Kanawha Capital Management, LLC

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

Investment Perspective

# *FALL IS IN THE AIR*

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Autumn has arrived, and many creatures have been making dutiful preparations to survive the winter months. But not all are so inclined, particularly our political leaders. Indeed, along with crisper air temperatures and more vibrant colors, it would just not feel like fall without the annual Washington squabbles to fund the federal government and increase its borrowing authority.

The dysfunction in the nation's capital has reached the point where our elected officials seem incapable of governing. There is a fundamental debate going on about the appropriate size and role of the federal government. But that debate has persisted since the formative years of the Republic. It began with Alexander Hamilton on one side advocating a strong centralized unit and Thomas Jefferson on the other, arguing for more dispersed power. America has been divided many times in the past, but generally our politicians could at least keep the lights on and the bills paid. This is no way to run a country.

## Uncertainty is certain

Stock and bond markets have largely shrugged off the D.C. dissension this year. But the ripple effect on the economy, while hard to measure, has to be detrimental. As it is, this has already been the weakest recovery on record. Consumers and businesses continue to be uncertain about the backdrop, and uncertainty breeds caution. But that is just the near-term impact of the political inertia. The mindless budget and debt-ceiling tiffs do not inspire confidence that deeper and more basic challenges can be overcome. Significant policy decisions loom over the next decade that may well determine whether we experience a rebirth of American prominence or its ongoing slow hemorrhaging. And a disconcerting thought is that the current crew — and perhaps the system itself — certainly does not seem up to the task.

The nonpartisan Congressional Budget Office (CBO) is out with new twenty-five year projections to 2038. Much can change over such a long time period, but demographic forces should largely play out as predicted. And they will represent quite a headwind for our public finances.

## Boomers may bring bust

The fiscal challenge primarily relates to the aging of the massive baby boom generation, those born from 1946 to 1964. A mouse moving through the snake's belly, that cohort has exerted significant socioeconomic influence as it has aged. But with respect to funding retirement and healthcare obligations, it is not a mouse but an elephant — and it is in the room.

The leading edge of the baby boomers turned 65 two years ago. Today there are 45 million Americans age 65 or older. Over the next decade, that number will grow by one-third. In twenty-five years, there will be almost 80 million, accounting for over 20% of the total population; those age 80 or older will make up 7% of the total.

The problem is that the aging of the baby boom generation will substantially alter the balance between working-age and retirement-age segments. The working-age population is projected to grow much more slowly. So while today there are 4.4 "workers" for every "senior," by 2038 there will be only 2.7.

## Unhealthy spending

How could these demographic trends spill over to our public finances? The CBO notes that government spending on health care and Social Security entitlement programs has averaged about 7% of GDP over the past 40 years. However, given the path we are on, such spending will surge to 14% of GDP by 2038. Most of the problem relates to the health care side. Not only will there be many more Medicare recipients, but spending per person will continue to increase. The medical field represents one of the few sectors in which technology enhancements have actually driven *up* costs.

Steadily rising entitlement spending is projected to contribute to ballooning deficits after 2020. Higher deficits must be paid for by the issuance of more public debt. The CBO notes that our IOUs could potentially grow to 190% of GDP by 2038. A debt burden of this magnitude would exceed Greece's at its worst point. Higher levels of debt would also increase interest costs, which in turn would aggravate the deficit. It could turn out to be a vicious feedback loop.

We suppose that future Congresses could simply refuse to raise the corresponding debt ceilings. That would solve the problem, right? If the Treasury does not issue debt, there's nothing to be repaid. Of course, to avoid inciting bands of cane-wielding senior citizens, politicians would still have to find a way to pay for their federal health benefits.

## How long will you trust us?

It is impossible to predict when our federal debt would become a house of cards that collapses. However, the CBO does caution that:

> *At some point, investors would begin to doubt the government's willingness or ability to pay U.S. debt obligations, making it more difficult or more expensive for the government to borrow money. Moreover, even before that point was reached, the high and rising amount of debt that CBO projects under the extended baseline would have significant negative consequences for both the economy and the federal budget.* (The 2013 Long-Term Budget Outlook, 9/17/13.)

With the annual circus over the Treasury's borrowing limit, one would think that global bond investors would be questioning that *willingness* sooner rather than later. The statutory threshold needs to be raised this fall to handle the spending that Congress had previously approved. Fixating on the debt ceiling is akin to focusing on the symptoms of an illness rather than its root causes. Instead, try agreeing on a budget that is fiscally sound in the first place.

The good news is that Washington still has a window to get us on a sustainable fiscal path. In fact, the federal deficit should actually continue to *shrink* over the next few years as spending flattens out and revenues increase. We worry, however, that Congress and the Administration will simply use this temporary reprieve to claim victory and defer politically difficult discussions to their successors.

## Think now about later

It may be inconsistent with their DNA, but our leaders need to think a bit more strategically (how to get in front of the big trends) and less tactically (how to win the next election). After all, why did they seek office in the first place? In practical terms, that means making difficult decisions today — potentially incurring short-term pain, including the wrath of some voters — in return for a better national outcome in the future.

Obviously, this is all wishful thinking, so the solution must be to institutionalize, or force, the right mindset. That means enacting term limits and campaign finance reform. It also means ending the revolving door between Capitol Hill and the K Street lobbying firms as well as between the Treasury Department and

Wall Street. It may also require a balanced-budget amendment. But any movement here will have to come from the ground up. Players benefiting from the status quo will have every incentive to resist changes to it.

It is critical that we get our house in order before the nation is eventually overtaken by events. Crucial policy issues are being obscured by irrelevant chatter and by a seemingly visceral focus on obstructing the other side. Where did the middle ground go?

## U.S. economy leads the way

With all the political dysfunction, it would be easy to remain pessimistic. However, if we can stabilize our public finances, there are some interesting trends developing that over the next decade could help the United States reassert its prominence. Indeed, five years after the global financial meltdown, the U.S. economy is leading the way, particularly compared to Europe and Japan. Major sectors such as housing and autos are on the path to recovery, and the banking industry is much healthier than its foreign counterparts. Furthermore, even considering the aging baby boomer group, our demographics will be much more conducive for economic growth than elsewhere in the developed world.

American prominence has ebbed and flowed in the past. We have seen this movie before. For instance, the United States emerged from the Second World War as the only major industrial economy left largely intact. Uncle Sam dominated the economic landscape for the next three decades until the rest of the world — with our help — began catching back up. Then, from the 1970s and into the 1980s, conventional wisdom held that Japan Inc. was poised to leapfrog America. A deeply unpopular war added fuel to the national malaise at the time. Yet, as is often the case, the consensus got it wrong. And if anything, Japan became the land of the *setting* sun. Meanwhile, the United States embarked on a new growth trajectory.

Similarly, with the end of the 20th century came the rise of a new and more formidable Asian rival, China. Any nation with a population of 1.3 billion is bound to cause waves once it reaches a certain level of industrialization. China's entry into the World Trade Organization in 2001 propelled substantial export growth. Attracted by cheap, abundant labor and a fixed currency, foreign companies flocked in to outsource production. The mass migration of rural workers into the cities prompted a boom in infrastructure spending. China became the swing consumer of raw materials from cement to steel to oil. And "everything" we buy is made in China now. But wait.

## America as a low-cost producer

Today, however, China is struggling with the social, financial, and environmental after-effects of its unbridled growth. Which brings us to a key game changer, the potential resurgence of American manufacturing. Anecdotally, one is hearing of more and more examples of "reshoring" – U.S. companies shifting production back to the mother country. Rising wages, shipping costs, and land prices have cut into China's cost advantages.

But this is much broader than a U.S. vs. China shift. The potential also exists for European and Japanese companies to move production from their home sites to the U.S. — to both serve the American market as well as export elsewhere. It primarily comes down to costs. The Boston Consulting Group (BCG) points out that America is becoming one of the lowest-cost producers in the developed world. The BCG projects that for a range of industries, the U.S. will have an export cost advantage of 5%-25% over Europe and Japan.

Labor and energy costs will be the chief source of the U.S.'s competitive advantage. Our factory workers are extremely productive, and the gap has only widened over the past decade. Adjusted for worker productivity differences, average labor costs in other developed countries will be 20%-45% higher than those in the United States. A decade ago, the U.S. labor cost advantage was only about 10%.

## Fracking to the rescue

On the energy front, there seems to have been a paradigm shift. The U.S. energy industry represents an emerging structural force that could help alter our growth curve. Thanks to technological advances such as horizontal drilling and hydraulic fracturing, vast deposits of oil and natural gas can now be tapped. U.S. natural gas production has surged over the last several years, prompting prices to drop precipitously. Meanwhile, after declining since the 1970s, domestic oil production has rebounded to levels not seen since the late 1980s. Although "energy independence" will remain an elusive goal, the country's imports of natural gas and crude oil have dropped sharply.

Industries that rely heavily on natural gas as a fuel or feedstock will benefit from the lower prices. The new era in gas further boosts U.S. competitiveness. And the manufacturing sector has a sizable multiplier effect. So if substantial production is in fact shifted here, as the economics might suggest, the impact on overall job growth would be even more consequential.

## Adults needed for a new era

America faces many challenges, some of which we have not had to wrestle with in the past. The nation's deteriorating fiscal position represents a significant long-term issue that will not cure itself through benign neglect. Our representatives need to start acting like adults and lay out a long-term game plan. If they won't, we need to finally hold them accountable. For America also has much potential and, despite sentiment to the contrary, could be on the cusp of a new era.

In the meantime, the ebb and flow of the fiscal debate in Washington will continue to frustrate investors with unnecessary volatility. Fortunately, key drivers of stock prices remain fairly constructive. The global economy is slowing expanding, inflation expectations and interest rates are still low, and valuations seem reasonable. Good news on the political front to get past the current gridlock could jump start stocks again.

***— Christopher J. Singleton, CFA, Managing Director***

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