KANAWHA CAPITAL MANAGEMENT, LLC

2235 Staples Mill Road, Suite 100 / P.O. Box 6862 / Richmond, Virginia 23230 / (804) 359-3900

ABSORBING THE SHOCK MARKET

April, 2012

Global stock markets rallied in the first quarter of the year, in response to more signs of economic healing. The backdrop has been improving, on balance, but the global economy remains fragile, leaving it exposed to shocks — and there are plenty of potential ones out there. But the current dip is likely just a standard response to more optimistic investors.

We all know that stock market returns are anything but linear. After moving sharply in one direction, stocks often pause and, in many cases, reverse course for a bit. In early April, we have been experiencing such a reversal. Ned Davis Research recently pointed out that a 3%-8% correction would not be unusual based on the history of stock market cycles. Such a retracement would be the market's normal (and healthy) mechanism for letting off some steam. The alternative would be an overly-inflated market that becomes susceptible to a more severe correction.

Ah, the '90s...

There's certainly still plenty of noise in the background. Pick the source — economic, political, or geopolitical. But can anyone remember a time when there wasn't much for investors to worry about? The mid-to-late 1990s would be one obvious exception. It seemed a time of limitless possibility, as capitalism spread globally and technology revolutionized industry. The stock markets back then reflected the euphoria. In hindsight, there should have been plenty of things to worry about, but instead the mood was complacent. That is not a characterization we would make today.

Eurodebt and Chinese checks

In our view, fallout from the European debt crisis and a slowing Chinese economy are still the greatest risks to a sustained market rally. Both issues will continue to hit the headlines from time to time. EU policymakers finally took decisive action late last year to provide some breathing room for banks and struggling sovereigns. That was obviously a positive development. However, policymakers are still treating only the symptoms of the disease. The fundamental problems — from competitive disparities among nations to an imperfect fiscal union — have not yet been addressed.

Meanwhile, Chinese authorities have reduced the near-term growth outlook — although it remains one of the most vigorous in the world. Like Europe, and the United States for that matter, China has some structural imbalances that must be remedied for the nation to keep its momentum. Most notably, central planners must take steps to reduce their economy's reliance on fixed investment and instead nurture their consumer sector. They must also eventually drive decision-making down to the private sector level, as it will be increasingly difficult for the government to efficiently allocate resources.

Steady on the gas

Ongoing tensions in the Middle East, particularly between Israel and Iran, have also emerged as a potential threat to stocks. The turmoil has manifested itself in higher crude oil prices and thus gas prices of around $4 a gallon in the United States. Iran is the second largest oil producer in OPEC, behind Saudi Arabia. Western sanctions on Iranian oil exports have pressured an already tight market. A military attack by Israel would further impact prices.

The spike in oil prices could certainly affect consumers and threaten the economic recovery. We saw this early last year, when rising pump prices conspired with other factors to slow things down. However, as BCA Research noted, it is worth pointing out several distinctions between then and now. First, this time the increase in gasoline prices has been more gradual than in 2011. Second, the move up has occurred while driving miles are dropping, not rising. And lastly, consumers are in better financial shape today thanks to an improved job market and rising incomes. That said, another leg up in prices from here would impact pocketbooks.

Stop partying…

Markets may be choppier in 2012 than they might otherwise be, since we are in a presidential election year. And this should be a crucial election, as the nation faces some sizable financial challenges. Such challenges come at a time when the major political parties have hardened in their conflicting notions of how to address them.

Specifically, the federal government must reduce the size of its annual budget deficits and the *pace* of debt accumulation. And we need to move beyond the blame game. What's done is done. U.S. public debt has been piling up since the early 2000s, a period that encompasses presidential administrations of two different stripes and multiple sessions of Congress. So there is plenty of blame to go around. And the sharp recession of 2007-2009 only aggravated the widening budget imbalance.

…And fix the mess

What we're facing is a math problem, and math shouldn't be partisan. Total federal debt stands at over $15 trillion, a level equivalent to the country's GDP — our entire output of goods and services in the last year. Reputable academic studies have demonstrated that once the level of public debt approaches a nation's GDP, economic growth tends to slow noticeably. Interest rates tend to rise and private sector borrowing is "crowded out" by that of the public sector.

We have not yet witnessed this phenomenon because global fears have kept U.S. bond yields extremely low. So luckily, even as public debt has surged, the U.S. Treasury has been able to comfortably service it. At the moment, net debt service requires only 6 cents from each dollar of government revenues. But what happens when the Treasury's average financing rate of about 2% moves up to more normal levels? For instance, at 6.5%, interest costs would absorb one-fifth of revenues.

Our house of debt

Low Treasury yields have enabled politicians to delay difficult decisions — and in other cases, make imprudent ones. For a parallel, consider the U.S. housing market during its heyday. In the early 2000s, the advent of the interest-only, negative amortizing mortgage allowed consumers to buy more home than they could reasonably afford. After several years, the teaser rate would reset to market (or higher) levels, the principal balance would have *grown*, and the new monthly payment would be unaffordable. Folks who took on such mortgages were counting on rising home prices to bail them out and allow them to refinance down the road.

Sound familiar? Through our fiscal policies, the United States for years has been "buying more home" than we can afford. And the U.S. Treasury must continuously refinance the public debt. This year, some $3 trillion in Treasury bonds will mature and need to be rolled over. This is on top of new issuance to cover the budget deficit. So ultimately we are susceptible to the whims of the bond market and the willingness of investors to absorb these securities.

We could choose one solution...

Because the U.S. government has the luxury of controlling the supply of its currency (unlike Greece for instance, or U.S. homeowners), the dollar is a reserve currency, and our public debt is issued in dollars, theoretically we will always have the capacity to pay our debts. In a pinch, the Federal Reserve could simply print more money. Imagine, however, the sharp impact on the dollar (down), inflation expectations (up), and interest rates (up) if the markets presumed we were going to monetize our debt.

While many recognize that our present fiscal path, left unchecked, will lead to a crisis, there is no consensus on the remedies. The political climate over the past several years has not been constructive for finding a middle ground. Yet the math indicates that our elected officials will indeed have to compromise. The budget gaps cannot be closed merely by cutting certain spending as some insist or raising taxes on the "wealthy" as others advocate.

...Or both

The 2011 federal budget illustrates this dilemma. Only 18% of total spending came from non-defense *discretionary* line items. In other words, both defense and entitlement categories need to be on the table if we are going to do any serious budget cutting. Meanwhile, whether one defines wealthy as those with incomes above $200,000 or $1 million, there simply are not enough of these taxpayers on which to place the entire deficit burden.

The Congressional Budget Office (CBO) concluded as much in a recent letter to Paul Ryan, Chairman of the House Budget Committee. Congressman Ryan had asked the agency to score two separate scenarios: An across-the-board increase in income tax rates as well as an across-the-board reduction in government spending (excluding health care). To significantly reduce future deficits via higher income taxes would require that tax revenues increase by more than one-third through 2023 and by 50% in 2030. On the other hand, focusing solely on non-health care spending cuts would translate into sharp reductions of more than 25% through 2023 and by almost 40% in 2030. Neither route would be politically or economically palatable.

Bending the health curve

So clearly a middle ground needs to be found. Additionally, health care spending in particular must be addressed. The CBO has pointed out that over the next several decades, the aging of the population along with rising costs could cause federal spending on health care to double from the 5% of GDP it comprised in 2011. Health care reform legislation was passed by the 111th Congress and signed into law by President Obama. It aims to expand access to care. However, whether or not it stands up to judicial review, it is a misnomer to label this package "reform," at least in a broad sense.

As a society, we can accept the current trajectory of health care spending and take steps to fund it — through substantial tax increases, sizable spending cuts elsewhere, or some combination of the two — or, we can attempt to bend the cost curve. Neither path will prove easy or be free of controversy. Any meaningful health care reform will have to involve all the major stakeholders, including physicians, hospitals, and payers. It will have to examine and address the issues of demand, supply, and payment for health care services. The health care debate must and will be front and center over the next decade.

Shockingly strong

Whatever the outcome, the 2012 presidential and congressional elections could prove pivotal. Not only in the path to addressing our long-term financial challenges, but also in determining the fate of a number of expiring tax provisions. Uncertainty around these various issues will no doubt affect stock and bond markets this year. The good news is that the U.S. economy has been fairly resilient and the major risks seem to be receding, although slowly.

— Christopher J. Singleton, CFA, Managing Director
April 18, 2012