A Saver's Guide to Surviving the Global Debt Solution

September, 2012

Now in its fourth year, the plan to solve global debt problems should be crystal clear. The world's most powerful bankers have undertaken a coordinated effort to add to the monetary base, thereby supporting asset values through liquidity and currency devaluation, and to reduce borrowing costs to all-time low levels. The hope is that lower interest costs paid by borrowers will create jobs and encourage new projects. Through the devaluation of currency, asset prices will be supported. And so long as inflation remains under control, the supporting of asset prices will help investor confidence, improve corporate outlooks, and improve state and government budgets.

Proponents of the strategy point to a rising US equity market and low consumer price index as proof that this plan is working. Real estate is showing signs of life; prices have stabilized and in many areas, it is again cheaper to own than to rent. Corporate earnings have benefitted from low-cost debt issuance as lower interest costs push up earnings.

Those who are less enthusiastic about the plan point to a core government inflation calculation (which excludes things like food and energy) that is far different than a real life scenario. And point to negative real wages for American middle class workers, who are shouldering the debt burden through taxes, while also experiencing a reduction in their purchasing power.

The debt levels of certain countries, several states, numerous corporations and a multitude of individuals represent a clear and present danger to global financial sustainability. Together these debts dwarf the size of the global economy. Coordinated central bank actions have been equally astounding. Intervention and open market activity on this scale has never been attempted. They are, in essence, trying to implement a solution based in theory.

Debt is retired in a number of ways. It can be paid back from income, or (less desirable) with devalued currency. Leverage can be reduced by inflating asset values, or through destruction (bankruptcies). Sudden shocks like bankruptcies and price declines are extremely painful. Businesses fail, people lose their jobs and savings, and politicians don't get re-elected. The current plan appears to use a combination of all these measures except bankruptcy. In order to work, the world's debts must be devalued subtly and the consumer must feel optimistic enough to spend money. It is the most politically appealing and those who are required to shoulder the burden, tend to feel it least.

The American middle class is at the epicenter of the debt solution. The American middle class of workers and taxpayers must be willing and able to shoulder the direct tax burden and also the indirect erosion of future purchasing power. Fatigue and stress among the American middle class are warning signs that should not be ignored.

What Does An Investor Do About It?

It is always a good idea to understand what the world's central banks are doing and seek out investments that will benefit from their actions. As we just discussed, central bankers are devaluing currencies through their liquidity programs, inflating assets to reduce debt and leverage, and providing borrowers with the lowest possible interest rates.

Declining currency values tend to push the prices of real assets higher. If a dollar is worth less today than it was yesterday, then is stands to reason that it will take more dollars to buy an asset today than it did yesterday. The major currencies of the world are like skydivers who have jumped out of an airplane. When viewed relative to each other they appear fairly stable, moving together, seemingly with only slow or small variations. But when viewed from the ground level, they are all plummeting in value relative to real assets like stocks, gold, art, collectibles and property.

The Federal Reserve has stated its willingness to be slow to raise interest rates in the coming years in order to help support growth and asset prices. In other words, it is willing to let inflation rise above its target rate. Even if inflation is only slightly higher than normal, investors would still need to find a 4-5% yield to offset purchasing power losses.

Investors who have an income allocation, and especially those who are retired and actively using their savings, are confronted with a serious challenge: how to offset the effects of inflation (maintain purchasing power) without significantly increasing their risk of loss.

A five-year Treasury bond will pay 0.6% at today's rates. The Lehman Aggregate Bond fund, designed to track the total return of the entire US investment-grade bond universe yields 2.2% today. High yield bonds (also known as junk bonds due to the lower quality ratings of the issuers) offer 6% in today's rate environment, but have historically yielded closer to 9%. The higher yield also means higher risk of bankruptcy and price volatility within the specific group of companies. In the 18 months from Q4, 2007 to Q2, 2009 high yield bonds posted a -40% price decline while the Lehman Investment Grade Bond Index posted a +1% return. For comparison purposes, a basket on blue chip dividend paying stocks posted a -25% during the same time period.

The problem is not in exchanging dollars for euros or euros for yen. It is the (in)ability to maintain purchasing power.

In Search of Sustainable income (And the Protection of Purchasing Power!)

It's a challenge to find safe income that can also offset inflation. Opportunity lies in securities offering strong yields that are both stable and sustainable. Income-paying securities that can also appreciate in value during inflationary periods may be most timely. Real estate typically appreciates with inflation; so do precious metals, most commodities, and stocks.

For a strong yield that is reliable and can grow, consider some of the world's biggest and best companies. For example, Johnson & Johnson (JNJ), the $200 billion behemoth that makes everything from Band-Aids to Tylenol, currently offers a 3.6% dividend yield and has grown its payout from $0.56 per year in 2002 to $2.44 in 2012, a 15% annual increase. If JNJ only increases their dividend by 5% per year over the next 10 years, they will be paying a yield of 6%, or more than $4 per share in income. During the last 10 years, JNJ's stock has risen by 17%, but it has paid out 36% in income for a total return of 53%.

For some investors, a small allocation to securities like real estate investment trusts (REITs) that offer 4-6% yields from rental income, and pipeline partnerships which yield 6-8% by distributing income from oil and gas pipeline revenues, can enhance a portfolio yield without dramatically altering the risk profile.

An investment class that generates income and also benefits from a continued decline in the US dollar is global bonds. The investment-grade variety invests in countries with balanced budgets and strong interest coverage and offers a 4% yield. In the global crisis, global bonds held their value while REIT's and high yield bonds experienced large declines.

Lastly, investing in Treasury Inflation-Protected Securities (TIPs) is an attractive, low-risk allocation. TIP prices rise when inflation expectations begin to increase. Timing TIPs right for an investment is a matter of determining whether the increase in inflation expectation will be greater than the increase in real yields, or vice versa. While there is little current yield, rising inflation expectations would move the price higher, offering a compelling total return.

Bottom Line

Finding income is much harder than simply investing in US Treasuries. Make no mistake: Investing all of your savings in US treasuries and most traditional investment-grade bonds for anything other than ultra-liquidity, is to risk losing purchasing power.

Be aware of the added risk when seeking out higher yields, it can be a stealthy and dangerous proposition. Investments should always be initiated with the proper time horizon and in an appropriate amount. High quality dividend-paying stocks may be the best choice for a long-term investor with income needs. Other timely allocations to real estate, commodities, pipelines, TIPs and global bonds make tactical economic sense, but will need constant monitoring.

If you have cash building up at your bank, think about the risk of earning less than 1% on your money, virtually guaranteeing a loss in future purchasing power. There are still many investment vehicles and strategies that can offer income and good total return potential without increasing overall risk.

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