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Falling down

Macro-economics is not my forte, but then again I don't have to be an expert on the machinery of a train to appreciate that it's big, it's heavy, and it's going to hurt like hell if I get in front of it. My investment focus is on individual companies and I steadfastly believe that if I invest in solid companies, run by owner orientated management and I get all this at a reasonable price then my investors will do just fine.

One of the tenets I follow is to only invest in countries of which the currency is stable over the long term. This is because an investment is still ultimately realised in the currency of the country in which that company is based. Although an investment like Berkshire Hathaway might be linked to a multitude of currencies, I will still me handed a wad of dollars when I sell it one day. I chose investment countries like Canada, America and the UK specifically so I don't have to bother with keeping track of the currency. Resources spent on trying to make sense of the economy just don't produce a worthwhile return for me. Though, this is true most of the time it is not true all of the time. Once in a while things get out of whack to such an extent that you have to take the time to analyse the situation and decide whether you need to act. The US is a case in point. Whenever I listen to salesmen like Alan Greenspan, John Snow and George Bush discussing the state of the American economy I juxtapose that with humble geniuses like Sir John Templeton, Charlie Munger, Warren Buffett and Francis Chou. This always reminds me of a scene in the 1993 movie "Falling Down" in which Michael Douglas holds up a shoddy hamburger he just ordered, points to the picture of the burger above the serving counter, in which it looks simply mouth watering, and asks while looking at the shoddy burger, *'Can somebody please tell me what's wrong with this picture?* Well I have looked at the American economy over the last five or so years and at the dollar, which represents its value. This is analogous to analysing a company. You have intrinsic value and that value is represented by a number of shares. Your investment value is influenced both by the change in intrinsic value and any change in the number of issued shares or both. So let us look at the value behind the dollar, call it the *intrinsic value* of America if you will.

Shoddy burger number one - net external debt.

My Father taught me a number of things in life and one of them is to stay away from debt. There were ample examples where my Father would point out a certain man that was starting to live the high life, funded by debt and low and behold, a number of years down the line the guy would be flat on his ass. Granted, my Dad was not always right. America went into a net external debt position in 1986. It is astonishing if one looks at America's net external debt of $2.6 trillion at the end of 2002 to find that this debt averaged less than $300 billion for most of the early 1990's. Then from 1995 to 2002 that debt compounded by 33% per annum (Link). As far as I know the 2003 numbers are not out yet, but it looks like there is going to be yet

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another significant increase. Net external debt is also reaching significant proportions in relation to GDP. At the end of 2002 it made up 26% of GDP and it is hard to believe that the 2003 numbers will not increase this ratio to 30%. You don't hear this often, but America has been in this position before, back in the 1890's, immediately after the Civil War. However, back then the money was spent on building roads, railroads and canals. Today it is spent on cars, larger houses and, in general, on things that do not create lasting value for the economy. The book of Proverbs teaches us that you are a servant to those whom you owe money. So whom does America serve? The main debt collectors are Europe ($400 billion), Japan ($350 billion) and Non-Japan Asia ($650 billion). Asia has been growing their foreign dollar reserves quite significantly over the last five years by buying mainly US treasuries. Interestingly, total private investment in the US by these countries has been dropping steadily in 2003. It is fair to assume that the buying will decrease as long as the net external debt increases. Annual private capital inflows to the US have already dropped to just north of $200 billion from a 2001 high of about $450 billion. We all know how the dollar weakened over that same period. Capital outflows from the US include a large chunk of my investors' money and I will be betting against the dollar for as long as the US fails to deal decisively with its debt problem. Historically it has taken a minimum of five years to turn a twin deficit around. That is five years after the digging of the debt hole has stopped. Currently America is only digging faster and the day that it will actually stop digging does not seem to be in sight. The deeper the hole, the cheaper the dollar will be. Rising interest rates will slow the economy and increase the debt service payments, so don't expect a stronger dollar from rising interest rates; it is not as simple as that. The IMF (Link) believes that the external debt to GDP ratio can run op to 40% of GDP by 2007 and this claim does not look wide of the mark.
The math behind this is actually quite straightforward. The current account deficit (trade balance + debt service payments) is about 5% of GDP. If you assume GDP grows by 5% and debt does not get paid down then net external debt will reach about 40% of GDP by 2007 and God forbid, 60% of GDP in 10 years (The Pride of profligacy: Economist 18 Sep 2003). On the one hand the Latin American countries started running into trouble when the current account deficit reached 5% of GDP and on the other hand countries have been able to pull themselves out of the debt hole despite running up very large external debt to GDP ratios, as the following illustrates, America 1890 23%, Mexico 1980 25%, Australia 1996 60%, Ireland 1983 70% and New Zealand 1999 85%. However, this was/is not achieved without some considerable pain to both their economies and currencies.

Shoddy hamburger number two - social and Medicare deficits

Social and Medicare obligations are increasing and the number of taxpayers servicing these obligations is diminishing. According to the IMF (Link) the ratio of retirees to working age population is set to increase from 20% to 40% between now and 2050. The Medicare scenario is even worse and the layouts for these two systems are projected to rise to 10% of GDP over the next twenty years. What worries me most is the reluctance to deal with the problem. All I see are measures to put off dealing with the problem. IMF

estimates put the fiscal imbalance at a mind boggling $47 trillion. That is $47 trillion that America doesn't have. To deal with the problem is very simple. Decrease the obligations and increase the contributions. However government is giving this the same treatment as it does the entitlement programs of pension and health insurance. Link .The senate passed the pension 'relief bill' with a 78-19 vote in April 2004. By tweaking the formula for employer contributions, these contributions were cut by $80 billion over the next two years. Instead of dealing with the very real long-term pension problem, the senate decided to focus on the short term and give the economy a boost. Sounds more like a 'we are in denial bill' to me. The biggest problem with the above is that it is essentially off-balance sheet debt. Unfortunately the status of this debt is abused in exactly the same way as it was at Enron. It is abused to paint a picture that is not a true reflection of the truth, let us say a Picasso.

Shoddy hamburger number three - derivatives

Most companies go bankrupt due to cash flow or liquidity issues and derivatives threaten liquidity in the system. Derivatives have been a thorn in my side for a number of years. I don't like it, because I cannot get a handle on the risk that it poses. What I have come to appreciate is that the people running the institutions dealing in these instruments don't appreciate the risk either. My position is not one easily explained, because it is not based on a well-defined set of facts, but rather on an increasing feeling of unease, which I have acquired over the last five years through reading substantial material on the subject. I always tell my investment partners that if I cannot explain something to you in an understandable way then it means one of two things.

Either I am mincing words or I don't know what I am talking about. Nothing in the financial world is that complicated that you cannot explain it to someone who has reasonable financial sense. Still, the vast majority of annual reports I read never leave me feeling confident in my understanding of what is going on in the company's derivatives book. In his 2003 annual report Warren Buffett wrote,

'*No matter how financially sophisticated you are, you can't possibly learn from reading the disclosure documents of a derivatives-intensive company what risks lurk in its positions. Indeed, the more you know about derivatives, the less you will feel you can learn from the disclosures normally proffered you. In Darwin's words, "Ignorance more frequently begets confidence than does knowledge."*'

Still, you might be somebody who needs facts to be convinced and will merely see the above as fiction. Well I will show you where fact meets that 'fiction'.

If you look at The Comptroller of the Currency's 4TH quarter derivatives report (Link) then you will find the following. The total notional value of derivatives in 1990 was way under $10 trillion, in 1995 it was $17.3 trillion and by the end of 2003 it was $70.1 trillion. This makes up 35% of global OTC notional of around $200 trillion. What is interesting is that where end-user notional increased from $1.4 trillion in 1995 to $2.4 trillion in 2003,

dealer notional increased from $15.9 trillion to $67.7 trillion (The end user is the guy who actually uses the derivative to hedge some type of real business risk, while the dealers are for the most part just playing musical chairs with other people's money). However, the compound growth rates for end user notional and dealer notional are 7% and 19% respectively. It is important to understand that the notional value of derivatives is not a good indicator of risk, but the rate of increase is.

The real focus should be on the credit- and counter party risk or exposure. The total credit exposure of derivatives in the US at the end of 2003 was $755 billion. What is most worrying is that $646 billion or 85% of that credit exposure sits with only three banks. These three banks are JP Morgan Chase, Bank of America and Citibank. These banks will tell you that their net exposure (after accounting for what the other guy owes them) is less than $160 billion. My worry is that if they are sitting with 85% of the credit exposure between them then what happens if one of them fails? JP Morgan's *total credit exposure to capital* ratio is 844%. 'Can somebody please tell me what's wrong with this picture?' As stated, for me the derivatives problem is not quantifiable. Unfortunately it does not diminish its importance or the fact that it is real.

Shoddy hamburger number four – increase in the money supply

Then of course there is the money supply problem. As stated before, this is the same as increasing the number of shares in a company or increasing the slices of a pizza. It does not make the pizza any bigger. The current situation is similar to what Nixon did in the 1970's. Bush knows that if the economy falters in an election year then he is out of the race. All the buttons have been pushed to flush liquidity into the system. Under Nixon the M3 money supply was increased by 14% in 1971 and 1972. This time it is only in the region of 10%, but it goes hand in hand with tax cuts, ridiculously low interest rates and things like pension contribution changes. Don't be confused by all the financial geek speak, this is pretty uncomplicated. Just like a company's shares are backed by that company's value as reflected in the balance sheet so a country's currency is backed by that country's intrinsic value. In the case of the dollar, the assets backing it are replaced by debt as you can glean from the above. This devalues the dollar. Printing more dollars only compounds the problem. However, it does give the populace a false sense of an increase in wealth for a short period of time. It should get a politician through and election year, for example as it did Nixon in 1972. Still, we all know how the economy suffered in 1973 and 1974.

Probably, the first place the devaluation of the currency gets noticed is in commodity businesses. This is simply, because it is the most marginal of all businesses. Take a commodity like oil for example. Saudi Arabia gets virtually all its money from oil and it has huge fiscal demands. The country notices immediately when its oil dollars does not buy them what it used to do. So the price is adjusted upwards.

Then the dollar is devalued some more and 'mysteriously' the dollar price of oil goes up some more. Of course the culprits behind the devaluation of the dollar will turn to the Saudis and say you need to drop your price, because

you are killing our economy. (Link)*Speaking at the G8 meeting on Sunday night (24 May 04) US Treasury Secretary John Snow said: "It is vital that oil producers provide adequate supplies to ensure that prices are at levels that foster strong global economic growth. "Lower oil prices would contribute to our efforts to achieve strong and sustained growth," Mr Snow added.* Of course Mr Snow says nothing of the fact that the Saudis cannot buy what they used to with their oil dollars due to the devaluation of the dollar.

Don't put your faith in guys like Snow and Greenspan (personally Greenspan scares the living daylights out of me). Snow kicked off his January 2003 appointment by saying that the US will follow a strong dollar policy. Mmmm, and what happened to that one might ask? Stop fretting about how strong you want to keep the dollar and rather focus on fixing the fundamentals behind it. People will figure out the value of the dollar for themselves. Get the US to stop wasting money on things like commercial Humvees (what is a thing like that doing on the road anyway?) and rather get it to start paying off credit card debt. As Jim Rogers says, *'We're like the untrustworthy brother-in-law who keeps borrowing money, promising to pay it back, but can never seem to get out of debt. Eventually, people cut that guy off'*

It was only 35 years ago that the UK had to be bailed out by the IMF, due to their policy of increasing liquidity and increased borrowing. Don't think it cannot happen to the US. If you want to see what a healthy balance sheet looks like, take a look at Botswana. (Link)

In conclusion, it is unlikely that the outflow of capital from the US will stop. The liabilities are building and despite the shenanigans it is still easy enough for people to figure out that America's intrinsic value is sliding. In the world of investments there are no certainties. However, if you align your interests in such a way that the odds favour you the most then you will suffice. Make no mistake you will take home some serious battle scars, but on **average** you will survive and prosper. The odds are stacked against America and particularly the US dollar.

I am not so paranoid about the dollar that I am prepared to terminate my very fruitful relationships with corporate dynamos like Prem Watsa, the Markel brothers, George Joseph, Rich Santulli, Ajit Jean, Charlie Munger, Warren Buffett and a host of other outstanding gentlemen and women. However, I will continue to allocate the majority of our capital elsewhere unless my margin of safety is big enough that it discounts the devaluation of the dollar. In the current environment this is a tall order. Ultimately this is a game of odds as counted by the allocator of capital and this allocator sees the odds stacked firmly against America. For the most part, I'll rather catch you on the rebound.

God Speed,
Martin van Blerk