling back to our original question, we do believe US deficits will continue to be negative for the economy, but the likelihood of a cataclysmic economic event is not as high as some might believe. Instead, we believe that a financial crisis is in place currently which will negatively impact US growth for a significant number of years.

Based on this thesis, it's reasonable to assume that economic growth will be substandard for at least the next five years. In all likelihood, the long-term economic impact of significant deficits could very well have a negative impact for more than a decade with the problem becoming more substantial as entitlement spending becomes a greater part of the overall US economy.

Some pundits suggest that the US economy is headed towards a traumatic crisis with the result being a plunge in market values. This is a possibility, but we do not believe this to be the likely scenario; instead, we believe that a traumatic crisis will actually be divided among many years with each year shouldering a percentage of the overall long-term deleverage impact.

Instead of a Great Depression where economic activity plunged 20% in one year, the US economy will likely grow at over 1% a year less than it might have if US fiscal health was less debt constrained. A slow-motion economic crisis is likely to look much like current conditions with substandard growth as the rule of the day.

Let's be clear that a new crisis from unforeseen events may be just around the corner; the world is an uncertain place. There are numerous other scenarios that could result in a traumatic shock to the US economic system. Bank failures, an economic collapse in China, additional disruption in Europe, terrorist attacks, increased political uncertainty, and a variety of black swan events that we can't even imagine could all cause significant damage to the US economy and markets. One must be diligent in scanning the economic horizon for future economic icebergs.

For this reason, we believe strongly that it is important to have an investment strategy in place that is designed for the long-term and not dependent on a fortunate guess regarding economic issues. Traumatic events are never easy to predict and having the right allocation and a long-term strategic plan is the best potion to defeat short-term market and economic disruptions.

The right investment strategy should be designed in conjunction with a long-term strategic plan and an allocation of assets designed provide for diversification. Economic conditions should be monitored consistently and portfolio adjustments made, if necessary, if conditions arise that potentially might lead to dramatic market disruption. Once a strategy is developed, it should be monitored consistently and an economic overlay applied to one's allocation to make sure that the investment mix fits the goals for the portfolio as well as current conditions. This flexible strategy is the best way forward in a world where uncertainty is the only certainty.

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