

A QUARTERLY PUBLICATION FOR THE CLIENTS OF HERITAGE INVESTMENT GROUP, INC.

# The Municipal Bond Scare That Wasn't

As we live through the turbulence of the European debt crisis it is instructive to remember one recent "crisis" that got a lot of attention but never happened: the scare over massive municipal bond defaults by the states. The call for hundreds of billions of dollars in defaults and a collapse in the municipal bond market came late in 2010 from Meredith Whitney, a former bank stock analyst

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who had formed her own research firm. As part of a marketing program for her firm she produced a report that predicted gigantic losses ahead as struggling states faced higher costs and lower revenues.

#### The 60 Minutes effect

She gained a lot of attention in an interview at the end of 2010 on the TV news show "60 Minutes." She said strapped state budgets would result in a record number of bond defaults over the next 12 to 18 months.

Whitney had some credibility. As a banking analyst for Oppenheimer & Co. before and during the 2008 financial crisis, she was the first to predict that Citibank would cut its dividend. This was one of many drastic measures by financial institutions that caused investors to flee financial stocks.

Her latest prediction was that 50 to 100 counties, cities and towns would default, causing \$100 billion or more in losses, well above the previous record year of

about \$8 billion in defaults. Her comments so unnerved individual investors in the \$8.2 trillion municipal debt market that it fell soon after the interview as these investors redeemed individual bonds and shares of bond mutual funds.

#### Crash has not come

Yet municipal bonds have since recovered and were one of the best investments to own in 2011. One benchmark, the Barclays 7-Year Municipal Bond Index, gained 10 percent for the year.

Meanwhile, defaults on muni bonds are plunging, down more than 60 percent in the first half of 2011 compared to 2010, according to Bloomberg News Service. States have also been slashing costs and payrolls, and getting more aggressive about revenue collection.

In interviews Whitney has continued to stick by her predictions. She may even be proven right at some point. However, those who heeded her advice have missed a great period of returns in municipal bonds. This is yet another reminder that, while some experts will speculate correctly on some occasions, over time their predictions usually prove to be nothing more than guesswork.



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# HERITAGE PERSPECTIVE

# The Good Old Days?

"The hardest arithmetic for human beings to master," wrote the great American working man's philosopher Eric Hoffer, "is that which enables us to count our blessings." It is a piece of wisdom worth recalling after another year that has tested the nerve of many investors and prompted questions about what current generations have done to deserve to live in such a tempestuous stage of history.

As we enter 2012, financial markets are gripped by uncertainty over developments in the Eurozone crisis. Each day brings fresh headlines that send investors scrambling from virtual despair to tentative optimism. While not seeking to downplay the very real anxiety generated by these events, particularly in relation to their effects on investment portfolios, it's worth reflecting critically on our often second-hand memories of the "good old days."

### A Brief History of the 20th Century

Nearly 100 years ago, Europe was engulfed by a war that destroyed two centuries-old empires, redrew the map of the continent, and left more than 15 million people dead and another 20 million wounded. The economic effects were significant, with widespread rationing in many countries, labor shortages, and massive government borrowing. Just as the Great War was

ending, the world was struck by a deadly pandemic – the Spanish flu, which, by conservative estimates, killed some 50 million people. About a third of the world's population was infected over a two-year period.

A little over a decade after the Great War and the pandemic, the Great Depression cut a swath through the global economy. Industrial production collapsed, international trade broke down, unemployment tripled or quadrupled in some cases, and deflation made already groaning debt burdens even larger.

In the meantime, resentment was growing in Germany over its Great War reparations to the Allied powers. Berlin resorted to printing money to pay its debts, which in turn led to hyperinflation. At one point, one US dollar converted to 4 trillion marks.

In a new militaristic and nationalist climate, fascist regimes arose in Germany, Italy, and Spain, which led to the Second World War. More than 50 million died in the ensuing conflict, including a holocaust of six million Jews. The war ended with the invasion of Berlin by Russian and western forces, while Japan surrendered only after the US dropped nuclear bombs on two cities, killing a quarter of a million civilians.

In economic terms, the war's impact was profound. Most of Europe's infrastructure was destroyed, millions of people were left homeless, much of the UK's urban areas were devastated, labor shortages were rife, and rationing was prevalent.

While the thirty-five years after World War II were seen as a golden age in comparison, the geopolitical situation remained fraught as the nuclear armed superpowers, the Soviet Union and the US, eyed each other. The breakdown of the old European empires and growing east-west tensions led the US and its allies into wars in Korea and Vietnam, each of which resulted in over one million deaths.

The cost of the Vietnam and cold wars created enormous pressures concerning balance of payments and inflation for the US and led in 1971 to the end of the post-WWII Bretton Woods system of international monetary management. The US dollar came off the gold



standard, and the world gradually moved to a system of floating exchange rates.

In the mid-1970s, the depreciation of the value of the US dollar and the breakdown of the monetary system combined with war in the Middle East to encourage major oil producers to quadruple oil prices. Stock markets collapsed and stagflation – a combination of rising inflation alongside rising unemployment – gripped many countries.

While the 1980s and 1990s were a relative oasis of calm – aided by the end of the cold war – there still was no shortage of bad news, including the Balkan wars, the Rwandan genocide, recessions in the early part of both

decades, and currency crises in the mid and late 1990s.

In the past decade, there have been the tragedies of 9/11, the 2004 Asian tsunami, the 2011 Japanese earthquake and nuclear crisis, and the continuing financial crisis sparked by irresponsible lending, complex derivatives, and excessive leverage.

#### Another Perspective

From this potted history, it seems fairly clear that tragedy and uncertainty will always be with us. Yet, despite all of the hardship mankind has faced over the past 100 years, capitalism has remained resilient. In fact, \$1,000 invested in large US stocks in 1927 would have grown to over \$3,040,000 by the end of 2011. Obviously there have been many positive developments during this time as well.

Alongside the wars, depressions, and natural disasters of the past century, there were some notable achievements for humanity, such as women's suffrage, the development of antibiotics, civil rights, economic liberalization, the spread of prosperity and democracy, space travel, advances in our understanding of the natural world and enormous advances in telecommunication.

Today, while the US and Europe are gripped by tough economic times, much of the developing world is thriving. Populous nations such as China and India are emerging as prosperous nations with large middle classes. And smaller, poorer economies are making advances too. The United Nations in the year 2000 adopted a



Millennium Declaration that set specific targets for ending extreme poverty, reducing child mortality, and raising education and environmental standards by 2015. In East Asia, the majority of twenty-one targets have already been met or are expected to be met by the deadline. In Africa, about half the targets are on track, including those for poverty and hunger. Rising levels of

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education and health, and workforce participation also mean the foundations are being built for a healthier and peaceful global economy, dependent not on debt, fancy derivatives, and fast profits but on sustainable, long-term wealth building.

Anxiety over recent market developments is completely understandable, and it is quite human to feel concerned about events in Europe. But it is important to remember that previous generations have stared down and overcome far greater obstacles than we face today. The world is changing in positive ways that provide plenty of cause for optimism and, at the very least, gratitude for what we already have. These are ideas to keep in mind when we scan the news and long for the "good old days."



# HERITAGE PERSPECTIVE

### nvestors Should Know Their Real Returns

Many investors and savers probably think about the returns on their assets only in "nominal" terms. That means they only take note of the yield or return on their investment before accounting for inflation. In that view a two percent bond yields two percent. A six percent annual gain on a basket of stocks is a six percent gain.

However, the proceeds of savings and investments are not spent or exchanged in an unchanging world. Every minute of every day relative prices of goods and services are changing, and in aggregate they almost always go up over time. That is the basis of the concept of inflation.

#### The silent killer

Inflation is the silent enemy of anyone who is trying to accumulate capital. It continually eats away at the value of one's savings and investments. It can even turn an investment perceived as "safe" into a wealth destroyer.

Investors these days are faced with two hurdles: a volatile stock market that has had some sharp drops over the past five years, and a very low interest rate environment that has pushed yields at banks and money



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market funds close to zero. The market's roller coaster ride has caused many investors to pull money out of their portfolios and put it into cash holdings, mutual fund industry statistics show. Those who are hunkering down in cash may think they are protecting their nest eggs, but, with consumer inflation running at two to three percent over the past 12 months, savers have actually been losing purchasing power on money that they thought was safe.

Dimensional Fund Advisors, a Santa Monica-based investment company, notes that the popular press has reported investors are "shifting their portfolios to money market funds... with the intent to return to stocks and bonds when the economy shows signs of improvement." The problem with this strategy, however, is that it is impossible to consistently time the movements of the markets. By the time the economy is back in full swing, the market will almost certainly have risen significantly, and investors who were waiting for a clear sign to get back into the market will have missed the easy money.

As they wait for the "all clear" sign before re-entering the stock markets, these same investors are risking a significant loss of wealth from another, less obvious source of risk – inflation. The truth is, when investors move out of the stock market and into cash, they are not eliminating all forms of risk from their portfolios. They are merely exchanging stock market volatility risk for inflation risk. While volatility risk may be easier to see and more frightening on a day-to-day basis, the erosion of purchasing power from inflation poses a far greater risk to an investor's well-being. As Dimensional notes, "investors ultimately may lose wealth even as they try to protect it."

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